Inter-University Centre Split/Berlin, Institute for Eastern European Studies, Free University of Berlin

The PEPPER III Report:

Promotion of Employee Participation in Profits and Enterprise Results in the New Member and Candidate Countries of the European Union

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by
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and a CD-ROM containing Extended Country Reports

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And a CD-ROM containing Extended Country Reports
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Preface

The PEPPER III Report has been written by Jens Lowitzsch (Inter-University Centre) in cooperation with a core-team of experts in the field of Financial Participation. It is based on an initial research (Lowitzsch, 2004) supported by the Kelso Institute for the Study of Economic Systems, extended and updated in cooperation with Herwig Roggemann (Inter-University Centre), Milica Uvalić (Perugia University), Iraj Hashi (Staffordshire University) and Daniel Vaughan-Whitehead (International Labour Organisation). The European Commission's Directorate General Employment, Industrial Relations and Social Affairs and the Kelso Institute have supported the extension of the initial project, especially the systematic screening of the concerned countries. The country screening was supervised by three regional coordinators, Iraj Hashi (Balkans), Niels Mygind (Baltics) and Richard Woodward (Central Eastern Europe); the editing of the country reports was supervised by Patricia Hetter Kelso and Larry G. Lyon. For individual countries' chapters of the PEPPER III Report, an extensive use was made of the Extended Country Reports prepared for the Workshop 'Financial Participation of Employees in the New Member and Candidate Countries' (May 2005, Split, Croatia). These reports, being the result of an interdisciplinary research by economists and lawyers, are included in a CD-ROM attached to the PEPPER III Report and were written by (first line economists, second line lawyers):

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The Report is divided into three parts. The first part consists of an overview chapter which provides a summary of the development of employee financial participation in the countries under consideration, as well as chapters on the experience of employee financial participation in Western Europe and its relevance in the framework of the European integration process. The second part consists of country chapters, each covering four main issues: the general environment for employee financial participation, highlighting the background, the attitudes of social partners as well as government policies; the legal foundations for different forms of participation, including the incentives for application of schemes; available information on the incidence of various financial participation schemes; and the empirical evidence on the performance of companies with varying degrees of employee participation. The third part of the Report outlines the way to a European platform for financial participation.

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Foreword

Two years after the 10 new Member States joined the European Union, it is clear that the enlargement has acted as a catalyst of economic dynamism and modernisation for the EU, helping the economies of old and new Member States to face better the challenges of globalization, while the predicted major shocks or disruptive impacts have not taken place. However, important challenges remain for both old and new Member States, namely the ageing population and the strain it puts on public finances and the further increasing global competition. The European Commission has estimated that population ageing will reduce potential growth in the EU-15 to one half of the current rate over the next 25 years, that is from 2.25% to some 1.25%. For the recently acceded Member States, the adverse impact on population ageing on growth will even be more pronounced.

To address both challenges, we need to enhance the productivity and competitiveness of our economies, making the EU a more attractive place to invest and work in. The framework conditions set by legislators are an important factor enhancing innovation and entrepreneurial activity, productivity, and finally growth and jobs. The EU strategy for growth and jobs, which is also known as the 'Lisbon strategy', lays out an integrated framework to bring this about. This spring, the EU leaders agreed to focus their action in particular on four areas: knowledge and innovation; unlocking the business potential, including promoting SMEs; employment policies; and a common EU energy policy.

In the area of employment, the strategy for growth and jobs aims at raising the employment rate in the EU to 70% of working age population. The envisaged measures include increasing flexibility on the labour market, while providing a level of security and lifelong learning that will enable people to adapt to challenges in their working life. The possible measures may include elements such as flexible contractual arrangements from the perspective of employers and employees; active labour market policy; efficient lifelong learning systems; modern social security that combines the provision of adequate income support with the need to facilitate labour market integration, mobility and transitions. A stronger link between pay and performance can be one of the possible ways to reform the labour markets. Such performance pay schemes can come in many forms. Employee participation in profits and enterprise results is one possibility to entice workers to be productive and adaptive to change.

The systematic approach followed in this PEPPER III Report will help to deepen our understanding of the pros and cons of financial participation schemes. The country-specific analyses can serve as a tool for the exchange of best practices, and this report can be helpful in facilitating mutual learning among the Member States. I hope that the experiences with financial participation schemes in the new Member States and the Candidate Countries as presented in this PEPPER III Report will serve as a catalyst for new developments and dynamism in other EU countries and thus deliver a contribution to the success of the reviewed strategy for growth and jobs in the EU.

Brussels, October 2006

Günter Verheugen,
Vice President of the European Commission

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I. PEPPER III: An Overview of Employee Financial Participation

Iraj Hashi, Jens Lowitzsch, Milica Uvalić, Daniel Vaughan-Whitehead

1. Introduction

Employee participation in enterprise results – whether in profits or in ownership – most frequently referred to as *employee financial participation*, or *PEPPER*,[1] has been on the EU agenda for over fifteen years. In 1989, the Commission of the European Communities (CEC) decided to include employee financial participation among the priority objectives of its Action Programme for the implementation of the Community Charter of Basic Social Rights of Workers (CEC, 1989). This initiative led to the preparation of the first PEPPER Report (Uvalić, 1991), reviewing the experience with financial participation in the EC countries, and an EU Commission's Recommendation on PEPPER which was adopted by the European Council in July 1992, inviting Member States to facilitate the spreading of PEPPER schemes in practice (Council of the EC, 1992). The information on individual EU countries experiences' was updated in the Commission's Report PEPPER II (CEC, 1997).

The present PEPPER III Report extends the previous two reports to cover the new Member States and Candidate Countries of the EU.[2] The initial research[3] was undertaken by a team of researchers from both old and new Member States. For each coun-

1 'PEPPER' stands for the Promotion of Employee Participation in Profits and Enterprise Results.

2 Cyprus, Czech Republic, Estonia, Hungary, Lithuania, Latvia, Malta, Poland, Slovakia and Slovenia as countries that joined the European Union on May 1st 2004 and Croatia, Bulgaria, Romania and Turkey as Candidate Countries.

3 The results of the investigation were discussed in regional meetings as well as at a Conference in May 2005 in Split, Croatia. The extended country reports are available online at http://www.intercentar.de.

try a team of economic and legal experts investigated the nature and extent of employee participation and its future prospect. Countries were divided into four groups on a regional basis: Central and Eastern Europe, the Baltic States, South Eastern Europe and the Mediterranean block (Turkey, Cyprus and Malta), with the country teams of each region working together to identify and highlight the similarities and differences between the countries of each region.

In what follows, we provide a summary of the main findings regarding employee financial participation in the new EU Member States and Candidate Countries within a comparative framework. Similar to the individual country chapters (see Part 2 below), four main issues are discussed: (2) the legislative framework and fiscal incentives; (3) the general attitudes towards PEPPER of social partners and the governments; (4) the incidence of PEPPER schemes in the individual countries; and (5) empirical evidence on the effects of schemes on enterprise performance. Following (6) the conclusions, the related information from the country chapters is summarised in the Appendix Table 'Financial participation in the new Members and Candidate Countries of the EU'.

2. Legislative Framework and Fiscal Incentives

The legislative framework for employee financial participation varies widely across the group of countries under consideration, reflecting their recent history and their different approaches and attitudes to the role of employees. There are important differences between the former socialist countries (the transition bloc) and the market economies (Cyprus, Malta and Turkey) and also within the former group, between those in which employees enjoyed a privileged position (such as the former Yugoslavia and Poland) and those which were managed along the more orthodox Soviet model (such as Czechoslovakia). The legislative framework for employee participation was largely developed in the course of privatisation (particularly for the transition countries under consideration) and supplemented by the provisions of other laws, most importantly the company laws and the laws on cooperatives. These laws, of course, were designed to transform ownership of all or parts of companies from state to private, and, as such, were not laws specifically aiming at financial participation. The specific laws on financial participation are limited to only few countries. A rare exception of recent legislation found in the majority of the countries under consideration, though not adopted in the context of privatisation, are rules permitting joint stock companies to acquire their own shares in order to transfer them to their employees, and to facilitate this acquisition by financial assistance. This phenomenon has its roots in the second Council Directive on Company Law[4] and, as part of the 'hard' *acquis*, corresponding legislation

[4] See Art. 19 para. 3, 23 para. 2, 41, para. 1 and 2 of the Directive 77/91/EEC, dating back to 13 December 1976 which allow derogations from the European legal framework for joint stock companies designed to encourage the financial participation of employees (see Part 3, IV 3).

was adopted in the context of accession to the EU. As such it seems to have been rather a 'legislatory reflex' than part of a national policy supporting financial participation, which partly explains why this legislation is rarely used in practice. Since up to now these rules have been of little practical relevance and remained 'dormant' across all countries, they are discussed in the context of future developments (see below Part 3, IV 3).

a) Employee Share Ownership

To begin with, in countries with a tradition of workers' self-management (Slovenia and Croatia), the initial legislation on the transformation of social property (which came into force in 1988 and 1989 in former Yugoslavia under its last Federal prime minister Ante Marković) clearly favoured employees, giving them special position in the process: the ability to buy a large amount of shares of their company at heavily discounted prices (even up to 70%). Although the new successor states of former Yugoslavia replaced the so-called Marković law with their own transformation (or privatisation) legislation, the special position of employees remained unchanged in Slovenia and, at least in the early years of the new system, in Croatia too.

In Slovenia, with the exception of those in publicly owned companies, employees could obtain up to 20% of shares of their company in exchange for vouchers (freely distributed to all citizens), and could potentially buy up to another 40% of shares, depending of course on the size of the company and their ability to pay. Employee ownership was to some extent preserved by the conscious decision of the legislators and companies themselves: the imposition of the 2-4 year restriction on the sale of employee shares; the adoption of internal acts (company statutes) prohibiting the sale of employee shares to outsiders; the institutionalisation of Workers' Association and empowering them to resist takeovers, etc. More importantly, the implementation of the 1993 Codetermination Law in companies with less than 500 employees has led to the allocation of one-third of the seats on the Supervisory Boards of companies to employees, and in companies with more than 500 employees, also one seat on the management board.

In Croatia, the first transformation (or privatisation) law in 1991 enabled employees to buy 20% of shares of each company at large discounts and up to another 30% at market value. These provisions were not included in the later privatisation legislation in 1996 (where other groups of citizens such as refugees, war veterans, war-invalids, etc., were given preference over employees). Unlike Slovenia, the state was not interested in the preservation of employee ownership and no attempt was made to preserve it. Many employees who acquired shares in their companies in the early phase of privatisation sold their shares to others; some, who did not want to (or could not) pay the instalments of their purchase, returned the shares to the state. Indeed, many of the privatisation contracts of the early 1990s were reversed by the Law on the Revision of Transformation and Privatisation (of 2005). In Croatia, there were some attempts to engage in privatisation using an ESOP-type arrangement (though very broadly defined).[5] Although there were no formal rules governing such arrangements, they were implemented in a number of large Croatian companies though the scale has remained fairly limited.

In Poland, the strong position of employees which developed during the 1980s, together with the influence of the independent trade union *Solidarność*, ensured a privileged status for the employees during the early years of transition. The Privatisation Law of 1991 (Art. 37) enabled employees in small and medium size companies to embark on the so-called privatisation by liquidation, or leased buy-outs, and led to the formation of the largest number of employee owned companies in the whole of Central and Eastern Europe (over 700). In addition to the employee lease-buy-out method the privatisation law allocated 15% of the shares of companies undergoing privatisation to their employees for free.[6] Another group of 512 larger companies were privatised through the National Investment Fund Programme (Poland's version of mass privatisation), also applying the rule of 15% free employee shares. For these companies, however, as in Croatia, there was no attempt to preserve share ownership by employees and many of them disposed of their shares in the early years. Codetermination on the strategic level exists in the form of the obligatory representation of employees on the supervisory boards of commercialised companies (2 out of 5 board members are employee representatives; when the state treasury ceases to hold 100% of the shares the representation drops to one third). In companies established as the result of commercialisation having more than 500 employees one seat on the executive board is given to employees.

In Hungary, too, the insiders had the opportunity to embark on the purchase of their company in the course of privatisation on preferential terms – though this time the managers had a particularly important role in the process. Indeed in the immediate pre-transition period, and based on a decision by the Council of Ministers in 1988, state owned enterprises could issue 'property notes' to their employees, free of charge (subject to a maximum of 10% of the firm's capital). The 1992 law on Employee Share Ownership Programme enabled firms to offer credit to their employees to buy shares at large discounts if they set up an organisation (an ESOP trust) to act on their behalf and engage in the process collectively.[7] The trust could obtain credit at preferential rates from banks or the firm to buy shares of the company (from the State Property Agency) up to a maximum level and hold these shares on behalf of the employees. Once the loans obtained from banks, the firm itself or the State Property Agency for the purchase of shares under an ESOP's control were paid back, shares could be transferred to members and the ESOP would cease operation.[8] Later on, the 1995 Law on

5 This was defined as an 'organised programme of large scale involvement of employees in the enterprise ownership'.

6 The total value of shares given to employees could not exceed the equivalent of 18 months salaries of the company's employees.

7 At least 40% of employees had to participate in an ESOP to qualify for the relevant discounts.

8 This is the case of the so-called Privatisation ESOPs (those set up for the purpose of participating in the privatisation process). There are also non-privatisation ESOPs where the employee organi-

the Realisation of Entrepreneurial Property in State Ownership continued the policy and strengthened the incentives for employees to embark on buying shares of their companies. Furthermore, an Approved Employee Share Benefit Programme has been in existence since 2003; the typical scheme involves issuing free shares to employees. The advantage of this type of reward is the lower tax rate associated with benefits in kind.

Romania was another country where employees could set up ESOP-type organisations to take part in the privatisation process collectively. The government decision on the Standard Procedure for the Privatisation of Small Enterprises by the Sale of Shares (1992) established the principle that employees could, through a collective organisation, take over all or the majority of shares of their enterprises. This method of privatisation was given priority over the alternative public tender method. The shares would not be acquired by employees themselves but by the 'association of shareholders'.[9] Shares purchased by the association could be paid for by vouchers or by cash instalments. Apart from the small privatisation, the voucher privatisation scheme (the 1991 Law) allowed for 30% of shares of companies to be transferred to employees, in return for vouchers or cash. Although the law did not provide any incentive for insiders, it contained preferential treatment in the form of pre-emptive rights for employees. But as many citizens had traded their vouchers for cash to supplement their incomes, not many employees took advantage of this provision.

In the Baltic States, the Soviet era ended somewhat earlier than in the rest of the Soviet Union, allowing certain degree of economic change to take place even before the formal systemic change. The small privatisation programmes of the late 1990 (in Estonia and Lithuania) and 1991 (in Latvia) enabled employees to buy shares of small and medium size companies on preferential terms. Later on formal privatisation legislation imposed more specific conditions on employees' rights. In Estonia, the Privatisation Law of 1993 stopped the preferential treatment of employees altogether, going for a strict auction method with emphasis on privatisation to foreign investors. In Latvia, the 1993 legislation enabled firms to issue shares (up to the equivalent of 10% of their capital) to employees which could be paid for at a later point (if employees or board members left the firm, they were required to pay for their shares in full). The 1994 Privatisation Law changed this and ended the special treatment of employees. In Lithuania, however, the employees' privileges continued somewhat longer. Firms could issue shares up to 10% of their capital to employees to be paid for by a mixture of cash and vouchers. The proportion was increased to 30% in 1992 and 50% in 1993 (when the Communist Party came to power again). Although a new Privatisation Law

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sation would buy shares from other entities and manage them. The main difference is that this type of ESOP does not receive any preferential treatment.

9 There was no special legislation governing the operation of this form of organisation in 1992. However, the Law on Associations of Employees and Members of the Management in Companies in the Privatisation Process, passed in 1994, provided the legal basis for the associations of employee shareholders. In Romania, 30% of employees had to participate in the establishment of an association before it could participate in the privatisation process.

came into effect in 1995, ending employees' privileges in new privatisations, the previous law remained in force until 1997.

In Bulgaria, the early privatisation legislations contained a certain degree of preferential treatment of employees. In mass privatised companies, employees were entitled to receive up to 10% of shares of the company free of charge. In companied privatised by other methods, employees could buy up to 20% of shares at prices discounted by 50%. Employees could also set up Management Employee Buy Outs (MEBO) for the sole purpose of participating in the privatisation process. MEBOs could buy up to 10% of shares of their companies. There were some attempts to create incentive for employees to set up MEBOs but their number remained limited. The amendments to privatisation legislation in 2002 removed privileges given to employees.

In former Czechoslovakia, the mass privatisation programme launched in 1992, in principle, allowed employee shares and ownership to emerge. Employees could buy up to 3% of their company shares in exchange for their vouchers at prices (expressed at that time in voucher points) announced for all bidders. Many people preferred to transfer their vouchers to investment funds or use them to buy shares in other companies. Once the country was divided, the two partners chose separate ways. The Czech Republic continued with the second wave of mass privatisation, still offering no preference to employees while in the Slovak Republic the second wave of mass privatisation was cancelled in favour of other methods. Although there was much discussion of providing support for employees to participate in privatisation, and even though the Ministry of Privatisation prepared a document, Principles of Implementation of Workers' Participation in the Privatisation of Enterprises, aimed at promoting and regulating employee ownership, in practice there was little progress in this area. The non-transparent privatisation process in the Slovak Republic resulted in the transfer of many companies to supporters of the political party in power.

In the three non-transition countries under consideration (Cyprus, Malta and Turkey), employee ownership and participation has a different history and, at the same time, is very limited. Only in Turkey a significant number of companies (around 300) have been privatised or marked for privatisation. In these companies, a proportion of shares can be transferred to employees on a preferential basis according to regulations approved for each specific case. Employees could buy a certain percentage of shares of their company either at discounted prices or by instalment (5% in the case of Turk Telecom, e.g.). They could also set up 'foundations' or 'associations' which could hold shares on their behalf collectively (ESOP-type arrangements). Companies can also allocate up to 5% of their profits to employee 'foundations' to enable them to purchase their shares. The amount allocated to 'foundations' for this purpose is tax deductible for the company. These institutions can also obtain credit on preferential terms to buy shares of their companies. However, the Commercial Code prevents companies acquiring own shares in order to transfer them to their employees on a preferential basis (i.e. at prices below the market price). Foreign companies intending to set up preferential schemes for employees have to apply to the Capital Market Board for permission. But, on the whole, the scale of financial participation schemes is fairly narrow and, in most cases, limited to managers. Furthermore, there are no obvious and significant tax benefits associated with these schemes.

In Malta, the privatisation programme of the 1990s (which reversed the previous government's nationalisation policies) created the basis for some employee ownership schemes - though the scope of the programme has been very limited. In two specific companies BOV (Bank of Valletta) and Maltacom, a proportion of shares were given to a trust specifically set up for the purpose of holding shares on behalf of employees[10] Until the amendment of Trust legislation in 2004 these trusts, which are the main vehicle of employee financial participation in Malta, were regulated by the Investment Services Act of 1994.[11] However, there are no tax advantages associated with these schemes. The Companies Act, however, allows preferential shares issued for employees under specific restrictions: the discount should not be more that 10%, the price should not be below the nominal value of shares, and the discount arrangement must be public. There are no tax benefits in such schemes and, with the exception of a few large companies, these schemes are generally offered to a few key personnel of companies.

Cyprus is the only country with no share ownership schemes emanating from privatisation programmes – indeed Cyprus has not had any privatisation or any specific legislation on privatisation. Although more than 50% of households own shares, these shares are not related to their employment position. In Cyprus there are only a few large companies (70 with more than 250 employees in 2000) and therefore there has been little interest in employee participation. There are no tax advantages specifically aimed at employee shares - profits from the sale of securities are tax free but for all shareholders and not just employees. Stock option plans are in place in some companies but only for their management personnel.

b) Profit-Sharing

Profit-sharing (in the form of cash or shares) is not a feature of company legislation in any of the countries under consideration. In a few transition countries, the company legislation refers to the possibility of employees having a share of company profits in accordance with the company's Articles of association (Art. 178.4 of the Czech and Art. 178.4 of the Slovak Commercial Codes, Art. 347-348 of the Commercial Companies Code in Poland, Art. 228 of the Company Law in Slovenia). Similarly, share-based profit-sharing is sometimes mentioned in the context of a capital increase. In Romania, there is a general scheme for cash-based profit-sharing in state owned companies (including the so-called *Regia Autonoma)* whereby some 5-10% of the net profit is allo-

[10] In the case of Maltacom, 3% of shares was allocated to a trust for this purpose.

[11] Interestingly, 'trusts' are traditionally used as collective investment schemes and are strictly regulated by the Trust Act but those set up for the benefit of employees are exempted from many formalities. Prior to 2004, Maltese residents were neither allowed (*ad validitam*) to set up trusts, nor could a trust contain immovable property situated in Malta (which at that time also included shares).

cated to a Fund for Employee Profit Participation to be paid to employees on the basis of their performance. However, given that only few of these companies make any profits, the number of employees benefiting from the scheme is relatively small. Employees in the public sector too receive a profit sharing bonus depending on the overall performance of the sector – as it would be difficult to link it to the performance of individual employees.

In Cyprus and Malta, there are no legislation specifically regulating profit-sharing (in the form of cash or shares). In Turkey, in addition to financial participation arising from share ownership, companies can introduce profit-sharing under certain conditions. The allocation of a share of profit to employees or 'foundations' is possible only if the company has paid dividends to shareholders and set aside the required reserves.

c) Cooperatives

Another important arena for employee ownership and participation is the cooperative form of organisation. Although cooperatives are not a specific form of financial participation in the strict sense (the term is usually used in reference to traditional enterprises), their presence implies the existence of some form of participation by worker members in enterprise results and decision-making, which is the reason why they have been included here.

In all transition countries, the old cooperative laws were replaced and the old cooperative organisations were dismantled as they were associated too closely with the former socialist system. New laws on cooperatives were passed in almost all countries (though as late as 2002 in some of them like Lithuania) to formalise and regulate the operation of this type of company. In a few countries, cooperatives are regulated through the existing company laws (like the Czech Republic, Estonia, and the Slovak Republic) or the Law on Commercial Associations (Estonia). Cooperatives, however, have not become a popular form of commercial organisation and their scale in most countries has remained limited. The main reason seems to be the negative attitude of the society which associates the cooperative movement with the former regime.

In the non-transition countries under consideration, the situation is quite different as they do not suffer from the negative association with a former socialist system. In Cyprus, where the law on cooperatives dates back to 1914, there is a very large cooperative sector, with almost half of the population being members of cooperatives. The profits of cooperative credit institutions, which provide loan facilities to other cooperatives, is tax exempt to the extent that it has been generated in operations with other cooperatives. In Malta, too, there is a small number of cooperatives whose operations are regulated by the 2001 Law on Cooperative Societies. The profits of a Cooperative (or a portion of it) is tax exempt if it is kept in the firm but will become taxable when it is distributed as dividends. A unique cooperative scheme in Malta (as an alternative to privatisation) is that employees of government departments can organise cooperatives and bid for their department's current activities in competition with the private sector; they receive their normal salaries plus a share of the cooperative profit.

3. Current Attitudes towards Financial Participation: A General Lack of Interest?

The relatively low incidence of financial participation in recent years in new EU Member States and Candidate Countries can be explained by the limited interest shown by both trade unions' and employers' organisations as well as the lack of a policy strategy and concrete enhancing measures by policy makers.

a) The Lack of a Long-Term Trade Union Strategy

No doubt the trade unions' policy toward this form of workers' involvement is among the factors that explain the current low incidence of financial participation. It is important however to distinguish here between employee ownership and profit-sharing schemes. Whilst the latter have only rarely appeared in the trade unions' policy agenda – with the exception of Slovenia and Bulgaria – trade unions in several countries under study – and especially in transition economies of Central and Eastern Europe – have taken some initiatives to promote employee ownership as an alternative way of privatisation, especially to avoid excessive reliance on private capital, particularly foreign investment, or on mass privatisation.

Employee share-ownership was often found in the policy programmes of trade unions (see the examples of the Hungarian trade union MSzOSz or of the Bulgarian trade union CITUB). The promotion of these schemes was generally presented as part of their views in favour of democratic participation, especially in countries with a tradition of self-management, such as Slovenia. In other cases, their support was more pragmatic and represented a means of avoiding the domination of ownership by an external buyer, as well as the restructuring and massive layoffs to be expected in this process.

Trade unions have tried to be active at different levels. At the national level, they have often managed to get involved in direct negotiations with the national privatisation agency, thus making employees deeply involved in the privatisation process – for instance in the creation of ESOPs in Hungary and Romania, or in the allocation or distribution of shares in Poland and Bulgaria. At the enterprise level, trade unions have also played a role in helping employees to get involved in the privatisation of their enterprise, and in defending employees' interests in this process as for example in Lithuania or Hungary (through the workers' councils). In Estonia, the local trade unions have sometimes used their own resources during the privatisation of their company. Trade unions have also influenced the kind of employee share-ownership scheme adopted by the company, by trying to involve all employees rather than only the management, and have thus helped to safeguard employee share-ownership against management domination – for instance on several occasions in Romania and Slovakia by preparing an EBO (or Employee Buy-Out) to counter the management's bid to acquire the enterprise through an MBO (or Management Buy-Out) (Brzica, 1998 and Munteanu, 1997). This promotion of employee ownership has enabled workers to obtain more influence in key policy areas, including employment policy: in many enterprises in Estonia, Slovakia, Hungary, and elsewhere, they have managed to influence employment decisions and avoid job losses (see chapters in this volume, Uvalić and Vaughan-Whitehead, 1997; Vaughan-Whitehead, 2003).

The attitudes of the trade unions however have not been supportive in all countries. The comparative table in the Annex to this chapter, for instance, shows that there has been a lack of interest since the beginning of the reforms in countries such as Latvia, Estonia, the Czech Republic and Slovakia, where financial participation had not been even considered as an element of reforms in the transition process. In Poland the trade union *Solidarność* initially supported employee ownership but once the decision to embark on other methods was made - particularly the mass privatisation method - it has shown no further initiatives for promoting employee ownership schemes.[12] Some national consensus had also emerged in the Czech Republic – including trade unions – around the voucher option.

But more generally we can conclude that in most new EU Member States and Candidate Countries the trade unions have done little to develop new institutions to promote and protect employee shareholders, despite their policy intention to support a wide extension of employee ownership. In particular the trade unions have not always played the monitoring and supportive role they might have. By not playing a more active role in informing the workers of their shareholders' rights and by providing them with little support to keep their shares, they generally did not help employees to maintain a significant degree of employee ownership in the enterprise. In any case, they did not seem much concerned by the progressive dilution of employee ownership. No doubt this 'laissez-faire' attitude contrasted with the efforts generally made by the same trade unions to press for a larger employee share ownership in the privatisation process. For instance the largest trade union in Slovakia (OK Kovo) was very active in promoting employee ownership in the privatisation process. Nevertheless their activity in this field has always focused on the creation and social control of legislation on privatisation. As a result it stopped as soon as the statutory bodies of employee joint-stock companies were created. At that point, trade unions reverted to their traditional role that is mainly collective bargaining and in particular negotiating for higher wages. A similar story is found in Bulgaria and many other countries in the region. The current lack of interest of trade unions generally observed in the countries under consideration – see the comparative table – obviously contributes to explain why employee ownership has progressively declined in importance over the last few years, despite the fact that this property form was found to have a number of net economic advantages (see empirical findings later in this chapter).

The trade unions and also employers' representatives have been – and generally continue to be – rather critical of profit-sharing schemes. Over the years of transition,

12 For instance *Solidarność*'s most recent programme, adopted in 2002, contains no mention of employee ownership or any other form of employee participation (see Country Report Poland in this volume).

most trade union leaders have, for a variety of reasons, expressed great concern at seeing this type of scheme being implemented at enterprise level. First because in the previous communist regime some Central and Eastern European countries had adopted but also mis-used profit-sharing schemes. They were usually implemented in the form of bonuses paid to employees and managers, and through indirect compensation for welfare services such as housing, holidays and so on. However although directly financed from enterprise funds, these schemes were not directly related to enterprise results and were difficult to distinguish from fixed wages. Since the start of the transition, such forms of profit-sharing have declined in importance. Workers – and with them the trade unions – became opposed to these forms of payment that did not respond to objective qualifications, requirements, or performance. The exchange of experiences with EU colleagues and certainly the long time needed to change mentalities seem to be required to change the bad feeling related to the previous regime in this area. The economic crisis has also contributed to this poor enthusiasm for profit-sharing schemes: the production crisis, combined with high inflation of the first years of transition, has restricted the possibility for employers to distribute bonuses related to profits. The fall in living standards and the growing poverty have also induced the workers to claim higher basic wage increases rather than the distribution of flexible profit-sharing bonuses. In a way the still lower living standards in most new and future EU Member States would explain both the dilution of employee-ownership – shares being sold for cash – and the poor motivation to apply profit-sharing. This might be one of the conclusions of different national studies in this volume indicating that that the priority of trade unions today is rather to promote the creation of works councils as required by the European Union and its directives in the field of workers' information and consultation.

In a few countries, however, the trade unions have been – and still are – rather supportive of profit-sharing schemes as in Slovenia, Bulgaria or Croatia. By contrast in Southern countries such as Cyprus and Malta social partners are rather involved in a tripartite social dialogue process at national level on different economic and social matters and have not shown much interest in promoting decentralized and more direct forms of workers' participation – including financial – at enterprise level. Quite significantly in these two countries workers' financial participation is not much quoted – if at all – in trade unions' policy agenda (see chapters in this volume). At the same time, however, in these two countries there has been an important support for the co-operative movement.

b) Employers: Neither a Conflictual Issue nor a Priority

Employers have also played a role in encouraging the development of financial participation. Obviously, the management's interest to get involved in employee-management share-ownership corresponded to the imperative need – especially since the managers did not have the funds for doing it alone – to get together with the workers to buy their company's shares and thus avoid the arrival of an external investor. Nevertheless, while this development can be explained by the opportunity or the necessity of obtaining shares in the privatisation process it also undoubtedly reflects a tradition and experiences of employee involvement and self-management in Central and Eastern Europe. The experience in this regard contrasts with experiences in the West – for instance in the UK and France which have developed employee ownership in the most extensive way – where only a small percentage of the capital of public companies has been privatised through employee ownership. The employers' aversion with regard to employee ownership was found to be much less prevalent in Central and Eastern European countries. It is significant to note that in some countries, those employers most suspicious of mixed forms of property including employee ownership were often foreign investors – also from the EU – and not local employers (though we also find examples to the contrary). To be noted, for instance, is the initial active support of Hungarian employers to ESOP schemes, or the continuous support of associations of employers and managers in Slovenia to profit-sharing schemes.

Nevertheless in other countries the employers' associations have remained rather passive with regard to financial participation schemes which are moreover clearly not seen as a priority by the myriad of managers of new small private enterprises.

c) Financial Participation Currently not on the Policy Agenda

Government policy has also not been neutral towards different forms of workers' financial participation schemes, notably through the promotion or absence of legislative or fiscal measures described earlier. However what is striking in many countries is the lack of even a clear position, let alone a long term policy to encourage the long-term sustainability of financial participation schemes.

First, with regard to employee ownership in the transition countries: while this property form was clearly put on the policy agenda in the privatisation process – either by default or reflecting some political willingness – it is also true that not much has been done to allow this property form to survive and develop in the longer run. For instance, while one of the weaknesses of employee owned enterprises clearly identified through empirical evidence is their poor access to capital, no government (with the possible exception of Hungary through the '*Egzisztencia*' Credit program) has taken concrete steps to solve this problem, through for instance some initiative in the banking sector. Similarly not much has been done by public authorities to limit the progressive dilution of employee shares – through for instance the temporary non-transferability of these shares (exceptions being Poland and Lithuania), some official campaign in favour of this property form, tax incentives, or measures to improve the governance process in employee-owned enterprises. As an exception, Hungary amended its ESOP law in 2003 notably to establish a limit for differences in share distribution, to regulate the operation of ESOP trusts and the mechanisms for the representation of owners' interest. On the contrary, many governments – for instance Estonia in 1993, Latvia in 1994, Lithuania in 1997, and Bulgaria in 2001 – have removed all preferences given to employees in the privatisation process.

Since the end of the privatisation process there have not been many attempts to encourage employee ownership including ESOPs in these countries outside the privatisation process. To be noted however, is the scheme designed in the late 1990s by the government of Malta to introduce financial participation in the public sector through the setting up of cooperatives, an initiative that was supported by the two main trade unions.

Second, with regard to profit-sharing schemes, there has been no legislation adopted so far despite the messages received – although not as binding regulations since there is no 'hard' *acquis* in this field – from the European Commission to do so. Only Slovenia proposed a law in 1997 in this regard but that was rejected by the Parliament. The same happened to a similar initiative in early 2006 (see the chapter on Slovenia in this volume). The context for a government initiative also seems to be appropriate in Bulgaria since the promotion of a profit-sharing scheme may well respond to both the trade unions' claim to progressively increase real wages, which are still at 50 per cent of their 1990 level and among the lowest in Europe, and the employers' request for greater wage flexibility. In early 2006, both social partners were rather open to such a proposal that has clearly to be part of a more comprehensive and longer term incomes policy package (ILO, 2006). Nevertheless, a recent incomes policy strategy document prepared by the Bulgarian government does not include any proposal in this field.

Finally, in the light of the above remarks we can wonder if the influence of EU institutions on the new EU Member States and Candidate Countries has so far been sufficiently strong regarding workers' financial participation. While financial participation or PEPPER schemes continue to belong to the 'soft' *acquis* – with the immediate result that they are not seen by the newcomers as being a priority field especially in comparison with the numerous other fields where there are binding rules – one can also wonder whether the European social partners – both at European confederation level as well as national federation level – have been sufficiently active in this field.

4. Financial Participation in Practice: Incidence of PEPPER Schemes

Contrary to the experience of the EU-15, where a rich variety of financial participation schemes have been used during the last twenty-five years, in the new Member States and Candidate Countries from Central and Southeast Europe we observe very limited incidence and variety. During the whole post-1989 period, the only diffused form of financial participation in these fourteen countries has been employee share ownership, including several cases of ESOPs, whereas the other main form – profit-sharing – has emerged only sporadically and can be considered negligible.

a) Employee Share Ownership

Employee share ownership is the principle form of financial participation in the new Member States and Candidate Countries. It has emerged almost exclusively through the process of privatisation. In the countries from the former socialist world, although a variety of privatisation methods have been used during the 1990s, employee ownership has turned out to be a very important, sometimes even dominant, outcome of ownership transformation. As a consequence, immediately after the initial phase of privatisation, many previously state or socially-owned enterprises in Slovenia, Poland, Hungary, the Baltic States, Bulgaria, Romania and Croatia, ended up being owned by insiders – employees and managers. Nevertheless, there has also been a clear tendency for the share of employee ownership to decline, as many workers have sold their shares in the meantime, most frequently to managers but also to external owners. Thus today we observe a much smaller number of countries that still have a significant stake of enterprise property in employee ownership, while in an even smaller number of countries – primarily in Poland, Slovenia, and Romania - are there still a substantial number of firms that are in dominant employee ownership. There are also some countries, like former Czechoslovakia and subsequently the Czech and Slovak Republics, where not even employee ownership has been an important form of financial participation, since privatisation was based on methods not promoting the acquisition of enterprise shares by insiders. In countries like Cyprus, Malta and Turkey, the experiences have been somewhat different, since no privatisation programmes of such a large scale were applied over the past decade, but a common element with the former socialist countries is that employee ownership has also emerged as a consequence of privatisation.

ESOPs or ESOP-type schemes have also been implemented, though only in a few countries. In Romania, ESOPs were the main method of privatisation of small companies; by the end of 1998, over a third of all industrial firms had undergone ESOP privatisation, with average employee ownership of 65%. Moreover, ESOP participants were the largest owner group in one-fourth of Romanian privatised firms (see country chapter). In Hungary, some 287 ESOP purchases took place during 1992-99, involving 80,000 employees; in 47% of cases the ESOP was a full or majority owner, and in 24% an owner with controlling rights (owning 25-50%). During the last few years however, no new ESOP has been created in Hungary. Moreover, as a result of changes in legal regulations, the majority of ESOPs ceased to exist after the repayment of loans, so that by early 2005 there were only 151 ESOPs, involving only 1.2% of total company employees. In Croatia, some well-know and successful enterprises (Pliva, Zagrebačka Banka, Kraš, Dalekovod, AD Plastik) have been introducing models with ESOP elements; in some of these firms, this was done in order to explicitly transfer the majority share to employees (AD Plastik, Dalekovod). In Turkey, there have been some ESOP-type schemes, based upon foundations which collectively hold employee shares, with the employer company contributing from company profits to facilitate the acquisition of shares by employees (e.g. Adana Kağıt Torba Sanayii T.A.Ş, or the Teletaş Telekominikasyon Endüstri Ticaret A.Ş., which enabled the sale of 8.14% of share capital to its employees). In Malta also, there were a few cases of ESOP-type funds, as described previously.

Looking at the situation in individual countries, the experiences have been very diverse. In Bulgaria, initially, only around 4-5% of enterprises was privatised through acquisitions by employees on privileged terms. After 1994, however, sales to MEBO companies reached 1,436 or 28% of total, another 22% were other sales that also included privileges for employees, so that almost 50% of privatisations were carried out through full or partial acquisitions by insiders. As elsewhere, many insider owned firms are today in dominant managerial ownership, and only about 10% of enterprises privatised by MEBOs are still majority employee-owned. As to the method of mass privatisation, after a peak in employee ownership, achieved immediately after the completion of mass privatisation in 1998, with about 7-12% of shares being in employee ownership, many shares were transferred to managers and outside owners. The number of employee-owned firms as well as the number of shares held by employees has significantly declined in the meantime.

In Croatia, 42% of the initial nominal value of enterprises that were included in the privatisation process was acquired by employees (and some other buyers). However, many employees were not interested in paying off their shares so they were returned to the state. Whereas initially small shareholders, mainly current employees, held 20% of the nominal value of the 2,586 privatised firms, the share fell to only 12% in 1998 and continued falling thereafter (Jelusić and Perić, 1999; Tipurić et al., 2004).

In former Czechoslovakia, and later also in the Czech and Slovak Republics, mass privatisation did not favour insider ownership. In the mass privatisation programme, only 1.5% of shares was allocated for employees, but not even these were purchased because of the unfavourable share price. Only 171 firms eventually gave shares to their employees, representing 0.31% of the total number of shares. Lately, some Czech firms have issued 'employee shares' to improve employee motivation; e.g., the second largest bank, Komerční banka, offered its employees the right to subscribe a limited amount of a new share issue at a discount of 50%. Although over 60% of employees used this opportunity, their share in property remained insignificant (less than 1%). A similar proportion of shares was sold to employees in Československá obchodní banka and also in some smaller banks (e.g. Pragobanka).

In Cyprus, it is reported that it is a common phenomenon for employees to buy shares of the company where they are employed, especially in public companies, but there are no data on the scale or the incidence of such practices.

In Estonia, employee owned firms represented the largest share of privatised enterprises in the early privatisation period, up to 1992; in a sample of firms, they represented as much as 38% of the total. It is estimated that 80% of the 450 small enterprises of the first wave of privatisation were taken over by insiders, frequently through leasing. After 1993, there was a clear movement away from employee ownership. In 1995, even in enterprises with majority employee ownership, on average 46% of the employees were already non-owners and this percentage increased further over time.

The most recent 2005 survey of Estonian firms shows a further decline in employee ownership: only 2% of the companies had majority employee ownership, in 78% there was no employee ownership, while 20% of firms had a minority employee share (Jones and Mygind, 2005). In only 7% of the enterprises with minority employee ownership did the employees own 20-49.9% of the shares. Employee ownership is randomly spread over different industries, and there is no significant variation regarding enterprise size. Agriculture is the sector with the highest rate of majority employee ownership.

In Hungary, minority employee ownership (typically less than 10% and nowhere exceeding 15%) was introduced in some 540 companies during 1990-92, usually in small and medium-sized firms. ESOPs were an important method of privatisation (see above). Among the early buy-outs, majority management ownership was eventually created as many workers who initially owned shares sold them to managers. By 1998, only around 1% of the assets of all companies was in management or employee ownership in Hungary. Approved Employee Share Benefit Programmes, introduced in 2003, exist in 7 or 8 companies with a few thousand employees. There have been some recent cases of employee ownership, as in 2004, when 37% of the Hay Group clients gave their employees shares, but less than 1% of employees actually received employee shares.

In Latvia in the early 1990s, there were favourable conditions for insiders to buy their enterprise shares through direct sales, or leasing with the option to buy later. Direct sales to employees was one of the most frequent methods, and more than half of the enterprises in the small privatisation process were sold by instalments to employees. Though the exact number of employee-owned firms is not known, the majority of small enterprises privatised by 1994 were taken over by insiders. After 1994, however, insider take-overs lost their importance. Within the other privatisation route, the mass privatisation programme, by the end of 1998, only 13.56% of shares were sold for vouchers to employees. Still, according to a 1997 survey of 167 companies, two thirds of very small enterprises (1-4 employees), more than 50% of small firms (less than 100 employees), and 18% of large firms (more than 500 employees) were majority insider owned. Insider ownership was highest in agriculture and fishing, and lowest in transport and services (see country chapter below). However, in a sample of 915 firms for the 1997-99 period, insider ownership was by far the least stable form (see Jones and Mygind, 2005), confirming the typical ownership cycle form employee to management and then to outside domestic or foreign ownership.

In Lithuania too, a large number of employee-owned companies were created during the first phase of privatisation. The percentage of enterprises where the majority of privatised assets was taken over by employees increased from 3% in 1991-1992, to 65% in 1993, and to 92% in 1994-1995. After 1995, when preferential terms for employees were abolished, employee ownership started decreasing, but at least until 1997, the ownership structure significantly differed from that prevailing in other Central and East European companies, due to extremely low foreign ownership and very high ownership by insiders. However, in employee owned enterprises, the proportion of employee owners fell from 76% in 1993 to 66% in 1999. There are also some new trends in the opposite direction, as there have been several recent cases where employees have obtained shares in companies as part of employee incentive schemes. In Bitė GSM, the second largest mobile service provider in Lithuania, every company employee was granted the possibility of becoming a stockholder of the joint stock company TDC, the sole owner of Bitė GSM; employees were offered TDC stock options to purchase company shares at a privileged price during a 5 year period. Another case is of the Baltic Beverage Holding which provided the possibility for employees to acquire shares.

In Malta, employee ownership emerged in a few companies in the banking and telecommunications sector during the privatisation of previously nationalised companies. The two major private banks nationalised in 1974-75 – the Bank of Valletta and the Mid Med Bank – both have some employee ownership. When in 1994, the government offered shares of the Bank of Valletta (BOV) to the public, some shares were issued for the purpose of setting up a trust fund for its employees, the funding for which was provided in the form of a government loan. A similar trust fund was also set up in Maltacom (formerly Telemalta), the main provider of the fixed telephone system, on the occasion of public sale of shares in 1998: some 3% of shares was allocated in the form of a loan to a foundation set up to administer a trust fund on behalf of employees. When the Mid Med Bank was sold to the HSBC Holdings (UK) in 2002 becoming the HSBC Bank Malta, an employee share ownership scheme was introduced in the form of a 'Save-As-You-Earn' scheme, allowing employees to save for HSBC shares. There have also been enterprises that have offered share options to all employees (e.g. Vodafone), but the general policy tends to limit these schemes to key personnel.

In Poland, employee ownership was the most frequent outcome of privatisation during the first half of the 1990s. Initially, lease-leveraged employee buyouts within the 'liquidation' method represented 66.9% of all completed privatisations, but thereafter, they dropped to a little over one third. Most of these were small to medium-sized firms, usually with less than 500 employees. Although there were some restrictions on the trading of shares (particularly imposed by companies themselves), the scale of employee ownership gradually reduced over the years as companies had to open up to outside ownership in order to attract new financial resources for their development and expansion. But even over ten years later, employees as a group still remain the largest owner of many companies privatised by this method. However, despite the establishment of a number of institutions (such as the Union of Employee Ownership and the All Poland Chamber of Employee Owned Companies) to lobby for, and promote, employee ownership, these companies account for a small proportion of total economic activity and employment in Poland. In the case of 512 companies privatised through the mass privatisation programme in which 15% of shares were offered free to employees, by year 2000, only 13 enterprises had evolved into majority employee-owned by 2000 (Grosfeld and Hashi, 2005). The average shareholding of insiders (managers and employees) in the group of mass privatised companies had reduced to

11.4% in 2000 (Kozarzewski, 2002). A study of 80 of Poland's 500 largest companies which were privatised between 1990 and 2001 suggests that employee shareholdings were marginal. Insiders possessed some 12.7% of shares at the beginning of 1998, and this fell to 11.4% two years later. Non-managerial employees held no shares in almost half of the companies in the sample, whereas insiders (managers and employees) had majority stakes in only 5% of the firms (Kozarzewski, 2002).

Romania is one of the countries where employee ownership has been most wide-spread, though there are no accurate statistics on its incidence (EBRD 2002, World Bank, 2004). Several privatisation methods enabled the emergence of employee share ownership – mass privatisation, ESOP-type schemes applied in small-scale privatisation, and sales of minority stakes to employees. However, ESOPs were the primary method of privatisation (see above). There were also many cases of minority sales to employees, though the importance of minority shares held by employees has been decreasing over time.

In the Slovak Republics, though the conditions for employee shares were more favourable after the split than in the Czech Republic, there have been very few cases of employee owned firms. SlovGlass was privatised in 1994 using employee shares, but it is reported that no dividends have been distributed since. Some Slovak banks have also used employee shares in order to improve employee motivation (e.g. Tatrabanka), and so did some foreign companies (e.g. Dell). Only a very small number of companies were privatised through management led employee buy-outs, such as the Slovnaft Joint Stock Company, in which the Slovak National Property Fund sold 39% of the shares to the Slovintegra Joint Stock Company, in which employees held 49% and management 51% of the shares. Another case is the cement producing company in Ladce which was privatised in 1995 involving more than 95% of employees.

In Slovenia, at the time of privatisation, 90% of companies chose internal distribution and internal buy-outs as the main privatisation method, so insiders obtained about 40% of capital subject to ownership transformation. Information on the incidence and scale of employee ownership in the years after the initial privatisation is rather limited and, generally, is based on sample surveys. In one survey of 319 companies, the insiders obtained more than 60% of capital, representing 16% of total employees but only 8% of privatised capital (see country chapter). Insider ownership prevailed in smaller, labour-intensive companies. Recent surveys by Simoneti et al. (2001) and Damijan et al. (2004) confirm the importance of employee ownership, though also clearly showing its continuous decline. Prašnikar et al. (2002) report a decrease in insider owned firms during 1996-2001, from 39% to 25%, for 124 medium and large joint-stock companies, while the number of firms in dominant employee ownership declined from 74 to 26. Managerial ownership has been increasing, but in contrast to many other countries the reduction in employee ownership has led to an increase in outside ownership rather than in managerial ownership. In the Damijan et al. sample, only 26 firms that were dominated by employees at the end of privatisation remained in dominant insider ownership by the end of 2003. In most cases, the dominant ownership went from insider owners to domestic non-financial firms, or to funds.

Finally in Turkey, the privatisation schemes undertaken during 1985-89 were aimed at ensuring the broad participation of the public, including employees. In the privatisation of the Karabuk Iron and Steel, 35% of shares were transferred free to the employees; some additional shares were paid for from their severance payments, so at the end employees held almost 52% of all shares. In the 2006 sale of Turk Telekom shares, 5% of shares are to be allocated to employees. Employee ownership can be found in foreign multinational companies. To date, 26 foreign multinational companies have implemented employee share ownership. Out of 35 recent applications, some are share option plans while others are oriented towards employee ownership.

b) Profit-Sharing

The other main form of financial participation – profit-sharing - has been implemented much less frequently, usually on a purely *ad hoc* basis, and there is practically no empirical evidence on its incidence. Generally, there are no specific limitations on the use of schemes such as profit-sharing, but there are also no specific incentives to introduce them. In many countries, bonuses paid to workers from profits are usually subject to personal income tax at the corresponding individual rate, which is not the case with dividends which often are taxed at a lower flat rate, so employee share ownership assures higher payments to employees.

Experts report that profit-sharing is not very popular in Bulgaria, that there are no practices of profit-sharing in Cyprus, that it is rarely implemented in the Czech Republic (only sometimes in foreign companies), that it is not common in Estonia - only in 13 cases in a sample of 220 firms in 1997, in some IT enterprises and in the real estate sector, and that there are only a few cases of profit-sharing in Lithuania. In Latvia, in a 1997 survey of 167 firms, profit-sharing was reported in 7% of enterprises; but within the 28 majority owned firms, it was present in only 5. In Malta, the only known case of profit-sharing is in the Malta Shipyards Limited, where the government agreed to offer a profit-related bonus to the 1,761 employees when the company was created in 2004: employees are to receive a quarter of the additional profits achieved through a cut in labour costs.

In some of the other countries, profit-sharing seems to have been more frequent. In Hungary, where profit-sharing was used before 1989, it is reported that most domestically owned companies still give their employees a variable part of income in addition to the basic wage. According to the Hewitt Associates, about 80% of the enterprises in Hungary use short-term incentive tools, of which 20% use profit-sharing (but only 10% of the entitled employees actually receive a share of profits), and about 50% of the companies use performance bonuses not linked to profits. In Slovenia, Kanjuo-Mrčela (2002) report that about 7% of the 41 large firms have established a fund with their own shares in order to remunerate their employees, while about 32% of firms have introduced the possibility of profit-sharing in their Articles of Association, though this possibility often remains unexploited (this is the case of 22% of the firms in the sample). In Romania, since cash-based profit-sharing became compulsory in state owned companies and in the public sector in 2001, it has been increasingly used by firms: the 'profit participation' scheme, created in state owned companies in order to allocate 5-10% of profits to employees depending on performance, is estimated to cover more than 200,000 employees and is used in the banking and insurance, mining and aluminium industries, and utilities; while the 'bonus scheme' envisaging a bonus paid to public sector employees on the basis of overall performance of the sector, covers more than one million employees. However, net profits directly paid to employees in Romania in 2003 were only about 2.2% of labour costs. Furthermore, since many state or municipal owned companies do not make any profit, the actual number of beneficiaries is relatively small. In Turkey, a screening of 50 randomly selected public companies found that more than 80% included profit-sharing in the Articles of Association, while the percentage of profits for employees or board members ranged from 1-20% of the distributable profit.

c) Cooperatives

Cooperatives play an important role in only a few of the countries considered. Here again there are important differences between the former socialist countries, and the other three countries – Cyprus, Malta and Turkey. Cyprus is considered to have one of the strongest and best-organised cooperative movements worldwide. In 2002, the cooperative sector incorporated 673 entities, involving a bit less than 390,000 persons. In Malta, although there are only 58 cooperatives, they had 4,569 members, and some are rather important for their respective sectors; one of these is a secondary cooperative consisting of seven agricultural cooperatives, which handles about 26% of agricultural sales. The public sector cooperative programme is implemented mostly in the services sector, but there are some in manufacturing activities too. Despite its unique feature, the take up of the scheme has been unimpressive, with so far only about 100 employees having organised such cooperatives. In Turkey, in 2004, there were 26 different types of cooperatives, almost 60,000 active cooperatives involving more than 9 million members, of which 12% are agricultural cooperatives, and 52% of workers are members of agricultural cooperatives.

In the new Member States with a socialist background, cooperatives have played an important role in many countries, but their importance has significantly declined over the last fifteen years. In Bulgaria, there were as many as 7,570 cooperatives in 2003; more than half are agricultural cooperatives, and 95% of those that belong to the two biggest cooperative unions, representing 17% of all cooperatives, are workers cooperatives. In the Czech Republic, cooperatives initially accounted for 4% of the total number of registered firms, but within two years their share has fallen to 3% and remained quite stable at this lower level (2003). In Estonia in 1990, cooperatives represented around 7% of employment, but many have been transformed into normal enterprises. In Hungary there were over 5,200 cooperatives in 2004, but involving only 0.2% of employees, mainly in services, agriculture and trade. In Latvia, there were about 140 cooperatives in 2004, mainly in agriculture, with some 8,000 members. In Lithuania, there were 262 cooperatives in 2004, including consumer, agricultural, production and credit cooperatives. In Poland, at end of 2001, 411,700 persons worked in the cooperative sector, which represented 2.9% of employment (down from 642,000 at the end of 1995); of the 18,682 registered cooperatives at the end of 2002, only 2,208 (11.8%) were industrial workers' cooperatives. In Romania, despite the long tradition of cooperatives, their number has been declining rapidly to 2,236 in 2003 accounting for 0.2% of total employment. In the Slovak Republic, cooperatives represented 9% of the total number of industrial firms in 1993, which rapidly declined throughout the 1990s, to only 2% of all enterprises in 2004. In Slovenia, the 327 cooperatives in 2003 employed only 0.9% of all employees, produced 1.3% of value added, and were mostly operating in agriculture and forestry.

5. Empirical Evidence on the Effects of PEPPER Schemes

Given that financial participation schemes have been implemented to a very limited extent in most new Member States and Candidate Countries, it is not surprising that very little empirical research has been done to assess their effects. Indeed, empirical evidence is limited to studies undertaken of firms in the Baltic States, Hungary, Poland, and Slovenia. The evidence in most cases is mixed. Most of the studies are based on the situation in the 1990s when employee ownership and participation was higher than in the more recent period.

For the Baltic States there is some empirical evidence on the impact of employee financial participation on economic performance, based on employee owned enterprises. In Estonia, the results show that labour productivity of employee owned companies does not differ significantly from that of other domestic companies; only foreign owned companies are significantly more productive and have a higher degree of strategic restructuring. The main problem for insider owned companies is access to capital for investment. For Latvia, a production function analysis based on the 1994-95 data does not show any significant differences in factor productivity between ownership groups, but employee owned firms had lower capitalisation and higher debt ratios (see Jones and Mygind, 2000). In-depth case studies of 9 enterprises suggests that the performance of most employee owned companies does not point in the direction of employee ownership as a barrier to the adjustment of the labour force (i.e. reactive restructuring), though the barriers to strategic restructuring seem to be more important (see Mygind, 2002). In Lithuania, the data for the early years does not indicate a bias in the direction of low capital-intensity for insider owned enterprises, as was the case in Estonia and Latvia (see Jones and Mygind, 1999). Another study shows that insider owned enterprises had quite high labour productivity, wage levels, profit margins and return on assets, but also relatively few bank loans and low investment levels (Mygind, 1997). Still another study, based on a cross section analysis of factor productivity levels shows no clear tendencies of variation between employee-owned firms and other owner groups (Jones and Mygind, 2000). While some of the findings are clearly inconclusive, all studies confirm that the lack of capital is a barrier for insider-owned enterprises.

The evidence on Hungary (Boda and Neumann, 1999) suggests that the performance of ESOP companies during 1993-97 was not worse than of other companies. Kovács and Csite (1999) found that enterprises in employee ownership in 1996 were more efficient than other ownership forms in terms of per assets sales revenues, though there were less successful in terms of labour efficiency, and firms with minority employee ownership seemed to perform better than the ones in majority employee ownership. Many small and medium sized employee-management firms and ESOP companies seem to be solid and efficient. However, ESOP companies tend to invest less than other types of firms.

Empirical research on the effects of employee ownership in Poland has been undertaken by a team headed by Maria Jarosz as well as by Woodward, Hashi and Kaminski. According to some of the Jarosz group findings, in the first half of the 1990s employee-leased companies were, on the whole, financially sound in spite of the burden of lease payments. Profitability indices for the average employee-owned company have been close to or better than the average indices for firms privatised by other methods. In the second half of the 1990s, the Jarosz group found gross profitability to be declining amongst employee-leased companies. A 2000 State Treasury report lists these companies along with foreign-owned companies, publicly listed companies, and companies with domestic strategic investors, in the group of companies with relatively high and stable rates of investment. However, investment per employee and the ratio of investment to sales revenues was much lower in employee-owned and other domestically owned companies than in foreign-owned companies. Employee-owned companies showed a great deal of flexibility in their employment policies, often engaging in significant layoffs. Woodward has carried out two econometric studies of the effects of employee participation on productivity, using data from the two Jarosz samples (Kozarzewski and Woodward, 2003). The economic performance of employee-owned companies in Poland is certainly satisfactory in comparison with most other ownership groups. However, econometric evidence provides little or no support for the hypothesis that employee ownership is related – either positively or negatively – to performance.

There have also been a number of empirical studies on Slovenia, many of which found no persuasive evidence of the negative effects of employee ownership. Prašnikar and Svejnar (1998) analysed the investment and wage behaviour of a panel of 458 Slovenian firms in 1991-95, finding that firm investment behaviour is largely influenced by the trade-off between investment and wages and the availability of internal funds. Firms that were privatised to insiders had a significant positive relationship between investment and value added, and are hence more dependent upon internal funds for restructuring. In a sample of 130 large and medium-sized firms, Prašnikar and Gregoric (2002) show that there is a 'leading' group of firms with stronger management, which have adapted to international competition better than other firms. In these firms, employee ownership exerts a positive effect upon the power of managers; hence, the employees behave more like firms' shareholders than other stakeholders. With regard to firm restructuring, Domadenik et al. (2003) and Domadenik (2003) observed no significant effect of employee ownership on strategic restructuring. Consistent with the findings by Prašnikar and Gregoric (2002), they observe that in the group of leading firms, employee ownership did not have a negative effect on the speed of defensive or strategic restructuring. In one of the latest studies, Simoneti and Gregoric (2005) find some evidence of the negative influence of inside ownership on firm productivity in 183 privatised firms. However, the impact is negative only in firms with insider stakes below 25%, and only for listed firms. In another recent study, Damijan et al. (2004) evaluate the impact of ownership concentration and owner identity on firm economic efficiency and financial performance; the authors find that when dominant, insider owners and domestic non-financial firms perform better than state-controlled funds (used as the reference group).

6. Concluding Remarks

The comparative analysis and assessment of employee financial participation in the ten new EU Members and the four Candidate Countries presented here suggests certain similarities and differences in the legislation, general environment, incidence and effects of PEPPER schemes. Despite substantial country-to-country variations, major similarities are found among the countries from Central and Eastern Europe, where the process of transition to a market economy implemented during the last fifteen years has also resulted in certain similarities in the development of employee financial participation. Given the different historical context of the three non-transition countries – Cyprus, Malta and Turkey – the situation here was found to be somewhat different.

The analysis of the legislative framework in the fourteen countries investigated has shown that there are practically very few laws specifically dedicated to employee financial participation. In both the former socialist states and the non-transition countries, the laws enabling forms of employee financial participation refer almost exclusively to employee share ownership, as there have been only a few cases of legislation on profit-sharing. Employee share ownership has largely developed in the course of recent privatisations, but its implications have been much more far-reaching for the transition than for the non-transition countries. Despite different privatisation strategies in each of the transition countries, many privatisation methods led to the initial emergence of substantial employee share ownership – including sales of enterprise shares to insiders at privileged terms, employee-management buy-outs, leasing, mass privatisation, ESOPs and ESOP-type schemes. More recently, however, the conditions for employee ownership have generally been more restrictive, which is one of the reasons why we observe its declining role over time. Among the non-transition countries, Turkey and Malta have implemented privatisation programmes which also created the basis for some employee ownership, but its diffusion has been very limited, especially in Malta.

Profit-sharing is even less present in legislation of the new Member States and Candidate Countries, despite the fact that company laws in several countries do refer to the possibility of employees having a share of company profits – e.g., in the Czech and the Slovak Republics, Poland, Slovenia. However, Romania is the only country that has specific legislation on a general scheme for cash-based profit-sharing in state owned companies (though implemented in a small number of companies). Among the non-transition countries, only Turkey has legislation on profit-sharing. Participatory forms are also regulated in legislation on cooperatives.

Although all countries today have laws on cooperatives, this form of organisation has not been very popular in any of the transition countries, mainly due to the negative attitudes towards cooperatives inherited from the former regime. The situation is different in the non-transition countries, where cooperatives play a more important role, particularly in Cyprus.

The comparative analysis of the general attitude of governments and social partners shows the lack of concrete policy measures supporting PEPPER schemes by policy makers, and limited interest both by trade unions and employers organisations. Rather than being actively promoted as in some old EU Member States, employee financial participation has most frequently not been considered, or has been viewed with suspicion. If we exclude the one-off incentives offered to employees to become shareholders of their enterprise within the privatisation process, policies actively promoting the introduction of employee financial participation have been almost non-existent. Surprisingly, employee financial participation has rarely appeared even in the trade unions policy agenda. Only sometimes have trade unions been supportive of employee ownership, but they remain rather critical of profit-sharing. The employers have been generally indifferent towards financial participation, despite a few cases of active support (as in the case of ESOPs in Hungary).

Regarding the incidence of PEPPER schemes, employee share ownership is the principal form of financial participation found in the new EU Members and Candidate Countries. As mentioned previously, it has emerged during the last fifteen years primarily as a consequence of the process of privatisation. Various degrees of employee ownership are still today present in most countries, but there has been a general tendency towards the reduction of ownership by non-managerial employees. Thus today, there are only a few countries which still have a substantial number of firms in majority employee ownership.

Given the limited incidence of PEPPER schemes, it is not surprising that the empirical evidence about the effects of schemes is available for only some countries – the Baltic States, Hungary, Poland, and Slovenia. Whereas much of the evidence is preliminary and refers primarily to the 1990s, when employee ownership played a more important role than today, these studies suggest that the performance of enterprises in employee ownership, frequently, has not been worse than performance of firms with other ownership forms.

In conclusion, employee financial participation has so far played a marginal role in the new EU Member States and Candidate Countries: whereas some employee share ownership is found in most countries today, profit-sharing is almost non-existent. Still, the potential beneficial effects of both forms of employee financial participation should not be neglected. Given the prevailing economic conditions in most of the incoming countries from Central and Southeast Europe, the beneficial effects could be even more important than in the advanced EU economies - for strengthening workers incentives, raising productivity, improving overall enterprise efficiency. Scholars critical of employee financial participation in transition economies have ignored its potential advantages, which could possibly more than offset the expected adverse effects. Employee financial participation has been actively promoted by a number of western governments, as well as by the EU, precisely because it is expected to lead to a number of positive effects.

Annex

Table: Financial participation in the new Members and Candidate Countries of the EU

Country	General attitude	Legislation and fiscal or other incentives	Incidence of schemes
Bulgaria	**Social Partners:** TU open to FP, EA indifferent; not a current topic on either of their agendas; long tradition of Coop **Government:** ESO strong support 1997-2000, since then ignored; FP generally ignored	**ESO:** PrivL - voucher privatisation: up to 10% ES for free, other privatisations: up to 20% ES at 50% discount, both max value of 24 months salary; all privileges ended in 2002; NTL - uniform 7% dividend tax **MEBO:** PrivL - MEBO firms possible, incentives: payment by instalments, low interest credit, tax exemptions for 4 years **PS:** None; NTL - SPS exempt from personal income tax **Coop:** Law on Cooperatives; NTL - production/consumer dividend deductible from corporate tax; consumer dividend income tax exempt	**ESO:** After 1994 50% of privatisations, mainly MEBO (28% of total), but declined rapidly; only 10% of these firms are today still in dominant EO In mass privatisation, in 1998: 7-12% of shares in EO **PS:** very few cases **Coop:** 2003: 7,570 coops, 1% of registered entities, mostly in agriculture
Croatia	**Social Partners:** TU recently promote ESO in revision of privatisation; EA indifferent to FP; long tradition of self-management **Government:** ESO supported until 1995, since then FP ignored; Coop tolerated but no active support	**ESO:** PrivL - ES available at 20-70% discount in the early phase of privatisation, subject to a max of 50% of capital and a value of € 1 mil.; NCL - preferential ES in JSCs possible, financing by firm possible, subject to a max. of 10% of capital of firm; NTL - dividends and profits from sale of shares are tax exempt **ESOP:** ESOP-type organisations develop spontaneously, general rules of NCL apply **PS:** None **Coop:** Law on Cooperatives **Employee representation:**: One supervisory board member	**ESO:** Initially 42% of nominal value of privatised firms, decreased to only 12% by 1998; in 2004, 12% of firms with majority EO **ESOP:** Elements of ESOP in 9,4% of firms (52 out of 552) **PS:** Very rare **Coop:** 2003: 878, 0.31% of employment
Cyprus	**Social Partners:** FP not an issue on TU / EA agendas **Government:** FP so far ignored; long tradition of active support of Coop	**ESO:** NCL - preferential ES possible in JSCs; financing ES by firm possible **PS:** None **Coop:** Law on Cooperatives; NTL - profits of cooperative Credit Institutions from operation with members tax exempt	**ESO:** AI: quite common **PS:** insignificant **Coop:** 2002: 673 entities with 387,960 employees, one of strongest cooperative movements worldwide covering half of the population
Czech Republic	**Social Partners:** TU / EA indifferent to FP, not a current topic on their agendas **Government:** ESOP discussed in 1990; FP ignored after introduction of Voucher concept	**ESO:** NCL - preferential ES/SPS possible in JSCs, subject to a maximum of 5% of equity capital, financing by firm possible **PS:** NCL - CPS/SPS possible in JSC **Coop:** covered by NCL - Art. 221 – 260 **Employee representation**: 1/3 of supervisory board members in firms with more than 50 employees	**ESO:** 1990s: only 0.31% of privatised assets within mass privatisation; some recent cases of ES in banking sector **PS:** insignificant, only in some foreign companies **Coop:** 2003: only 0.6% of total number of firms (75% housing coops)

Country	General attitude	Legislation and fiscal or other incentives	Incidence of schemes
Estonia	**Social Partners:** TU indifferent; EA opposed to any extension of employee participation **Government:** PrivL supported ESO until 1992; after 1993 FP ignored; little support for Coop	**ESO:** NCL - rights attached to shares issued before 1 Sept. 1995 (to employees) remain valid; no public prospectus needed for employees and management shares; NTL - no tax on dividends received by employees **PS:** None **Coop:** covered by the law on Commercial Associations	**ESO:** Until 1993: in 80% of privatised small firms incl. majority management ownership, but declining over time; 2005: 2% of firms in majority EO, 20% in minority EO **PS:** 1997: 13 cases in a sample of 220 firms **Coop:** 1990: 7% of employment, reduced substantially; 2003: 855 Commercial Ass.
Hungary	**Social Partners:** FP for managers to avoid external control, for employees to preserve workplace; TU lobbied for ESO in privatisation, recently passive; EA indifferent **Government:** ES/ ESOP strong support in PrivL until 1996; climate FP-friendly but lack of concrete econo-mic policy; Coop tolerated but left aside	**ESO:** PrivL - preferential treatment through: discount (up to 50% of price), payment by instalment, and credit (*Egzisztencia)*; discount applied to a max. of 15% of firm's assets and could not exceed150% of annual min. pay; NCL - specific free or discounted ES possible in JSCs, max.15% of equity capital, financing by firm possible; since 2003 tax-qualified stock plans, first ½mil.HUF is tax free **ESOP:** ESOP-Law 1992; preferential credit; corporate tax exempt until end 1996; up to 20% of contributions to ESOP, is tax deductable; **PS:** None **Coop:** Law on Cooperatives	**ESO:** Early 1990s: minority EO in 540 SMEs, by 1998 only 1% of privatised assets; some recent cases (Hay Group) mostly foreign **ESOP:** 1992-99: 287 ESOPs employing 80,000; 2005 only 151 accounting for 1.2% of employment **PS:** Estimate: 16% of all firms (though only 10% of entitled employees receive profits) **Coop:** 2004: 5,219 coops, only 0.2% of employment, in services, agricult., trade
Latvia	**Social Partners:** TU/EA indifferent to FP, not a current topic on their agendas **Government:** Little support for ESO in PrivL; FP so far ignored; Coop left aside	**ESO:** PrivL - ES at discounted price possible, max. 20% of share capital of firm; in state or municipal firms can have special non-tradable ES; NCL - preferential ES in JSC free/discounted possible; NTL - Dividends tax exempt (for all shareholders) **PS:** None **Coop:** Law on Cooperatives	**ESO:** 1994: in more than half of small firms; 1999: only 14% of shares sold for vouchers; in a 1997-99 sample of 915 firms, 16% in dominant EO but falling over time **PS:** 7% in survey of 167 firms (IT, consulting, real estate) **Coop:** 2004: 140 coops, mostly in agriculture
Lithuania	**Social Partners:** Climate for FP friendly; TU interested, lack of actions; EA support individual firms **Governm.:** ESOP/ ES strong support in PrivL until 1996; now FP not on political agenda	**ESO:** PrivL - ES with deferred payment of max. 5 ys. possible, max. 10-50% of share capital before 1997, 5% since then and at no discount; NCL - ES possible in JSCs but restricted for 3 ys. (non-transferable/ non-voting), financing by firm possible; NTL - after holding period profits from sale of shares not taxed for all sharehold.) **PS:** None **Coop:** Law on Cooperatives	**ESO:** 1994: in 92% of privatised firms, but declining thereafter; some recent cases of EO **PS:** CPS mostly in foreign firms (IT, consulting, advertising, etc.); few cases of DPS **Coop:** 2005: 262 (consumer, agricult., production and credit coops)

Country	General attitude	Legislation and fiscal or other incentives	Incidence of schemes
Malta	**Social Partners:** TU support schemes in practice; FP not a current topic in tripartite dialogue **Government:** FP collateral effect of nationalisation (80s) /privatisation(90s); not a current issue; active support of public sector Coop	**ESO:** NCL - ES in JSCs possible, exempt from rules on prospectus/investment; max. discount 10%; financing by firm possible; NTL - SO only taxable when dividend is paid **ESOP:** Trust Act may lead to Trusts similar to ESOPs **PS:** None **Coop:** Law on Cooperatives; coops are exempt from income tax; members pay tax upon receipt of dividend or bonus	**ESO:** Few cases in banking and telecommunications sector **ESOP:** Trust Funds in Bank of Valletta / Malta Telecom **PS:** Only known case: Malta Shipyard Ltd, for 1,761 employees **Coop:** 2000: 58 coops, 4,569 memb., but responsible for 26% of agricultural sales; coops in public sector with 100 members
Poland	**Social Partners:** TU/EA indifferent to FP; managers / employees pragmatically motivated; Lobby groups / Institutions, e.g. banks for ESO **Government:** FP Supported in early privatisation period; ESO in most privatisations, since mid-90's more and more ignored; PS ignored; Coop tolerated, no active support	**ESO:** PrivL - 15% ES for free, subject to a max value of 18 months average salary, non-tradable for two years; *National Investment Funds Programme* 1995 - 15% ES for free; NCL - ES/SPS in JSC possible, financing by firm possible, subject to a max of 10% of equity capital; **EBO:** PrivL - *Lease-Buy-Outs:* instalments at reduced interest rate (50% of bank refinance rate); interest portion of lease rates treated as costs; full transfer of ownership possible after 1/3 of lease is paid; Insolvency Law - buy-out option **PS:** NCL - CPS/SPS in JSCs possible **Coop:** Law on Cooperatives **Employee representation in comercialised firms**: PrivL - 2/5 of supervisory board members (1/3 when the state ceases to hold 100% of the shares); in firms with more than 500 employees one executive board member	**ESO:** Early 1990s: 50% of privatised firms used the leasing liquidation method, mostly SMEs; in mass privatisation, only 13 firms majority EO; marginal EO in large firms (11.4% in 2000) **PS:** Insignificant **Coop**: 2002: 18,682 coops, 2.9% of employment, only 11.8% worker coops
Romania	**Social Partners:** TU support indiv. cases; EA avoid topic; Tripartite council tackled FP sporadically **Government:** ESO supported until 1997 esp. MEBO; then support declined; current government gives little support and has other priorities	**ESO:** PrivL- up to 30% of shares as ES mostly for free, in some cases with 10% discount; NCL- preferential ES in JSCs possible (e.g. financing by firm) **ESOP:** PrivL - A*ssociations of Employee and Managers* engaged in leveraged transaction on preferential terms: payment by instalment, credit with a max. interest rate of 10%; once shares are paid for by members, the association disappears; **PS:** compulsory in State/Municipal firms, up to 5-10% of firm's profit; **Coop:** Law on Cooperatives	**ESO:** ES 10% of shares issued at privatisation, decreasing **ESOP:** By end 1998: over 1/3 of industrial firms, average 65% EO; most frequently used method; 2000: 2,632 firms (1,652 majority ESO) **PS:** Since 2001: 1.2 mil. employees in public sector and state owned enterprises covered, though no. of actual beneficiaries is small **Coop:** 2003: 2,236 active, accounting for 0.2% of employment

Country	General attitude	Legislation and fiscal or other incentives	Incidence of schemes
Slovakia	**Social Partners:** TU/EA indifferent to FP, not a current topic on agendas **Government:** ESOP discussed in 1990; EBO concept failed in 1995; now FP generally ignored	**ESO:** NCL - preferential ES and SPS in JSC possible; max. discount 70%, to be financed by the firm **PS:** NCL - CPS/SPS in JSCs possible **Coop:** covered by NCL - Art. 221 – 260 **Employee representation**: 1/3 of supervisory board members in firms with more than 50 employees	**ESO:** Insignificant, some cases in banking, in few recent privatisations (Slovnaft / Ladce cement firm) **PS:** Insignificant **Coop:** by 2004: 2% of all firms
Slovenia	**Social Partners:** TU/EA very supportive to FP; Employee Ownership Ass. Lobbies for legislation; active support by Works Councils/Managers Ass. **Government:** Strong political support to FP; draft laws 1997/2005 in parliament rejected; long tradition	**ESO:** PrivL - max 20% ES for vouchers, not tradable for 2 years; possibility of an extra 40% for cash; shares for overdue claims; NCL - preferential ES in JSC/LLC possible, max of 10% of share capital **EBO:** possible if additional 40% of shares are purchased by employees; Workers Association can act as representative of employee shareholders (set up in some 4% of cos.); Takeover Law - Workers Association given additional power **PS:** NCL- SPS possible in JSC **Coop:** Law on Cooperatives **Employee representation**: Co-determination Law- 1/3 to 1/2 of supervisory board members; firms with more than 500 employees one executive board member	**ESO:** 90% of privatised firms; CS 1998 60% majority ESO, but accounting for only 23% of capital (18% by 2004, strong decline) **PS:** CS, in statutes of 32% of firms, but unexploited in 22%; for board members 20% of listed firms; **Coop:** 2003: 327 coops, 0.9% of employees, 1.3% of value added, mostly in agriculture ad forestry
Turkey	**Social Partners:** Climate for FP friendly; TU supportive, EA undecided, split; employees interested **Government:** FP issue raised in 1968 Tax Reform Commission; some attention in individual privatisations; 2002 program, lack of concrete measures	**ESO:** PrivL (and decrees) favour transfer to employees and other selected groups, using discounts, credit and instalments; NCL- issuing of preferential ES by JSCs not possible **ESOP:** NCL/CivC '*welfare funds*' or '*mutual assistance funds*' operate with financial support of firm, subject to some restrictions **PS:** NCL/CivC both CPS and SPS possible subject to company meeting certain reserve; **Coop:** Law on Cooperatives	**ESO:** 12 main cases, mainly privatisations: 9-37% ESO, 1case majority EO; some multinational companies **ESOP:** AI: few cases of ESOP-type schemes (Adana Kağıt Torba Sanayii, Teletaş Telekominikasyon) **PS:** in a sample of 50 public firms, more than 80% had PS in Articles of Association **Coop:** 2004: 60,000 active coops, 9 million members (mostly in agriculture)

Source: Country chapters in PEPPER III. Excluded from the study: Management Buy-out, General Savings Plans, Consumer Cooperatives, Housing Cooperatives.

Abbreviations: AI = Anecdotal Information only; CivC = Civil Code; Coop = Cooperatives; CPS = Cash-based Profit-sharing; CS = Case Studies; DPS = Deferred Profit-sharing; EA = Employer Associations; EBO = Employee Buy-out; ES = Employee Shares; ESO = Employee Share Ownership; ESOP = Employee Share Ownership Plan; FP = Financial Participation; JSCs = Joint Stock Companies; MEBO = Management-Employee Buy-out; NCL = National Commercial Legislation; NTL = National Tax Legislation; PrivL = Privatisation Legislation; PS = Profit-sharing; SO = Stock Options; SPS = Share-based Profit-sharing; TU = Trade Unions.

II. Employee Ownership – Western Lessons for the Eastern New EU Member States

Milica Uvalić

1. Introduction

Forms of employee participation in enterprise results (or employee financial participation), through profit-sharing, employee share-ownership, or both, have attracted considerable attention over the past few decades. Growing interest in these schemes has been present not only within academic circles, but also among politicians and governments, trade union organisations, employers' and other associations. The theoretical debate on the potential benefits of employee participation in enterprise results, together with the desire to introduce greater flexibility in payments systems and the commitments to a property-owning democracy, have led some governments to adopt measures actively stimulating their adoption, which in turn has contributed to the growth of such arrangements in practice. In the four largest EU countries, some 19% of private sector employees are covered by financial participation schemes (see Pérotin and Robinson, 2003). Parallel with such developments in individual countries, the Commission of the European Communities (CEC) decided to include employee financial participation among the priority objectives of its Action Programme for the implementation of the Community Charter of Basic Social Rights of Workers (see Commission of the EC, 1989). This initiative led to the preparation of the PEPPER Report (Uvalić, 1991), reviewing the experience with financial participation in the EC countries, and an EU Commission's Recommendation on PEPPER which was adopted by the European Council in July 1992, inviting Member States to facilitate the spreading of PEPPER schemes in practice (Council of EC, 1992). The information on individual EU countries experiences was updated in the Commission's Report PEPPER II (Commission of the EC, 1997). More recently, an initiative was launched by the European Commission and the European Parliament, as expressed in the opinion of the Economic and Social Committee of February 26, 2003 on the Commission's communication 'On a Framework for the Promotion of Employee Financial Participation' (see Lowitzsch, 2004).

Among the main reasons for the active support of PEPPER schemes by the European Union (EU) is the conviction that they are likely to have beneficial effects, particularly on workers productivity. The EU's main competitors, the USA and Japan, have for years been considered to have profit-sharing and employee ownership schemes of a more substantial scale than the EU countries, although some recent estimates suggest that there may be more schemes in the EU than elsewhere (see Pérotin and Robinson, 2003). Particularly today, in view of the EU objectives laid down at the Lisbon (2000) and Barcelona (2002) European Councils, of making the EU the most competitive and dynamic knowledge-based economy in the world, any scheme that has the potential of contributing to increasing enterprise competitiveness in the EU Member States is clearly of paramount importance.

An interest in some PEPPER schemes has also emerged in transition economies in Central and Southeast Europe (CSE) - the new EU Member States (NMS), EU Candidates and potential candidates - though quite independently of the described developments in the EU. Following the radical political and economic changes in CSE in 1989, in many countries the privatisation process has led to the widespread diffusion of employee share-ownership. The other form of employee financial participation – profit-sharing – has been implemented much less frequently, usually on a purely *ad hoc* basis, and only in a few countries has specific legislation been proposed (e.g. Slovenia). It appears that the rich experience with PEPPER schemes in Western market economies is not sufficiently known in CSE countries, which is one of the principle reasons why the adoption of specific policy measures on PEPPER has not been considered by the post-1989 CSE governments. There have also been misinterpretations of some types of schemes, employee ownership in particular, and rejections on the basis of ideological arguments.

The present chapter tries to bridge this gap, by pointing to the main lessons that CSE countries could learn from the much longer experience with employee financial participation in Western economies. It focuses primarily on employee ownership as the principle type of scheme present in CSE countries, though part of the analysis refers to the broader category of employee financial participation. Starting with the Western experience (section 2), we discuss the principal forms of employee ownership (2. a); the main theoretical arguments advanced in favour and against employee financial participation (2. b); and empirical evidence on the effects of various types of schemes (section 2. c). Although the theoretical arguments and the empirical evidence are far from new, they are worth recalling precisely because they have not been considered sufficiently in reference to transition economies. As to the experience in CSE countries (section 3), we briefly recall the important role that employee ownership has played within the privatisation process (3. a); examine the main problems which are expected to arise in case of dominant employee ownership (3. b); and present some findings based on empirical evidence (3. c). The principle conclusions regarding the different experiences are drawn at the end (section 4).

2. Employee Ownership in Western Market Economies

a) Forms of Employee Ownership

In developed market economies, employee ownership is present in very different forms and in various organisational types of enterprise, sometimes in combination with employee participation in decision-making. In discussing these various forms, it is important to distinguish between the workers' cooperative and the more conventional forms of enterprise (joint-stock company or other), because of different implications for enterprise governance.

1) In the *workers' cooperative*, there can be up to 100% participation of workers both in enterprise results, through profit-sharing and workers ownership, and in decision-making. Workers members have full decision-making rights over major enterprise decisions, and membership usually also implies some form of workers' share-ownership - through the payment of an entry fee, subsequent loans of individual capital, or other types of investment of private savings. What distinguishes the cooperative from a joint stock company is that workers control over major decisions is assured irrespective of capital contributed, since voting rights are not linked to individual members' capital stakes, but to membership, usually on the basis of one man, one vote.

2) In the *traditional firm*, the two forms of participation - in enterprise results and in decision-making – are more limited in scope and usually do not coincide (as in the workers cooperative). The forms most frequently encountered are profit-sharing and minority employee ownership, whereas decisional participation may, but need not necessarily be present. In other words, forms of employee decisional participation, such as workers councils or systems of co-determination, exist independently of employee ownership.[13]

Employee ownership in traditional firms is by far the more diffused form in Western economies, as the incidence of workers' cooperatives remains small relative to conventional organisational forms (Bonin, Jones and Putterman, 1993). In traditional firms, workers' shareholding can either be part of a profit-sharing scheme, or be introduced independently of realized profits (though still indirectly linking employee income to enterprise results). Of the two forms, employee ownership is the one which is more frequently encouraged by Western governments, usually through fiscal benefits for both enterprises and employees (see Uvalić, 1991).

The majority of *profit-sharing* schemes in both the EU and the USA are of a deferred type, assuring employees, in relation to profits or some other measure of enterprise performance, a portion of shares of the enterprise where they work. These shares are usually frozen in a fund for a certain period of time, after which workers are allowed to dispose of them. Alternatively, a certain percentage of profits is directed to an enter-

13 Many US companies have ESOPs, but workers are frequently not involved in meaningful decision-making. In Europe, workers are sometimes given non-voting shares of their enterprise.

prise fund, which is then invested for the benefit of all employees, most frequently in shares or other securities.[14]

There are a number of specific *employee share-ownership* schemes in Western market economies, which provide for employee participation in enterprise results on the basis of their participation in property, either through the right to receive dividends, and/or through the appreciation of employee-owned capital. While such schemes are not directly linked to enterprise profits, they are related to enterprise profitability as they enable participants to gain from the growth of company profits. Typically, a portion of company shares is reserved for employees and offered on sale at privileged terms (priority in subscribing shares in public offers, discounts with respect to the market price, deferred forms of payment), most frequently within general privatisation measures. Alternatively, the enterprise may distribute shares freely to its workers, sometimes with the direct support of the government through state subsidies. A specific arrangement applied in the UK, combining sales with the free distribution of shares to employees, is the so-called BOGOF scheme - buy one, get one free - which ensures that employees receive a free share for each one purchased. Employees may also be offered options to buy their enterprise's shares under favourable fiscal provisions; sometimes this is done in combination with special savings plans, as in SAYE ('Save-As-You-Earn') schemes promoted through fiscal incentives in the UK since 1980. Another possibility is the setting up of an employee benefit trust through Employee Share Ownership Plans (ESOPs), which acquires company stock that is allocated by periodic payments to each employee's ESOP account.[15] A further form is an employee-management buy-out, when an enterprise in difficulty is taken over by its management and employees, sometimes with the help of special loans. There are also external share-ownership schemes offered to the whole population (e.g. Personal Equity Plans in the UK), but these do not provide for employee ownership in the enterprise of employment.

Employee ownership schemes therefore provide employees with their enterprise's shares either automatically (through deferred profit-sharing, ESOPs, free distribution of company shares), or through voluntary employee purchases of enterprise shares. Since these schemes in many cases overlap, they have frequently been treated jointly in the literature. The generic term 'employee share-ownership' is used to denote both share-based profit-sharing and employee ownership. Similarly, 'profit-sharing' is frequently used in reference to both cash bonuses linked to profits and share-based profit-sharing schemes. The distinction between individual and collective employee ownership is also not always clear cut, as they are not mutually exclusive: certain individual shareholding schemes which envisage shares being held in a trust bear similarities with a collective scheme offered to all workers; while certain collective schemes,

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14 This is, for example, the case of the French scheme on employee participation in company growth, which has been introduced in 1967 and has for years been obligatory in all enterprises employing more than 50 workers.

15 ESOPs have been especially popular in the USA, but have also been promoted by the UK government in 1989. On the history and different types of ESOPs, see Wilson (ed.) (1992).

offered to all employees, in practice involve only a limited number of individuals (Uvalić, 1991).

b) Employee Financial Participation: The Theory

Which are the main arguments that have been advanced in favour and against employee financial participation? Whereas the advantages proposed in the theoretical literature generally apply to both organisational forms with employee ownership - the workers' cooperative and the conventional firm - the potential drawbacks are somewhat different, since the workers' cooperative is expected to face some additional problems. These arguments are equally relevant for CSE countries considering the introduction of employee financial participation schemes, despite having been proposed by scholars in reference to mainly developed market economies.

(1) Potential Advantages

In the vast theoretical literature, several arguments have been put forward in favour of employee financial participation. Although traditionally the main arguments in favour of financial participation were motivated by objectives such as greater equality in the distribution of income and wealth, and improving relations between workers and capitalists, today these schemes are considered as part of a new culture of industrial relations based on innovative managerial strategies and more flexible remuneration policies, which should ultimately result in increased enterprise efficiency. As stressed by Hansmann (1990), there has been an unusual convergence of economic thought from opposite ends of the political spectrum. On the left, with the collapse of state socialism as an economic ideal, workplace democracy has emerged as the principal institutional reform that today commands widespread support among critics of capitalism; employee control of enterprises, it is hoped, will succeed where state control has failed in equalizing power and wealth and in decreasing worker alienation and exploitation. On the right, in turn, there has been an increased discouragement with the efficiency of traditional forms of labour-management relations, and in search of an alternative, many have turned to employee ownership (Hansmann, 1990, p. 1751). Minority employee ownership within traditional firms has been accepted also by influential international organisations, such as the IMF or the World Bank. Its advantages are particularly stressed within the context of property owning democracy (or peoples' capitalism), which ought to ensure more widespread ownership than traditional capitalism.

The main arguments in favour of financial participation are all closely inter-related and mainly concern the expectation that it will improve *workers' incentives*.[16] The incentive argument has been applied to all schemes which link some measure of enterprise performance to employee income, thus encompassing both profit-sharing and employee

16 There is an enormous literature on these arguments. For a survey, see Bartlett and Uvalić (1986), Bonin and Putterman (1987) or Uvalić (1991).

ownership. The change from a rigid system of guaranteed wages in which rewards are independent of effort, to a system which provides employees with a part of income directly linked to enterprise performance, will increase individual motivation and commitment, and will provide for greater identification of employees with the interests of their firm, thus resulting in higher labour productivity and improved overall enterprise efficiency. In employee ownership schemes, by receiving dividends, or through the appraisal of the value of their shares, employees will be more interested in enterprise performance.

There is disagreement among scholars, however, which of the two is likely to have major effects on employee motivation. Some scholars have stressed that the incentives argument is actually more applicable to employee ownership than to profit-sharing (Conte and Svejnar, 1990), while others consider that the link between profit-sharing and productivity is stronger (Bonin, Jones and Putterman, 1993). Conte and Svejnar (1990, pp. 153-154) justify their view by arguing that it is not always in the interest of the firm to increase current profits. When a firm needs to invest heavily in new technology in the present to ensure future profitability, in the early years of such an investment profit-sharing may provide few benefits to employees because accounting profits are low; by contrast, such an investment should increase stock prices in the early years, thereby providing the correct incentives to employees shareholders.

Making employees partial owners of the firm may improve the system of *monitoring* individual workers. Although each individual worker will bear only a small fraction of the costs of his own shirking, he/she will also have an incentive to monitor his/her fellow workers and to apply pressure to them not to shirk (Hansmann, 1990, pp. 1761-2). Consequently, more cooperative behaviour is to be expected, and the possibility of mutual monitoring of effort levels by workers themselves, thus reducing monitoring costs (see FitzRoy and Kraft, 1986, Weitzman and Kruse, 1990).

Employee ownership can also induce *wage moderation*. Enterprises introducing employee ownership may be able to offer lower wages, since workers will be receiving a part of their income as shareholders. The wage that management must offer workers to persuade them to accept it will be lower if employees are likely to lose capital gains and dividends by rejecting the wage offer. This may in turn lead to less variable employment policies, which can lower the risk of unemployment.[17]

Employee ownership can thus *lengthen the duration of employment contracts* and reduce labour turnover. Although job security will foster labour immobility, the firm will in turn gain employee trust and identification with the interests of the firm. Because of higher employee commitment, we can also expect lower employee absenteeism and increased interest in education and training, thus higher investment in firm-specific human capital.

17 Although the employment argument is also applicable to employee ownership, it was advanced primarily for profit-sharing by Martin Weitzman in his famous (1984) book, which provoked a very lively theoretical debate on profit-sharing.

Employee ownership can also *reduce inequality* in the distribution of income and wealth, thus leading to reduced intra-firm conflict. Mechanisms uniting the interests of workers and management, by giving everyone a stake in the outcome, are likely to reinforce productivity-enhancing workplace behaviour. Employee ownership can also provide for a more equal distribution of risk: forms of partnership in which both capital and labour share the risks of success and failure hold out more promise than other forms in which labour or capital bears the whole of the risk (Meade, 1972, 1989).

The problem of the *separation of ownership and control* could potentially be much less acute in firms based on substantial employee ownership (Hansmann, 1990, pp. 1768). In the traditional firm, investors of capital are often widely dispersed and are frequently not in a position to control the firm's management; by contrast, in a firm with employee ownership, workers have a personal stake in the capital of the firm and also dispose of important information about the firm simply as a by-product of their employment.

(2) Potential Disadvantages

Scholars critical of employee financial participation have argued that it may lead to a number of specific problems, ultimately resulting in enterprise inefficiency. These negative effects are expected in all types of firms, including the traditional firm with minority employee shareholding, and are not specifically related to the presence of employee decisional participation. However, if along with employee participation in ownership, decisional participation is also present, some additional problems are expected to arise. We will first consider the general drawbacks of employee financial participation, and then point to further problems which may arise in case an enterprise is fully controlled by its employees.

Within *general drawbacks,* the first is the *free rider problem,* i.e. of individual incentives becoming diluted in a group setting where rewards are linked to group effort. Since each worker will receive only a small fraction of any additional income due to his own effort, workers will be tempted to free-ride, shirking and on-the-job leisure will be encouraged, and difficulties in monitoring a single worker's contribution will arise. Consequently, it is argued that we can expect a lower level of effort and productivity, negatively related to the number of employees, along with additional monitoring costs.

A further argument against employee financial participation, advanced by scholars belonging to the Property Rights School,[18] is that it *weakens property rights.* Forms of economic democracy represent a continuing erosion of property rights, the transfer of wealth from owners of capital to workers, thus representing a purely distributive wealth confiscation scheme. This will lead to the dilution of the capitalist's incentives and may compromise their motivation, discretion, power, or authority. Such arrangements may also lead to increased workers' demands for participation in decision-making, which will further weaken the authority of capitalists and effective managerial control.

[18] Including A. Alchian, H. Demsetz, E. Furubotn, J. Jensen, W. Meckling, S. Pejovich.

Employee ownership will also expose workers to a *high degree of risk*. Because of the physical impossibility of diversifying the use of their labour in different sectors and enterprises (as capitalists can do with their capital), by putting 'all eggs in one basket', workers will not only bear the risk of unemployment but will also face additional income risk; thus if the firm goes bankrupt, they will lose not only their jobs but their savings as well (Meade, 1972).

In addition to the above general drawbacks, there are some further problems which may arise in case enterprise workers have full decision-making rights, as in the case of the *workers' cooperative*. The theoretical literature on the labour-managed firm (LMF), which has been developed in reference to both the Western cooperative and the Yugoslav self-managed enterprise, suggests the presence of a number of inefficiencies.[19] These problems of the LMF need to be recalled, since they have been frequently mentioned also in reference to the insider-owned and/or controlled enterprise in transition economies.

It should immediately be stressed, however, that the problems do not derive from employee ownership, but rather from the lack of it. In the Yugoslav LMF, no individual employee ownership was ever permitted, since enterprise capital was in social (non-private) property, intended as property of the whole society. In the workers cooperative, we usually find some restrictions on the appropriability of enterprise capital. The problems of the LMF arise because decision-making rights, and therefore full control of major policy decisions, are in the hands of workers. Control rights follow from membership in the firm's workforce, whereas capital ownership by itself confers no decision-making rights.

Short-term inefficiencies include *restrictive employment policies*, parallel with the maintenance of above-optimal employment levels because of the reluctance to lay-off workers; *inefficient allocation of labour*, due to the rigid response of the LMF to changes in product price, technology, and capital rental; *more restrictive monopolistic behaviour* (see Ward, 1958, Vanek, 1970). Medium and long-term inefficiencies mainly derive from the LMF's limited property rights - non-private ownership or restrictions on profit and/or capital distribution – and include a bias against the reinvestment of net income in the enterprise (the *underinvestment* or the Furubotn-Pejovich effect, first proposed by Pejovich, 1969), and distortions in project selection in favour of projects paying off quickly, due to workers' short time horizons. We can also expect specific *problems of finance*. The LMF will have to borrow funds on the capital market, which is likely to lead to its high dependence on external finance. This in turn may cause the principal-agent problem, i.e. conflict between the owner of capital and its user; and the moral hazard problem, arising from the risk associated with debt finance. The cooperative may lack the incentive to operate successfully if in risky situations a substantial part of the losses can be avoided by bankruptcy, so lending to a cooperative may involve a

[19] For a survey of the LMF theoretical and empirical literature, see Bonin, Jones and Putterman (1993) or Bartlett and Uvalić (1986).

higher degree of risk. Consequently, the cooperative will be unsuitable outside labour-intensive sectors and for risky ventures (see Nuti, 1988).

Further developments of the theory have suggested that under alternative assumptions, many of the alleged short-term inefficiencies could be avoided. Similarly, the problem of underinvestment applies primarily to cases of limited property rights, whereas restrictions on the appropriability of capital are present only in some types of cooperatives and in some countries (see Uvalić, 1992). In the practice of workers' cooperatives, many of these problems have been successfully overcome through specific institutional arrangements, and empirical studies have shown that many theoretical propositions have not been verified.

Some problems are still likely to be present in the worker-controlled firm. The most serious is the problem of finance. Workers cooperatives frequently face serious obstacles in raising outside capital, which is probably the main reason why cooperatives have spread primarily in labour-intensive sectors and those which involve a low degree of risk, and why the cooperative has been a minority, rather than the dominant, organisational form. In any case, the discussed problems could occur primarily if an enterprise is fully controlled by its employees, and their presence is not necessarily related to specifically employee ownership which can also be rather low, or even inexistent.

c) Employee Financial Participation: Empirical Evidence

In evaluating the positive and negative effects of employee ownership, we will present two sources of evidence: econometric studies and less formal evidence based on general information, attitude surveys or case studies. Although econometric studies do represent a more objective source of evidence, they should also be interpreted cautiously because of a number of methodological problems amply stressed in the literature.[20]

(1) Econometric Evidence

A study by D. Kruse (1993) provides a comprehensive survey of some 26 formal empirical studies based on econometric evidence on the link between employee participation in enterprise results and productivity. In a total of 265 estimated coefficients measuring the effects of profit-sharing on productivity, only 8.3% take on a negative value; by contrast, 91.7% of the coefficient estimates are positive, with 57.4% having t-statistics greater than +2. A fairly strong general conclusion therefore emerges, namely that profit-sharing is positively related to productivity. The average productivity in-

[20] There are a number of methodological problems, including the high sensitivity of results to model specification, indicators actually used and estimating techniques; difficulties in isolating the effects of employee ownership from other organizational factors; a potential estimation bias due to endogeneity and the selection of variables; ambiguity concerning the direction of causality (e.g., whether high profitability favours the introduction of profit-sharing, or profit-sharing actually increases profitability); and so forth.

creases were found to be larger for small companies and for companies adopting cash plans. These results have been confirmed in information provided in PEPPER II (Commission of the EU, 1997) and are essentially very similar to more recent findings reported in Pérotin and Robinson (2003).

The effects of profit-sharing on employment, through greater wage flexibility, are much more debatable. Whereas some early evidence for the UK and France suggested that profit-sharing has a positive and significant effect on employment (see Bradley and Estrin, 1987; Vaughan-Whitehead, 1992), more recent estimates show that the size of the effect may not be very large and may even be non-existent. On the basis of fifteen econometric studies, Kruse (1993) concludes that there is some evidence of profit-sharing being associated with greater employment stability. More recent evidence is also rather mixed, and does not support a clear conclusion on a positive link between profit-sharing and employment (Pérotin and Robinson, 2003).

The evidence on specifically employee share-ownership is reported in a survey by Conte and Svejnar (1990). The first group of econometric studies, based mainly on US firms with ESOPs, offers contradictory results. Some studies suggest a large positive and significant ownership effect, others show that ESOP firms outperformed non-ESOP firms, while still others found the effect of ownership to be negligible. The authors' conclusion is that ownership does not decrease the level of company performance; but whether employee ownership through ESOPs actually aids performance remains unclear, since the results vary depending on equation specification (Conte and Svejnar, 1990, p. 171). As to the evidence in the non-ESOP context, a number of econometric studies have been undertaken, mainly using data from workers' cooperatives. This evidence is generally more supportive of a positive link between worker's ownership and productivity (see Conte and Svejnar, 1990). In a sample of German firms, the productivity effect of employee ownership was found to be insignificant; but when the sample was divided into firms with high and low degrees of workers' participation in management, the effect of ownership was found to be significantly positive in the high-participation firms and significantly negative in those with little participation, suggesting the importance of decisional participation. The results of a similar study on Italian cooperatives suggest that individual worker ownership has significant positive productivity effects in manufacturing, but not in the construction sector (Jones and Svejnar, 1985). A study on British cooperatives suggests varying effects of worker ownership on productivity, ranging from positive to insignificant (Estrin, Jones and Svejnar, 1987).

(2) Evidence Based on Informal Studies

Many informal studies have shown that the incentive effects of employee financial participation will largely depend on the detailed design of the scheme, specific historical circumstances, organisational and other characteristics of the firm in which it is implemented. Nevertheless, the experience to date suggests that cash profit-sharing may have had more significant incentive effects than share-based schemes, supporting the hypothesis on workers' risk-aversion. In some of the surveys undertaken in different European countries, cash profit-sharing was by far the most popular scheme, while the main objective expected from deferred profit-sharing and employee ownership, of increasing workers' involvement as shareholders, has in many cases not been attained. This conclusion seems to be supported by the less than maximum involvement rates of employees in voluntary capital participation schemes in Germany or the UK, and the frequent practice in France or Britain of workers selling their shares as soon as they were allowed to.

The greater incentive effects of cash-based, in comparison with share-based schemes, is probably due to the fact that in employee ownership arrangements in some European countries, some important elements were frequently missing: e.g. adequate channels of informing workers about the scheme; or, due to the practice in some countries of giving employees non-voting shares, assuring workers some say in decision-making (Uvalić, 1991). However, provided they are property designed, employee ownership schemes could not only have similar motivational effects as cash schemes, but could also provide longer-term commitment of employees. Some scholars have pointed to cases in which share-based schemes may provide not only the right incentives, but would even be preferred (see Conte and Svejnar, 1990).

Looking further at the evidence from the two European countries - France and the UK - we find contradictory findings. In France, some employee ownership schemes have had very limited success (eg. Renault), as most workers had sold their annual quota as soon as they were allowed to. In 1986, when the French government decided to privatise a dozen large state holdings,[21] around 10% of shares were reserved for employees; though most shares were subscribed, they were bought primarily by executives, while the few employees who did subscribe, did so for purely speculative reasons. There have also been successful examples of employee buy-outs, such as the large watch manufacturer LIP, the Manuest furniture factory, and Moulinex. The French Cooperative Federation has been encouraging workers' buy-outs of not only firms in difficulties but also of sound companies, and during the 1980s there have been about 10-20 such buy-outs per year.

In the UK, in a 1987 survey on workers' preferences, where the choice between cash bonuses and shares was available, 80% of employees chose cash; but in firms which only had share-based schemes, 73% of workers answered that even if the cash option were available, they would still prefer receiving shares. In the privatisations of big public companies in the 1980s (Rolls Royce, British Airways, Cable & Wireless, British Gas), which envisaged special conditions for sales to employees, there was an extremely high response, leading to a rapid increase in the number of employee shareholders. Various empirical studies of employee management buy-outs in the UK have

[21] These included the industries Saint Gobain and CGE, banks such as Société Général and Crédit Commercial de France, financing institutions such as Suez and Paribas, and mass media such as Tfl and Havas.

shown that after the buy-out, enterprise performance has significantly improved (Wilson, 1992, pp. 168-172).

3. Employee Ownership in Central and South Eastern Europe

In comparison with the Western experience, employee ownership in Central and Southeast Europe (CSE) has emerged in a very different context: not as part of innovative managerial strategies aimed at strengthening employee incentives, but as a consequence of privatisation of a large number of previously state or socially owned enterprises. Due to specific circumstances which prevailed at the beginning of the transition, in many CSE countries, privatisation has led to employed workers and managers (or 'insiders') becoming significant, sometimes majority, shareholders of their firms. We will point to the main reasons why employee ownership has played such an important role in most CSE countries, recall the problems which are expected to arise in case of dominant employee ownership, and give some reasons why the alleged problems have not been as serious as has been initially assumed, based on both theoretical arguments and conclusions of the empirical literature on transition.

a) The Role of Employee Ownership

Privatisation has been the focal point of radical economic reforms implemented in CSE since the beginning of the transition to a market economy in 1989. Precisely because of its importance, it has also been one of the most debated issues, both during the early years of transition, in an attempt to define the most appropriate privatisation strategy in each country, and today, in light of a number of issues which remain controversial. The results of over ten years of privatisation have in several ways diverged from initial expectations. To a large extent, this is the consequence of excessive optimism which dominated the transition debates in the early 1990s. Privatising the bulk of an economy in a relatively short time span was an experiment without historical precedents and there were no blueprints on how to implement privatisation of such a large scale. The general economic conditions were not very favourable for implementing privatisation: property rights in many cases were not well defined, stock exchange markets were only emerging, capital markets were thin and undercapitalised, while the economic crisis of the early 1990s had greatly reduced savings, resulting in general unavailability of domestic financial capital, which in most cases has not been supplemented by substantial inflows of capital from abroad.

Although privatisation strategies of individual countries were usually based on a combination of different methods and techniques, the specific conditions which prevailed in CSE in the early 1990s explain why in practice, mass privatisation and employee-management buy-outs have been the most frequent methods, while a relatively small number of countries had initially relied on conventional sales to outside owners as the dominant privatisation method. Due to the heavy reliance on these two methods of privatisation, a large number of firms in many transition economies ended up being either in the hands of insiders (e.g. Bulgaria, Croatia, Estonia, Hungary, Macedonia, Poland, Romania, Russia, Slovenia, Serbia and Montenegro, Ukraine), or ownership was dispersed among a very large number of small outside shareholders and a few investment funds, in which state-owned institutions have sometimes remained the most important single shareholder (e.g. the Czech Republic, Slovakia).

It should be stressed that many CSE governments did not actually have the intention of actively stimulating substantial employee ownership, though in most privatisation laws the sale of shares at privileged conditions to insiders was usually included among the possible methods. This was done mainly for political reasons, as it was important to obtain wide support for privatisation by the working classes, particularly in countries with a long tradition of workers participation - not only former Yugoslavia and later its successor states, but also Poland and Hungary. Employee ownership has emerged as an important channel of privatisation for additional reasons. Given the general shortage of domestic capital, employees were usually in a better position with respect to other domestic buyers - not because they had more capital, but because they had better chances to buying their firms than would have been the case if domestic capital was abundant among outsiders. Insiders also possessed important inside information about their enterprise; external potential buyers felt even more uncertainty than insiders about the possibility of transforming state-owned firms into well-performing enterprises. Insufficient foreign direct investment has also greatly contributed to the frequent use of employee ownership as a privatisation method. These reasons explain why insiders frequently turned out to be the only potentially interested buyers of enterprise shares; by becoming shareholders, they hoped to be able to prevent their firm going bankrupt and thus preserve their jobs, and also had most to lose if no improvement occurred in their enterprise.

So despite the marked differences in the specific provisions of privatisation laws in individual CSE countries, in practice the privatisation process has led to similar results. Employee ownership has been a frequent outcome of the privatisation process in a large number of CSE countries and in many firms insiders have ended up being majority owners. Existing empirical evidence from the 1990s from 15 transition economies confirms these trends on the diffusion of employee ownership in many CSE countries, with few exceptions (see Uvalić and Vaughan-Whitehead, 1997). In a number of countries substantial insider ownership persists even today, a decade or more after privatisation (see Jones, 2004). What are the problems which are expected to arise from such diffused ownership by insiders?

b) Insiders Ownership: The Alleged Problems

Formal economic theory is found to yield no clear-cut predictions concerning the preferred form of ownership in transition economies (Jones, 2004, p. 174). In the early years of transition, there was a rich debate on the advantages and disadvantages of various privatisation methods. At that time, many scholars and policy makers have argued that improved company performance and the introduction of efficient corporate governance mechanisms would be easier in case of outside owners – including domestic firms or investment funds - than insiders (see Blanchard et al., 1991; Frydman, Gray and Rapaczynski, 1996; World Bank, 1996). Conversely, a number of adverse effects were anticipated in enterprises owned by employees, including the distribution of excessive wages, maintenance of above-optimal employment, and underinvestment, which in turn was expected to create obstacles to efficient restructuring, impede access to outside risk capital, discourage foreign investors and the inflow of fresh capital (Blanchard et al., 1991; Aghion and Blanchard, 1998). In reference to privatisation in Russia, Ash and Hare (1994, p. 620) note: 'The result of increased worker and management ownership is likely to be that Russian enterprises will develop more along the lines of the Yugoslav worker self-managed model rather than of Western-style holding model. In terms of the likely impact of privatisation on efficiency, the Yugoslav model suggests only a slow improvement'. These problems were sometimes also related to the fact that both of the most frequently used privatisation methods - mass privatisation and employee ownership - have failed to ensure the initial establishment of a strategic owner: of a single shareholder with sufficient stake to provide motivation for monitoring effectively (see Estrin, 2002, p. 111).

In response to these claims that widespread ownership by insiders in CSE would imply the presence of a number of specific problems, a lively debate on 'employeeism' developed in the second half of the 1990s, which tried to clarify the issues and propose some counterarguments (see Nuti, 1995; Uvalić, 1996; Uvalić and Vaughan-Whitehead, 1997; FitzRoy et al., 1998). Although these arguments are not new, the most essential elements of the debate ought to be recalled, since they offer a possible explanation why empirical evidence has frequently not confirmed the proposed theoretical drawbacks of employee ownership.

The divergence in interpretations derive, in the first place, from the misinterpretation of the traditional arguments against the employee-controlled firm, as known from the literature on the LMF; despite the apparent resemblance, there are fundamental differences between the privatising firm in CSE and the LMF. In addition, there are further reasons why the alleged drawbacks of employee-owned firms will not always be present, but only under certain conditions.

(1) *Differences between the LMF and the CSE privatising firm:* Most of the mentioned problems of the employee-owned firm are well known from the literature on the LMF, but comparisons with the LMF are unwarranted (Uvalić, 1996). The CSE privatising enterprise differs from the LMF in several important ways, both the Western cooperative and even more the Yugoslav LMF. The most important difference between the privatising CSE enterprise with employee ownership and the Yugoslav-type LMF is that in the pre-1989 Yugoslav firm the most essential element - individual employee ownership - was non-existent. According to regulations in SFR Yugoslavia, enterprise capital was in social property, so employed workers had no individual private capital stakes in

their firm. What the self-management system gave workers in former Yugoslavia were *usus* and *usus fructus* rights (the right to use socially-owned assets and to appropriate the proceeds) together with substantial decision-making rights (control over important decisions), but even these rights were severely restricted by government regulations.[22] Comparisons between the two types of firms are therefore highly misleading: by incorrectly identifying enterprises with employee ownership with the Yugoslav LMF, employee ownership is being mistakenly confounded with employee control. Such interpretations derive from the lack of knowledge of the main features of the Yugoslav LMF.

There are also important differences between the privatising CSE enterprise and the Western cooperative. First, enterprises in most CSE countries have been privatised only partially through the transfer of property to insiders, among other reasons because most laws imposed a limit on employee acquisitions at preferential terms.[23] Second, not always have all employees participated in such privatisations but only a subset of them, since subscriptions were most frequently voluntary, left to the discretion of the individual worker. Third, employee ownership has not always led to their full control over enterprise decisions; the practice in some countries (e.g. Estonia) has been to sometimes give employees non-voting shares or shares with limited voting rights; or in Russia, employees have frequently ended up owning the majority of shares, but the active owners have been managers with often less than a fifth of the shares. Therefore, the privatising enterprise in CSE, rather than being fully owned and controlled by all its employees, will more frequently be characterized by less than 100% insiders' ownership and control. In this case, whether and to what extent the adverse effects will be present in the privatising CSE enterprise, will depend on a number of additional elements.

(2) *Ownership vs. control.* The mentioned problems do not depend primarily on whether insiders have acquired a majority stake, but on whether they hold a controlling interest. Insiders can have control without majority ownership, especially if ownership of the remaining shares is dispersed among outside shareholders (see Earle and Estrin, 1994). Insiders can also have majority ownership but without effective control. Apathy by outside shareholders may allow insiders to control enterprise activities even for substantially less than a majority holding, whereas employee shareholders apathy may make a 60% shareholding by employees insufficient to exercise a controlling interest.

(3) *Insiders controlling interest & inefficiency.* If insiders do obtain a controlling interest, the insider-controlled enterprise may be faced with unique incentive problems, similar to those of the LMF. However even in this case, some further elements are important in determining the actual outcome. The most important is the individual employee's

22 E.g. on the distribution of income (minimum accumulation rates, limits on increases of personal incomes, the obligation to maintain the value of social capital through depreciation, etc.), as well as by numerous informal channels of limiting enterprise autonomy (see Uvalić, 1992).

23 While the limit should not, in principle, prevent employees in buying additional shares under conditions offered to other (external) buyers, in practice employees have usually limited their acquisitions to shares offered at privileged terms, since they could not afford to buy additional shares.

share in enterprise equity, as compared with his share in the firm's wage bill. Nuti (1995) has convincingly argued that an employee's short-term interests as a wage-earner are likely to prevail over his longer-term interests as a shareholder only if he/she has a lower share of company equity than of labour input supply. The individual employee, who has the double role of a worker and a shareholder, will realize a net gain from a wage increase only under the condition that Li/L is larger than Ki/K, where Li and Ki are the individual employee's supply of total labour L and total capital K respectively. The problems hence arise not from a controlling interest by insiders per se, but from a controlling interest being in the hands of employees who have a lower share in company equity than in labour input supply (Nuti, 1995).

The proportion between the number of insiders shareholders and non-shareholders could also crucially determine the balance between insiders' short-term and longer-term interests. If not all insiders are shareholders, there may be cases where the employee interests as shareholders (rather than as wage-earners) will prevail. In general terms, for a given proportion of equity in the hands of insiders, the less numerous are employee shareholders, the higher will their individual holding be and conversely the more likely is the prevalence of their longer-term interests.

The distribution of ownership and control between various categories of insiders - namely employees and managers – is also important. In case enterprise shares are mainly bought by managers, as has frequently been the case (e.g. Estonia, Hungary), they may indeed behave in the interest of other (external) shareholders. In Western economies, managers are frequently given performance-related bonuses in the form of enterprise shares (or options on shares) precisely in order to ensure that they do behave in the interest of other shareholders; if management is not efficient, there is a tendency for control of the firm to change hands.[24]

Therefore, the alleged problems of employee ownership in CSE countries are conditional on a number of elements, which frequently have not been taken into account. Some further convincing arguments why employee ownership may indeed be a welcome option are also given by Earle and Estrin (1995), and Uvalić and Vaughan-Whitehead (1997).

It has also been stressed that enterprises with insiders controlling interest are probably unstable, as in the course of time insiders will cease to be insiders (by leaving, retiring or dieing), cease to be shareholders (by selling), or cease to be guided by their short-term interests as wage-earners (by buying enough shares); or else the enterprise may suffer from lack of capital and shrink or collapse (Nuti, 1995).

Remedies also exist, such as stipulating a minimum large enough capital stake by insiders, reducing the votes that insiders can exercise individually or collectively, or giving them non-voting shares (as in fact has been the case in some CSE countries). Another solution proposed by Aoki (1995) is an external monitoring mechanism of the insider-

24 Still, this principle may not be fully applicable in CSE, since some important institutions are still non-existent, such as competitive markets for managers, or laws protecting minority shareholders.

controlled firm performed by a lead bank, which may work even if insiders are the dominant stockholders. The model shows that sound banking institutions can be designed to play an effective monitoring role in the corporate governance structure of insider-controlled firms. In case of non-performance, the control rights would shift automatically from the insider to the outsider (the lead bank of a consortium).[25]

c) Empirical Evidence on Employee Ownership in CSE

Today we dispose of a large empirical literature on privatisation in transition economies, also based on econometric evidence. Whereas earlier evidence on post-privatisation enterprise performance tended to lump together all private firms irrespective of specific ownership form and compare their performance to that of non-privatised firms, more recent studies have tried to take into account the different ownership outcomes. Despite a growing body of empirical literature on the effects of privatisation, there are still many questions which have not received sufficiently convincing or complete answers. One of these questions regards the link between the method of privatisation and post-privatisation enterprise performance. There is still some controversy about whether and in what ways the method of privatisation used in transition countries has been a significant factor differentiating the performance of privatised firms (see Blaszczyk et al. 2003).

In reference to the previously raised issues, two main conclusions can be drawn from the last ten years' experience in CSE countries with employee ownership. First, there is growing evidence from a number of countries that in many privatised enterprises which initially had dominant employee ownership, employees today no longer hold a controlling stake (in line with some of the propositions advanced a decade ago; see Nuti, 1995). The general tendency in practically all CSE countries has been for employees to sell their shares, frequently to managers and directors, or stop paying instalments for initially subscribed shares, so the number of enterprises with dominant employee ownership has declined significantly. The rapid erosion of majority ownership by non-managerial employees is also confirmed in one of the most recent surveys of the evidence (Jones, 2004).

Second, there is only weak support for the traditional arguments against employee ownership. Most existing surveys for transition economies yield ambiguous findings on the economic effects of different ownership structures. Although some studies reach fairly strong conclusions that the least preferred form of private ownership is employee ownership, there are also studies reporting quite contrary findings. It should also be noted that empirical evidence on specifically employee ownership in CSE has been relatively limited, frequently it is based on only small samples of enterprises, and

[25] Aoki is fully aware of some of the difficulties in applying this model to transitional economies: the role of banks may be limited because of their undercapitalization, low level of monitoring capacity, and the legacy of soft-budget constraints. But he also offers concrete proposals how these problems could be resolved.

most studies do not contain detailed information about many elements related to the earlier discussed theoretical hypotheses on employee ownership.

One of the most exhaustive surveys of the numerous econometric studies which report evidence on the multiple effects of privatisation has been undertaken by Djankov and Murrell (2002). The authors have covered 125 empirical studies that analyse the process of privatisation in some 20 transition economies, taking into account eleven categories of owners.[26] The survey also considers the effects of different types of owners for enterprise restructuring, where most of the conclusions regarding insider ownership are rather negative (see Djankov and Murrell, 2002, pp. 740-1). State ownership was found to be less effective than all other ownership types, except for worker-owners, who have a negative effect. Privatisation to outsiders is associated with 50% more restructuring than privatisation to insiders (managers and workers). Investment funds, foreigners, and other block-holders produce more than ten times as much restructuring as diffuse individual ownership. State ownership within partially privatised firms is surprisingly effective, producing more restructuring than enterprise insiders and non-block holder outsiders. In short, privatisation to workers is detrimental, privatisation to diffuse individual owners has no effect, and privatisation to investment funds or to foreigners has a large positive effect. Privatisation to funds is five times as productive as privatisation to insiders, while privatisation to foreigners or block-holders is three times as productive as privatisation to insiders. Still, workers are better owners in Eastern Europe than in the CIS, while banks and concentrated individual ownership are significantly more effective in the CIS than elsewhere. Considering the different areas of policy reform, the authors conclude that privatisation to outsiders is associated with the largest restructuring gains, while privatisation to workers has no effect in Eastern Europe and is detrimental in the CIS. Thus one of the main conclusions of this extensive survey is that insider ownership has obstructed enterprise restructuring (Djankov and Murrell, 2002, pp. 740-1).

However, there are a number of methodological problems in econometric studies on privatisation in transition economies that have been stressed in the literature, which also cast some doubts regarding the reported conclusions. The effect of privatisation on economic performance is surprisingly hard to determine, as many of the microeconometric studies suffer from serious problems: small and unrepresentative samples of firms, misreported or mismeasured data, short period of observations, and above all, not controlling adequately for selectivity bias (Svejnar, 2002, p. 15). The selectivity bias is probably the most serious: better performing firms were frequently privatised first, while many of the newly set up private firms have been created using assets and managerial skills of previous state-owned firms. Therefore, if these firms are more profitable than the partially privatised or state enterprises, it could simply mean

[26] Traditional state ownership, state ownership in commercialised firms, enterprise insiders, outsiders (non-employee, non-state owners), workers (non-managerial), managers (managerial employees), foreign owners of all types, banks, investment funds, block-holders (outsider ownership concentrated in the hands of large individual owners), and diffuse outsiders (individual outsider owners, each of whom owns a minuscule portion of an enterprise).

that they have absorbed the best resources from state owned enterprises at the beginning of the transition. When employees were offered the possibility of purchasing their enterprise's shares at preferential terms, the incentive to do so was primarily there in case of the more profitable enterprises, whereas workers had no interest to buy shares of loss-making firms.

Others have pointed to problems with the comparability of various studies, since they employ different methodological approaches, different performance measures, different time periods, etc. (Blaszczyk et al., 2003, p. 12). We also encounter the formulation of conclusions on the basis of evidence that is often questionable: for example, the conclusions by Frydman et al. (1999), that enterprises privatised by MEBOs do not differ from state enterprises in performance, are found to be doubtful, since in the sample of 185 firms from three countries (Poland, Hungary and the Czech Republic), only 10 firms are majority-owned by non-managerial employees and all 10 are from Hungary, and none from Poland, where this form of privatisation was applied to a much greater extent (see Blaszczyk et al.., 2003, p. 12).

Another problem involves cross-country comparisons of enterprises operating in very different institutional settings. Enterprise performance in different CSE countries crucially depends on the general environment in which they operate, including the legal framework, fiscal provisions, availability of finance, supporting economic policies and institutions. If the environment is highly unfavourable, if some of the legal and institutional reforms have been delayed, it is very difficult to assess firms performance and compare it with that of enterprises in another country, in which active policies promoting private firms have been applied. Much of the empirical evidence on the negative effects of insiders ownership is based on Russia, where employee ownership has been implemented under rather specific conditions and where many transition-related reforms have been substantially delayed.

As much of the evidence seems to suggest today, restructuring of firms has frequently been impeded not necessarily by the ownership structure emerging after privatisation, but by other unfavourable conditions linked to the incompleteness of the reform process and institutional and legal weaknesses. The institutional environment is a determinant sufficiently important to be able to make a fundamental difference, even if similar ownership structures have been created. Under equal outcomes of privatisation, the differences in capital market reforms, securities markets, bankruptcy procedures, managerial markets, or some other areas of reform, could be even more important for restructuring than the immediate outcome of privatisation. Some scholars have argued that the political and economic constrains of restructuring will be the same, independent of the privatisation policies adopted (see Roland, 1995, p. 42). Despite the success of the Czech mass privatisation, restructuring did not move faster there than in other countries; mutual funds may have a strong incentive to engage in rent-seeking activities to obtain subsidies and rents for their enterprises, instead of engaging in restructuring activities (Roland, 1995, pp. 43-46).

Given all these methodological problems, it is not surprising that other studies have reached much more optimistic conclusions regarding employee ownership, which do not converge with the quantitative studies reported in Djankov and Murrell (2002). A different type of evidence, based mainly on case studies, from 15 transition economies has shown that firms owned and controlled by employed workers and managers can be quite efficient (see Uvalić and Vaughan-Whitehead 1997, FitzRoy et al. 1998). Survey evidence on corporate governance in countries of the former Soviet Union – including Belarus, Russia and Ukraine – indicates that whereas outsider ownership never leads to greater restructuring, dominant ownership by insiders sometimes does (Estrin and Wright 1999). Earle and Telgedy (1998) found that in Romania, diffuse individual and insider ownership were surprisingly productive.

One of the most recent surveys of empirical studies on employee participation in transition economies by Jones (2004) leads to the conclusion that there is no persuasive evidence that a single form of private ownership is most efficient, or that the key obstacle to enhanced performance is employee financial participation. The author concludes that widely differing ownership structures may be most appropriate when institutional contexts vary (Jones, 2004, pp. 201-2). The main findings for the Baltic Republics is that the effects of majority ownership vary over time and across countries, while majority employee ownership has either positive or zero effects upon productivity. Some of the results provide only partial support for the standard theory of privatisation and stronger support for theorists who argue that insider ownership may be preferred in some circumstances in transition economies. Part of the evidence also suggests that employee participation in returns (and sometimes in control) has acted to enhance business performance (Jones, 2004, p. 200). Another study on Hungary, Slovenia and Poland shows that for most performance indicators, it is MEBOs that perform better than firms privatised by other methods, and these findings support the hypothesis that managers and employees have better knowledge of the industry, market and processes than do other economic agents (Cox et al., 1998, as reported in Jones, 2004, p. 193). On the basis of the reported empirical evidence on the economic effects of employee participation in economic returns and in control in transition countries, the author concludes that the findings reported in Djankov and Murrell (2002) - that the main obstacles to economic restructuring is the persistence of employee ownership and that what is needed are policies to undo this practice - are 'premature' (Jones, 2004, p. 172).

What follows is that even today it is too early to draw any generalized conclusions about the implications of insiders' ownership in CSE, as the empirical evidence has been mixed, confirming very heterogeneous experiences across countries. However, given all the methodological problems stressed earlier and the enormous complexity of evaluating post-privatisation outcomes, perhaps fully conclusive answers to some of the questions raised will actually never be possible. Still, thanks to growing empirical evidence, today we do have even more reasons to sustain that the early conclusions on the negative effects of employee ownership were unwarranted.

4. Conclusions

The ongoing analysis of the experience with employee ownership in Western market economies and in CSE transition countries suggests there are notable differences regarding a number of issues.

In advanced market economies, employee ownership has had a rather long tradition, it encompasses a variety of different types of schemes, and it appears mainly, though not exclusively, as minority employee ownership in traditional capitalist firms. A large part of the existing empirical evidence on employee financial participation suggests that the potential advantages of such schemes are likely to outweigh the possible disadvantages, and therefore that they are likely to be associated with higher productivity, and possibly greater wage flexibility, employment and employee commitment. These positive effects expected from employee financial participation has led a number of Western governments to introduce fiscal incentives stimulating its application, and since 1992, the European Union to become its active promoter. These policy measures in turn have contributed, at least in some EU countries, to the diffusion of different types of financial participation schemes.

By contrast, employee ownership in CSE is a fairly recent phenomenon, as it has emerged during the last fifteen years, primarily as a consequence of the process of privatisation of previously state or socially owned firms. Various degrees of employee ownership are today present in most CSE countries. The schemes applied within various privatisation programmes were essentially very similar, consisting of the free distribution, or share offers at preferential terms, to employed workers and managers. In several CSE countries, the extensive use of this privatisation method has initially led to dominant employee ownership, which was an outcome not always anticipated or desired by CSE governments. More recently, in practically all CSE countries, there has been a general tendency towards the reduction of ownership by non-managerial employees, leading to a substantial reduction in the number of enterprises in majority employee ownership. In the theoretical discussions, dominant employee ownership has frequently been identified with dominant employee control (which not necessarily has always been the case), which has led many scholars and policy-makers to argue that insider ownership will cause a number of specific problems, similar to those identified for the LMF. Thus rather than being promoted as in the West, employee ownership has frequently been viewed with suspicion, which has also led several CSE governments to introduce more restrictive conditions for employee ownership than those stipulated initially (e.g. in Estonia, Latvia, Serbia, Croatia, Slovenia). From today's perspective, the fears expressed by scholars regarding the negative implications of employee ownership in CSE were not sufficiently justified, especially considering that this was in many countries the most feasible, and thus fastest, method of privatisation.

Despite the notable differences regarding the implementation of employee ownership West and East, there are several lessons that the CSE countries could draw from the much longer Western experience:

- First, the *beneficial effects of employee ownership* (and more generally, employee financial participation) should not be neglected today in the CSE countries. These beneficial effects could be even more important in CSE than in the advanced EU economies, for strengthening workers incentives, raising productivity, improving overall enterprise efficiency. Scholars critical of employee ownership in transition economies have persistently neglected its potential advantages, which could more than offset the expected adverse effects. Employee ownership has been actively promoted by a number of Western governments and also by the EU precisely because it is expected to lead to a number of positive effects.
- Second, the Western experience suggests that *possible inefficiencies* are caused not by insiders ownership *per se*, but by insiders full control of enterprise activities. The specific problems which may arise in an employee-owned firm may not be as serious as is usually assumed. The case of (1) no controlling interest by insiders, or (2) controlling interest by insider shareholders who have a larger individual share in capital equity than in labour input supply, do not present particular problems, and therefore are likely to lead to the net advantages associated with employee ownership. On the contrary, (3) the case of controlling interest by insiders guided primarily by their short term interests - due to a lower share in capital yield than in labour supply - offsets at least some, or possibly more than, the advantages of employee ownership, and thus can be inefficient.
- Third, since in the practice of advanced market economies the prevalent form of insiders ownership is *minority employee shareholding*, it is very likely that also in CSE, the enterprise in dominant employee ownership will, in many cases, only be a transitory form. Indeed, the experience gained in CSE during the last ten years has confirmed that many firms with majority employee ownership have, for a variety of reasons, evolved into more traditional types of enterprise, as employees shareholders have been selling shares to managers or external owners.
- Fourth, the wide diffusion of employee ownership schemes in various EU countries has in many cases been *actively stimulated by government policies,* through measures offering incentives to both enterprises and workers involved. In CSE, if we exclude the one-off incentives offered for employee-management buy-outs within the privatisation process, this type of policy measure promoting the introduction of employee ownership has been almost non-existent. Although there have been scholars arguing against such government-induced measures of encouragement, the Western experience with profit-sharing and employee ownership clearly confirms that schemes have been most diffused in those countries where concrete measures have been introduced to support them.
- Finally, the rich experience with *profit-sharing* in EU Member States will probably become increasingly relevant also for the newcomers from Central and Eastern Europe where for the moment, this type of financial participation has been implemented to a limited extent. In the early 1990s, the general economic conditions – recessionary trends, falling wages, low or negative profits – have not favoured the

adoption of profit-related remuneration schemes. In addition, the changes in the area of labour relations have usually provided laws based on the standard wage employment contract, which together with rigid tax provisions, do not allow much flexibility in payments systems. Still, the need to strengthen incentives and increase workers productivity in the future could generate more favourable attitudes towards flexible remuneration schemes such as profit-sharing. In conformity with much of the Western experience, the lack of specific legal provisions on profit-sharing, which would provide a different fiscal treatment or other type of incentive, has been a major obstacle for its introduction. Probably some policy action in this domain in the new Member States from CSE would be useful.

There may also be an important *role for the EU* in promoting further employee financial participation in the now enlarged EU, as a continuation of its earlier initiatives in this area. By informing governments and policy-makers in the NMS of its various PEPPER initiatives, by reporting on the rich experience gained in many EU countries, and by indicating the positive effects such schemes have had in a variety of national settings, such action could contribute to a more widespread diffusion of employee financial participation also in CSE.

III. Workers' Financial Participation: What Future Place within the European Social Model?

Daniel Vaughan-Whitehead[27]

1. Introduction

The current debate about the European Social Model clearly illustrates that the EU is indeed at a crossroad in the social area, including financial participation.

For many, in a context of high unemployment and low living standards the top priority should be employment – that is to give a job to all – with social protection being then enhanced by employment and economic growth, as it was stressed in the recent meeting of heads of state and government in London under the British Presidency of the European Union (EC, 2005). For others, there is still place for significant and voluntaristic social policy at both national and enterprise level that would not undermine but on the contrary boost economic performance and generate growth. Thus, although all agree on the importance on certain policies – such as education, life-long training, and social protection etc. – policy makers continue not to agree on how – and in what sequence – to implement them.

The current debate on the European Social Model does indeed reflect such divergence. For some, the EU should keep its European Social Model. For others, there would be no such thing as a 'European Social Model'.[28] The EC Commissioner for Economic and Monetary Affairs, Joachín Almunia, seems to be doing the synthesis between the two approaches: 'actually, there is no such thing as a single European Social Model but there are different social policy models in the EU. They do however have a set of

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27 This chapter is the responsibilty of the author alone and does not necessarily reflect the views of the ILO.

28 It is interesting to observe that these different views are present among top European Commission officials themselves. For the EU Commissionner of Employment and Social Affairs, Vladimir Špidla, 'The European Social Model is characterised by a permanent interaction between the European and the national dimensions … and its main objective is to combine economic performance and solidarity' (Špidla, 11 October 2005); similarly for Odile Quintin, Director General of DG Employment and Social Affairs: 'The European Social Model is a unique feature of our continent, since it is built upon unity of values and diversity of systems' (Quintin, 13 October 2005). On the contrary, 'the European Social Model does not exist' for Günter Verheugen (Le Monde, 3 September 2005), Commissioner of DG Enterprise and Industry, and previously Director General of DG Enlargement – when during the negotiations for EU accession he had already shown little concern for social issues.

common features. They all involve government interventions which reduce poverty and social exclusion, achieve a fairer distribution of income, provide social insurance and promote equality of opportunity … broadening the picture, the debate on the social model in Europe also encompasses questions of labour market institutions and investment in human capital' (Almunia, 26 September 2005).

Clearly this debate becomes even more important in a context in which the recent EU enlargement to ten new countries – including eight transition countries for Central and Eastern Europe – took place. This process brought into the EU countries not only with much lower levels in economic and social terms but that also put in place free market economies often in a much more liberal way than former EU Members (Vaughan-Whitehead, 2003).

It is obvious that these policy directions may influence the future role of social policy in the EU. In the same way it will not be neutral with regard the future place and role of workers' financial participation. First because financial participation – together with other forms of workers' participation – represents an integrative part of the European Social Model, to be listed among the basic elements of the European Social Model as well as a contributing factor to the core values shared by EU societies. Second, because – as we shall see here – financial participation scope is very much influenced by the changing nature of the European social model itself. We shall also try to assess what impact could the recent integration of new Member States have on the future of workers' financial participation in an enlarged EU. This leads us in a final section to identify what could constitute a more voluntaristic policy agenda on workers' financial participation.

2. Evolving Role within the European Social Model

a) The European Social Model Does Exist

A common core of values

The European Social Model, despite great varieties of policies and practices at national level, does indeed exist, and is based first on a common core of values and principles, which includes, together with

- '*economic competition*' (with a clear recognition of the adoption and development of market economies, but with a more recent emphasis on knowledge type economy) also:
- '*social cohesion and solidarity*' (with a specific concern to reduce inequalities, promote redistribution and social protection);

- '*responsibility*' (with the involvement of all those concerned, and a particularly important role allotted to social dialogue and to trade union and workers' representatives at all levels);
- '*quality*' (a value that has been put forward more recently on European Commission's and individual Member States' working agendas and which is intended to apply to employment, working conditions, industrial relations, and social policy in general).

To the above values we could include many others such as '*non-discrimination*' and also encompass many other dimensions, such as culture, environment and education, and ways of living in general.

What is striking is that workers' financial participation may contribute to each of the above 'common' values. Promoting workers' participation in enterprise's profits and capital may be part – by allowing workers to become owners – of a redistributional policy agenda.[29]

Of course the way these schemes are implemented will have differentiated effects on inequalities, between for instance a profit-sharing scheme which is equally distributed among all employees whatever their position and background and a financial participation plan that would offer more opportunities and more benefits to managerial employees.

Financial participation also does promote responsibility since it is a way to involve the workers into the entrepreneurial process. Here again the effectiveness of the scheme will depend on how much it will be accompanied by workers' participation in decision-making.

Finally financial participation is also aimed at boosting workers' motivation and productivity, thus implying a move upward in the quality of the production process as well as industrial relations.

Common elements and policies

The European Social Model is also based on common elements and policies which have been progressively extended over the years. Community legislation for instance has progressively expanded to cover a greater number of labour issues – such as gender equal opportunities; discrimination, labour mobility; employment, health and safety; social inclusion. At the same time, the European Social Model has progressively extended its coverage not only to new categories of workers – for instance those working at transnational level or those working on atypical forms of labour contracts – but also to other categories of people outside the labour market – notably through the development and progress of Community policy against social exclusion.

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29 For the effect and benefits see above Part 1, Chapter II, 2 b).

Elements of the European Social Model

Labour law on workers 'rights
Employment
Equal opportunities
Anti-discrimination
Workers' participation, information and consultation
Social partner recognition and involvement
Social dialogue and collective bargaining
Involvement of civil society
Public services and services of general interest
Decent or 'fair 'wages
Social protection
Social inclusion
Fundamental working and social rights (of workers and citizens in general)
Regional cohesion
Transnational social policies and tools

Among the common elements (see box: extensive labour law on workers' rights; social protection; fundamental working and social rights; regional cohesion; social dialogue; social partners' recognition and involvement; involvement of civil society etc.) workers participation in decision-making – with also workers' information and consultation – and also workers' financial participation figure prominently since both forms contribute to reinforce economic democracy at the work place. These forms have been promoted not only through Community legislation but also by a number of innovative rules and practices in individual Member States.

What is making such schemes well rooted in the EU is the commitment to it of all actors concerned: not only trade unions, but also employers are convinced of the virtues of workers' participation in profits/capital as well as in decision-making or information and consultation as part of their corporate governance systems. Moreover, the formal recognition of the need to involve the workers and its promotion through the generalisation of appropriate institutions – such as works' councils – contrast strikingly with the forms of workers' participation often implemented on the initiative of the management that prevail in Japan, or the participation through share-ownership that characterises the American and, more generally, the Anglo-Saxon models.

More generally a comprehensive approach to social issues is lacking in Japan and in the United States, with a continuing dominance of economic over social considerations. In short, the general belief is that the improvement of economic performance is the only way to afford any kind of social policy, a view in striking contrast with the one prevailing in the EU, which considers social policy as an important element worthy of the attention of policymakers in its own right, and secondly as a potential source of improved economic performance.

Main distinctive features

Beyond the above common value and policy elements that may constitute its basis the 'European Social Model' can be seen as a goal to be attained, a sort of normative vision of the sort of society to which European citizens might be expected to aspire. Perhaps the main feature of this European Social Model is its constantly evolving nature.

First we must recall the impressive progress made by social policy since the Treaty of Rome, which in 1956 created the European Economic Community as a 'common market' and as principally a project of economic integration which did not do much to develop social considerations – apart from the expected catching-up process. This progressively changed along the completion of the single market – with the social dimension developed by Jacques Delors – and the Maastricht and Amsterdam Treaties that recognized social priorities and put the emphasis on the need to progress through social dialogue and coordinated employment policy.

This progress in social policy has also gone hand in hand with a general assessment that the sophistication of European economies, the development of knowledge societies, the modernisation of work organisation and the globalisation process require constant adaptation. In this evolving context however, it became clear that it would be increasingly difficult to make progress on the sole basis of general workers' rights – with the limits to legislation – especially given the very high levels of unemployment in some Member States and significant parts of the population left without social protection. The use of financial means through the European structural funds also appeared to be insufficient. This is also the reason why European social policy has developed in a number of complementary ways.[30] This development took place first because further binding provisions were not possible in a number of areas (such as employment, social exclusion, social protection, and so on) and secondly by the recognition that harmonious social and economic developments could not come from the use of merely one or two keys on the piano (legal and financial means), but from use of the entire keyboard. Today the art of the European social policy consists in choosing and measuring the extent to which key should be used according to the objectives pursued.

b) Financial Participation as Part of this Common Model

It is in this context that the promotion of workers' financial participation at EU level should be seen. Legal provisions in this area are difficult to reach at EU level. Since EU regulations on workers' participation can modify the way an enterprise operates at national level and local level, this is an issue on which political consensus among Member States has been difficult to reach.[31] As a result, some directives – such as those on

30 For instance the promotion of new tools such as social dialogue (which helped to get new EC directives on atypical forms of employment as temporary work); or the Open Method of Coordination (applied first to employment and then to social inclusion and social protection); or the revitalization of fundamental social charters.

31 See also Part 3 – Recommendations, section I.

European Works Councils and the European Company Statute – required many years (sometimes 30 years) to be adopted.

On workers' financial participation although the legal and the tax deduction keys could be promoted at national level in some countries – such as in France, the UK etc. – these were not possible at EU level. Other alternative forms were thus progressively developed but all provided significant contribution to progress in this area (PEPPER Report I in 1991 and PEPPER II in 1996; recommendation by the European Council in 2001; European Parliament resolution on financial participation; report on transational development of financial participation etc.). The European institutions have thus also been mobilised.

An evolving and multidimensional nature

At the same time, the scope of financial participation (along the ESM itself) has progressively evolved. In the early 1990s, financial participation was seen more as a form of workers' involvement, desirable mainly for social reasons, while its positive effects on workers' motivation and productivity were only beginning to be recognized (notably through PEPPER I and significant empirical evidence in EU Member States, especially in France, in the UK, Germany as well as in other non EU-countries as the US, Japan, Australia etc.). Since then, financial participation has been legitimised in a number of areas, not only in its social but also in its economic dimension. First accumulated empirical research confirmed its positive effects on productivity, profitability, and other measures of enterprise performance.

They also emphasized the potential effects of profit-sharing to flexibilise wages and stabilise employment in periods of economic downturns, thus contributing to internal flexibility and further investment in human resources and training. Secondly, the Commission's communication on Risk Capital of October 1999 underlined the need to develop financial participation in order to boost the risk-capital market, and notably to stimulate the growth of new dynamic enterprises, particularly important for the creation of new jobs. Thirdly, financial participation has also been discussed in the more general context of the modernisation of work organisation (mentioned in the EC Green Paper of 1997 on Work organisation and Commission's follow-up communication of November 1998). It is also worth remembering that even the general orientations of political economy (GOPE) adopted by ECOFIN (Ministers of Finance of EU Member States) in June 2000 underlined the need to reinforce systems of employee-ownership in order to stimulate capital markets. Financial participation is thus now clearly seen in the EU as stimulating the process of structural reforms aimed at capturing all potentialities of growth, employment, and social cohesion. It is not by chance that a new impulse was given to workers' financial participation by the Lisbon Summit, which precisely fixed the priority of developing a competitive (even the most competitive!) knowledge economy while developing social policies as productive factors. It led to the Community Social Agenda, adopted at the Nice Summit, in which the need for further development of financial participation was mentioned (and was also confirmed in the new Social Agenda for 2006-2010).

This led in early 2002 to a new Communication of the European Commission on this issue, accompanied by an action plan. The aim is to boost financial participation in terms of three priorities: (i) more pronounced emphasis on the general principles behind financial participation (such as the universal coverage of all employees, the transparency of the formula adopted, or the clear distinction between the basic wage and the flexible wage dependent on enterprise results); (ii) to remove the transnational obstacles to the diffusion of financial participation; and (iii) to launch new initiatives at EU level (pilot projects, exchange of best practices, data collection, and so on) to ensure the wider development of financial participation.

Financial participation is thus viewed as one important element that may contribute to EU countries' competitiveness while preserving their spcial cohesion.

Interaction within a wider participatory frame

In the European Social Model workers' participation in decision-making goes hand in hand with forms of workers' financial participation. In fact it has been increasingly been recognized that it is difficult to imagine workers being involved in decision-making notably through information and consultation, without having them also share in the financial results of these decisions. Empirical results also tend to confirm such interactive and scale effects between these different complementary forms of workers' involvement.

3. Capitalism in Enlarged EU: Slipping away from Economic Democracy?

In view of the above dynamics in respect of forms of workers' participation in the EU, and their place within the European Social Model, it is essential to assess whether they have been promoted and are developing along the same lines in new EU Member States. In particular, has the tradition of self-management and economic democracy of new EU Member States from Central and Eastern Europe – which involved workers in both their enterprise profits and decision-making – continued in these countries, or has the shift to free market economies brought an end to this type of experience? Our assessment of workers' participation trends in these countries after fourteen years of transition depicts a rather surprising and paradoxical situation.

a) First Paradox: Away from the Self-Management Tradition

A first general paradox may be observed: despite a strong tradition of participation in former Communist countries which could have led these countries to develop a strong basis for participatory experiences in line with the Community *acquis*, neo-liberal theories inspired by the Anglo-saxon model and advisers from international monetary institutions have led these countries in a totally different direction.

A significant example is offered by cooperatives that have been systematically dismantled in first years of transition often under the advice of external experts and probably because they represented the symbol of collective work in the former communist regime and thus an obstacle to free entrepreneurship. Cooperatives were generally asked to liquidate and serious restrictions concening the work of cooperatives were introduced to discourage the creation of new ones. The number of cooperative was allowed to drastically fall in almost all transition countries, for instance in Bulgaria, Estonia, Hungary, Lithuania and elsewhere.[32] As a result the influence of cooperatives has been weakened in all economic sectors – both in percentage of total capital ownership and in percentage of employment. Only in agriculture the number of cooperatives succeeded to remain at a significant number.

If employee-ownership turned as a major privatisation form it happened by default rather than by economic policy choice on the basis of strong tradition in economic democracy and self-management. Moreover this property form has been allowed by public authorities to progressively disappear through a dilution to the benefit of other prevalent – and often privileged – property forms.

b) Second Paradox: A Similar Past but Diversified Transition Outcomes

The second conclusion, or paradox, is that, despite a common past and a similar objective – belonging to the EU and applying its social standards – a rather differentiated situation emerges when we look at experiences country by country.[33] Countries such as Slovenia, in the tradition of self-management in the former Yugoslavia where economic democracy was deeply rooted in enterprises, have developed different forms of workers' participation. Other countries, such as the Czech and Slovak Republics have followed a more liberal approach in which little opportunity has been given to employees to participate in the restructuring and privatisation process on the assumption that total distribution to private capital would accelerate the pace of privatisation and enterprise restructuring and lead to the emergence of strong capital markets.

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32 The national chapters in the present volume sheds light on such progressive shrinking of the cooperative movement in transition countries: in Estonia, the number of cooperatives decreased from 2,000 in 1990 and 2,943 in 1993 to less than 1,000 early 2000. A similar process is described in other countries.

33 See Part 1, Chapter I and the relevant national chapters in Part 2 of the present volume.

c) Missing Interaction between Participatory Forms

A third paradox can be observed with regard the two main forms of workers' participation – in decision-making and financial results – which could have been expected to develop as in the EU in a harmonious and parallel way, or at least to follow similar trends.

First, the two forms of workers' participation in new EU Member States evolved independently of each other employee-ownership for instance not often involving worker voting rights. Only too rarely has the employee-ownership involved a 'one share-one vote' decision-making basis (ILO, 1998).

Employee-ownership often intervened on the initiative of the management that invited the employees to get shares –generally to avoid the takeover by an external strategic investor – but carefully avoided to loose control over strategic matters – often under the threat of possible jobs losses. This lack of involvement from the employees' side also explains why at a later stage they did not find many good reasons for keeping their shares and sold them to the management.

Second, the two forms of participation did not follow the same path over the years of transition. Forms of workers' involvement and information and consultation – such as works councils – were poorly developed in the first years of transition but better promoted in recent years, mainly to comply with the transposition of the Community *acquis*. On the opposite employee ownership was actively promoted in the first stage of privatisation – turning into a real 'privatisation surprise' and one of the major privatisation routes by default in the absence of foreign investment and domestic private capital and the failure of mass privatisation programme through the vouchers option – without being allowed to remain a viable property form in the longer run (Uvalić and Vaughan-Whitehead, 1997). To be also noted that employee ownership has been – and continues to be – diluted in these countries not on the basis of economic performance and good governance criteria.

It is also worth noting that employee ownership despite its massive development – at least in the first phases – in the privatisation process did not lead to increased recourse to profit-sharing thus confirming the total disconnection between different possible forms not only of workers' participation but also of workers' financial participation.

d) No Coherent Participatory Policy to Avoid Employee Ownership Dilution

In brief no coherent policy of workers' participation seems to have developed so far in new EU Member States including the two Southern countries, neither by public authorities, employers, nor trade unions.

While the recourse to employee-ownership happened by default, to replace missing domestic and foreign investment early transition, where it did emerge on a substantial scale, there was no policy plans by the public authorities – nor by the social partners – to try keeeping this property form in the longer run. Even if this property form was not found to be less efficient in terms of corporate governance no attempts were made by the authorities to help it to overcome resistances and obstacles to development – for instance by reducing limited access to credit or by helping employees to keep their shares through social measures and temporary non convertibility of shares. As a result employee-ownership appears in all transition countries as the least stable property form. The picture today is rather depressing.[34] In Estonia for instance, between 1995 and 2002 no less than 71% of employee-owned enterprises had shifted to another property form generally towards managerial ownership or foreign investment. In Lithuania where employee-ownership emerged on the most extensive scale, only 30% of employees were owners in 1999 compared to 50% in 1995. In Hungary the number of ESOPs has never stopped to decrease – from 289 in 1994 and 300 in 1998 to 151 in 2005 – and the percentage of majority employee-owned enterprises has sharply fallen from 80% of buy-outs in 1993 to 47% in 1995. Less than 1% of companies' assets was in management of employee ownership hands in 1998 – the year of closing privatisation.

The same conclusion can be drawn for other forms of workers' participation, for instance in decision-making. Even where workers' participation was promoted, it often concentrated in large state-owned enterprises, which already benefited from trade unions and other forms of social dialogue. In the private sector, especially among the new small and medium-size enterprises and businesses, not only is there no social dialogue but there is also no form of workers' participation. Since this type of enterprises (SMEs and very small businesses) represent a major form of economic activity in these countries this lack of participation clearly puts into question one basic element of the European Social Model.

e) The Total Neglect of Profit-Sharing as a Policy Element

At the same time, profit-sharing schemes that could have expected to follow employee ownership and to be encouraged alongside higher GDP and better economic performance, have been ignored by policy-makers and economic and social actors –including many trade unions.

No single country in Central and Eastern Europe has proposed tax exemptions either for employees or employers or for both related to the use of profit-sharing schemes. In some countries – as for instance Croatia – the possibility to distribute part of the profits to the employees is even not envisaged in the Labour Code. Among the new EU Member States – but we can also add the new Candidate Countries – only in one country, Slovenia, was a project of law proposed in 1997, which however did not receive the Parliament's consent. This first project law was rejected mainly because of trade union opposition to the prospect of wage moderation expected to follow the implementation of this law. However no tax deductions had been proposed at that time. More recently a new law (of April 2005) has been recently proposed that also does provide some tax

[34] See Part 1, Chapter I and the relevant national chapters in Part 2 of the present volume.

deductions dependent on a certain number of restrictive conditions. It is not sure however that this new draft law will be adopted at the Parliament considering the fierce opposition of certain actors. In the meantime there is yet no single law on profit-sharing in new EU Member States and other Candidate Countries to EU accession.

Paradoxically this absence of legislators and policy makers on profit-sharing does not mean that there are no profit-sharing schemes operating at company level. Enterprise surveys have shown that there were significant profit-sharing payments in countries as diverse as Ukraine (ILO, 1994; Vaughan-Whitehead, 1997), Bulgaria (ILO, 1993), Albania (Vaughan-Whitehead, 1998b; 1999), and Hungary (see country chapter in this volume). These however represent informal flexible payments that rarely involve significant workers' participation in decision-making. Nevertheless they show that both employers and employees may not be reluctant to develop these schemes. In this context no doubt these schemes could meet a definite success if the authorities decided to promote them either through legislation, or tax incentives or both (see last section for a policy agenda).

For the time being the distribution of bonuses and other advantages to employees seem to represent the form of incentives that employers prefer to use to pay extra income to the employees in order to increase their motivation and productivity and thus boost the overall performance of the company.[35] No doubt profit-sharing could take up that role if it were supported by some policy initiative.

To be noted as well that studies on transition countries (including in this volume; see for instance Bulgaria) tend to show that multinational companies in these countries not only tried to restrict employees share-ownership but also showed to be rather reluctant to offer their employees – with the exception to top managers – some kind of profit-sharing, a situation that strikely contrasts with their position in their home country – as well as EU level where they are favourable to removing transnational obstacles to profit-sharing schemes in order to extend these schemes to other countries where the company operates.

f) No Interaction between Financial Participation and other Policy Areas

Whatever the form of financial participation in the transition countries that has been promoted in transition countries of Central and Eastern Europe they have hardly been related to other policy areas. While it is true that employee ownership has been directly promoted within the privatisation policy area this has generally be a punctual policy move thast has not been repeated and sustained in the longer run. The absence of policy action to avoid employee-ownership dilution is sufficiently speaking.

The same can be said about profit-sharing. If here and there there have been some policy debates about profit-sharing these have rarely put forward the potential effects

[35] The chapter on Estonia in this volume reports that forms of monetary incentives in addition to the basic wage are used in more than 50% of enterprises. A similar process is described in the Hungarian contribution. For other examples, see Vaughan-Whitehead (ed.) (2005).

of profit-sharing schemes in other policy areas such as employment, industrial relations or wages and incomes.

Employment

No single debate has been taken place in transition countries with regard the potential effects of financial participation schemes on employment. While the priority has been rightly put on the possible new job creations in new private enterprises generally SMEs the need to carry out restructuring while limiting massive unemployment in state-owed or in newly privatised enterprises has often been neglected. In this regard the employment policy pursued in employee-owned enterprises may lead to interesting thoughts. In fact, studies of several countries – including Ukraine, Romania, the Baltic Republics, Poland and Russia – show that employee-owned firms often adjust employment no less than other firms and often more than in state ownership. At the same time, the process is often implemented more slowly than in externally-owned firms, and the degree of retrenchment is sometimes lower in firms in which insiders are the majority owners. Before resorting to layoffs, employee-owned enterprises in several Central and Eastern European countries often try to implement alternative restructuring measures, such as product rationalization, worker mobility, cuts in working hours, in wages, and so on.

Industrial relations

With regard to industrial relations although the transition has shown the deficiencies of industrial relations with insufficient workers' motivation and productivity and the lack of dialogue between workers and the management there have not been any proposal to consider profit-sharing as a way to reconcile workers and management's interests. Similarly in a context of poorly defined and unstable ownership structure employee ownership has not been much considered as a way to establish more stable and more efficient ownership and governance structure.

Wage and incomes policy

As with employment, findings concerning wages and incomes indicate that the situation is much more complex than traditional theory would suggest. Wages often lower than the average were found in employee-owned enterprises in many transition countries, including Estonia, Russia or Ukraine. Employee-owners, far from taking advantage of their position to pay themselves higher wages, were found to be more likely to accept temporary wage cuts in order to promote enterprise profitability and to avoid employment reductions. The long-term objective of such owners, however, is to ensure better pay and living standards for the workers in line with improved enterprise performance. Workers thus seek to introduce higher wage increases and to compensate past wage cuts as soon as enterprise performance improves. This is the reason why employee-owned firms in some Central and Eastern European countries –for example in Russia and Ukraine – have often promoted profit-sharing schemes and other payment systems related to economic performance.

However, this could not be systematically developed (as seen earlier in our profit-sharing sub-section), mainly because profit-sharing has never been considered – and therefore promoted – as a potentially good wage and incomes policy tool by policy makers of transition countries. This remuneration system – to redistribute company's profits – was not considered appropriate in a context in which there were hardly profits but rather a general collapse of output.[36] Experience however in certain countries, for instance in Albania, have shown that the possibility to link part of wage increases to productivity and to other economic performance could indeed become a powerful policy tool precisely in a context dominated by high inflation and fall in production (Vaughan-Whitehead, 1998b, 1999). Since profit-sharing allows wage payments that are not inflationary by nature since they are related to economic performance they would have represented in many cases a better and more efficient alternative than the tax-based incomes policy imposed early transition by International monetary institutions in all Central and Eastern European countries with poor and often even counter-productive results (Vaughan-Whitehead, ed, 1998).

This policy observation is important because it means that profit-sharing would not only be relevant for developed countries (where there are more profits to be eventually distributed) but that it may also apply in transition countries and developing countries. Emphasizing the contribution that profit-sharing could bring in this regard at policy level may hopefully contribute to reduce the developing countries' traditional opposition to profit-sharing thus allowing some more advanced policy agenda at international level.

Another dimension needs to be stressed: different findings in transition countries, including in this volume (for instance for Estonia) underline that profit-sharing may also have some effects to decrease wage differentials in the enterprise (between for instance managers and those lower paid at the lower end) while contributing to increase wage differentials between sectors and enterprises on the basis of economic performance. Profit-sharing would thus contribute to introduce more rational disparities in countries which assisted on the opposite so far to an uncontrolled explosion of inequalities. No doubt this could also contribute to reconcile economic competititiveness with social equity as pursued through the European Social Model.

[36] The opposition to profit-sharing is also explained by the failure of these schemes in the former regime. Although they had been introduced as incentives in their wage policy to motivate employees while boosting production they became a sort of fixed component of wages – thus rather demotivating – rather than a flexible part of wages dependent on performance.

g) A Missing Lever to Improve Working and Employment Conditions

More generally this absence of forms of workers' involvement – in decision-making; in profits; in capital – combined with the poor coverage and contents of social dialogue does mean that there is no lever to improve workers' conditions and rights at enterprise level. And in fact recent evidence provided by more than 30 concrete case studies carried out at enterprise level in the new EU Member States (Vaughan-Whitehead, ed., 2005) first confirm the expected gap between the official transposition of the Community *acquis* and its implementation at firm level; second it sheds light on the myriad of original practices followed by employers of these countries to circumvent the law – often remaining within the boundaries of legality.

An extensive recourse to atypical employment contracts

Although this form of employment did not exist in the early years of transition – most workers benefiting from permanent contracts – fixed-term work has become a major form of employment and is being increasingly used (as in the other EU countries) as an important source of flexibility. But it is mainly self-employment that has recently grown as one major form of flexibility. Self-employment in 2003 affected 24% of employees in Poland, 17% in the Czech Republic and Lithuania, and 13% in Hungary, compared to a 14% EU-15 average. It has recently increased significantly in 2004-05 in Slovakia, the Czech Republic and Lithuania. The percentage of self-employed persons is thus already above the EU-15 average in many of the EU new Member States. In Poland and Cyprus more than one employee in five is self-employed, a figure matched in the EU-15 only by Greece, Italy and Portugal. Self-employment is thus representing, as temporary work contracts, a new source of flexibility, often more convenient for the employers, since it allows the employer to reach maximum flexibility more easily, with maximum avoidance of social contributions and labour regulations. This is significant in Poland, Hungary, Lithuania and Latvia, but also in Estonia and other new Member States. Compared to the EU, this recourse not only seems to be more extensive already, but it may capture a different phenomenon than in former EU-15, that is practices that aim at converting employment contracts that are covered by the labour law into contracts covered by the much less constraining civil law.

Self-employed in the EU-15 also does integrate of significant proportion of small businesses. It is clear that employees working under these types of employment arrangements generally do not benefit from any participation in decision-making nor in profits/capital of the enterprises.

h) An Outcome Influenced by the Population's General Social Situation

Almost all such working and employment conditions at enterprise level in the new EU Member States and in the new Candidate Countries can be traced back to the population general social situation, particularly high unemployment and low wages. Most case studies mentioned above tend to show that the main reason why employees tend to accept bad working and employment conditions – without complaining or going to court – is the fear of losing their job. In particular, long-term unemployment in these countries acts as a strong disincentive for employees to complain about their working conditions, or to apply somewhere else for another job with hypothetical better working conditions. This process is generating poor workers' motivation and productivity in the enterprise and also very low turnover and mobility between enterprises. Another reason why employees generally accept very hard working conditions such as long working hours – often not remunerated – and very high and stressfull working rhythms is the urgent need to raise their living standards. It is again very low wages that provide the most plausible explanation for the progressive dilution of employee-ownership in transition economies.

This leads to an important conclusion: the future development of financial participation schemes in these countries will be greatly influenced by the evolution of employment and working practices that are themselves very much dependent on the general economic situation.

Specific case studies (also described in the present volume) on employee-ownership in transition confirms that many employees decided to become owners mainly to prevent some losses in jobs due to restructuring. This willigness to keep their job may also explain why the employees in many cases accepted to give majority shares to the manager so that he would retain control over the enterprise and avoid the take over by foreign investors generally more keen to implement layoffs. Employee-ownership was thus a way for the workers to keep control, or at least to influence the company's strategic decisions on employment. In the same direction the fears to lose their jobs induced employee-owned enterprises to accept large wage concessions in the transition process, sometimes more than in other property forms.

Along the process of economic convergence towards the EU average it is thus urgent to develop a policy agenda that would promote alternative employment and working patterns at enterprise level, including financial participation practices. With the hope however that, by that time, the type of market economy chosen by the new countries will not be too far from more collective forms of work such as employee-ownership or profit-sharing.

4. The Need for a Comprehensive and Multi-Level Policy Agenda

The different articles in this volume (Estonia, Hungary, Latvia, Lithuania, etc.) report that employee-owned enterprises have been doing rather well in terms of economic efficiency, confirming other studies on this issues (Uvalić and Vaughan-Whitehead, 1997; Jones and Mygind, 2005).

There is obviously a contrast between the economic performance of financial participation schemes and their diffusion not only in transition countries but also in all other European countries. This is clearly providing the example of a policy area where market forces are not sufficient to lead to a final outcome that may be desirable both on the grounds of economic efficency and social equity. It seems as if financial particpation would definitely need some policy push to reach its potentials effects. Moreover in the current context, dominated by increased transnational and interactive movements, it seems rather impossible to address such a policy area outside a more general multi-level frame to be negotiated between relevant political, economic and social actors.

a) The Need for Stimulation and Support at National Level

Two important lessons need to be retained from financial particpation experiences in transition countries so far.

First although employee ownership has emerged as one major property form in the privatisation process it has progressively shrinked to the advantage of other property forms not on the grounds though of lower economic performance but because of the absence of any supporting mechanisms either from the state or from key economic and social actors.[37] The same missing policy involvement has hit the cooperatives movement. This calls for a comprehensive policy in favour of employee-ownership considering its possible contribution – through both better competitiveness and redistribution – to the European Social Model. This is urgent if we want to avoid total dilution of employee-ownership in the transition countries and cancellation of what could have constituted their most original contribution to 'economic democracy' in the EU.

The second lesson concerns profit-sharing. Although these types of schemes could have brought an interesting policy contribution to economic reforms – especially in the transition context of high inflation, poor workers' motivation and productivity, and high sectoral and enterprise differences – they have missed a public debate and a more voluntaristic policy initiative. In Lithuania it is because employee-ownership has been given some preference and has also been associated to the vouchers privatisation method – thus allowing employees to buy shares without too much provision of their own capital – that employee-ownership developed in an extensive way, for instance much more than in the other two Baltic countries, Estonia and Latvia. This also allowed employees – compared with other transition countries – to buy shares also in larger and more capital intensive enterprises (N. Mygind on Lithuania in this volume). At the same time however the absence of a programme to sustain this property form in the long run has been determinant for its poor ability to survive in the longer term. As another example while ESOPs schemes have developed in Hungary thanks to a national consensus followed by a policy decision on the issue in 1995 (that brought a law

37 As clearly reported by Boda and Neumann (2005) for Hungary: 'cessation of ESOPs is only rarely related to business performance'.

similar to the one on ESOPs in the United States), the absence of a national programme in favour of financial participation (as well as an amendment to the 1995 law that put an end to preferential purchase of majority employee ownership) has led these types of financial participation to progressively loose substance (Boda and Neumann, 2005 in this volume).

Legislative variants in these countries thus often contribute to explain differences in the extent of employee ownership.

What experiences of profit-sharing in Western countries also show is that these schemes have the most developed in those countries – for instance France and the UK – where concrete measures – in terms of legislation, tax incentives, public campaign – have been implemented to encourage them. Public support of these schemes is thus essential.

A certain number of policy elements have been identified by a group of high level experts (ILO, 1998) in order to help employee-ownership sustainability in the longer run, with regard aspects like the transferability of share, accompanying voting rights, institution-building, and access to credit.

This last aspect is an essential element since there is general agreement that most serious weakness of employee-owned firms is their lack of fresh capital, and their unusual difficulties in gaining access to capital. If the different studies on employee-ownership report that this property form is rather performant in terms of productivity and profitability they also confirm their tendency to have lower levels of investment, smaller capital ratio per employee, lower equipment and technologies, lower exports, something that can be explained for a great part by their poorer access to credit. It is rather exceptional that employee-owned enterprises succeeded to perform strategic restructuring despite such general lack of capital. It is this lack of liquidity however that also explains employees' discouragement to continue the experience and induces them to sell their shares to a strategic investor (for instance a foreign company) that may bring the necessary fresh capital and new technoloies needed to sustain competition. In many cases employees did not have much choice after having repaid their initial loans. In this context a number of measures might be considered. Most of them are directed towards improving employee-owned enterprises' accountability to investors and credit institutions. Others may take more direct routes such as introducing legislation that deals with the amount of lending by banks and financial institutions to employee-owned firms (ILO, 1998).

At a moment in which many economic and social issues, including wage policy, are negotiated in many countries in tripartite discussions at national level – often leading to tripartite or economic and social pacts – it would be time to put the promotion of financial participation on the agenda, and to discuss how could its different forms contribute to pursue general economic and social goals.

It is also clear that legislation or government action is not enough. There is also a need for a greater mobilisation of the actors concerned, that is the workers, the employers' and their respective representatives. It is obvious for instance that continuous fall in trade unionisation has not helped the trade unions to convincingly put forward policy proposals, including in the area of financial participation despite their initial support of employee-ownership in the privatisation process. Their weakness and lack of consistent views on the issue explain why the management could buy back so easily other employees' shares. Trade unions did not fiercely oppose employees selling their shares.[38]

Similarly from the employers' side there is a need for real willingness to promote financial participation schemes not only nationally but also on a transnational fashion. It is striking to observe – as reported in several chapters in this volume, for instance Estonia and Hungary – that multinational companies seem to be rather reluctant to encourage employee-ownership as well as profit-sharing schemes to employees. Or if they did these schemes were mainly aimed at the top management, as in Hungary with regard stock plans or distribution of shares from the mother company introduced with the main aim of avoiding taxes for this category of employees. This seems to strikingly contrast with employers' efforts at EU level to reduce transnational obstacles to financial participation, a contradiction that would require extensive debates not only at EU level but also at international level, among employers', workers' and governments' representatives.

b) Messages to be Reinforced at EU Level

As for the national level it is essential not to under-estimate the importance of some policy guidelines at EU level. In the EU, financial participation schemes have developed since the adoption of the Council Recommendation in 1992 which certainly did help in showing the way. But as stressed by the Commission in its PEPPER II report, 'it is disappointing that the use of these schemes is still low, considering their importance for productivity, wage flexibility, employment and employees' involvement'. One of the conclusions of the report is that 'the development of financial participation schemes is strongly influenced by government action, in particular by the availability of tax incentives'.

In this regard it is obvious that the absence of more binding EC provisions on financial participation may explain why this item has not been much discussed in the negotiations for EU accession, thus allowing new EU Member States to continue ignoring developments in this area. More binding regulations may have helped in preventing the systematic disappearance of employee-ownership and may have contributed to place profit-sharing in their policy agenda. The fact that wages continue to remain the only prerogative of national Member States – with no possible intervention at EU level – has also seriously limited any EU messages on profit-sharing as an element of wage and incomes policy.

38 When they did not advise the employees to sell their shares, as seems to have happened in Hungary.

Nevertheless we face here another policy paradox at EU level: while the adverse developments of financial participation in new EU Member States and new Candidate Countries (Bulgaria, Croatia, Romania and Turkey) should push the European Commission to move towards more binding provisions in this area, or at least towards a framework directive that may help these countries to move in the right direction, the present European Commission position in favour of less regulations delivers to these countries a totally different message (Verheugen, 2005). Considering the limits reached at EU level, it is possible that some progress may be coming this time from the International level.

c) Time for More Voluntaristic Initiatives at International Level?

Consensus seems to be growing among international organisations concerning the importance of developing employee financial participation schemes. As we have seen, the European Union has been active on this issue.

The EBRD is also playing an active role in supporting ESOPs which have found it difficult to obtain capital. Concrete initiatives have emerged for instance in Hungary but also in Poland, Slovenia and Latvia, to help small ESOPs on the verge of bankruptcy which have no access to the money needed for restructuring.[39] It would be useful progressively to extend this type of financial support to other countries of the region. Other international credit institutions should also start to aknowledge the importance of this property form and start contributing to finance or at least to promote it.

The ILO has also been active in promoting employee ownership by providing systematic empirical evidence on its economic and social effects (see Vaughan-Whitehead et al., 1995; Uvalić and Vaughan-Whitehead, eds., 1997; series of working papers on employee-ownership by Schliva, 1997; Rondinelli and Iacono, 1996). The ILO has also been active on the development of cooperatives. The aim of the ILO policy report on employee-ownership in privatisation (ILO, 1998) was also to assist governments, employers, and trade union representatives more directly in their endeavours to promote this form of ownership within the frame of privatisation. The ILO itself is also playing an important educative role, including training of employees and managers in employee-owned firms.

At the same time however the ILO has never gone much further than the analytical and training dimensions.[40] Has not the time come for more voluntaristic initiatives on workers' financial participation at international level? We could wonder whether a sort of legislative initiative may not be appropriate at international level to provide the different countries with the necessary frame that may enable them to get from financial participation all its potential economic and social benefits. No doubt this could effi-

39 See 'New EBRD fund to target wobbly ESOPs', Budapest Business Journal, 31 March-6 April 1997, p. 8.

40 In this regard the European Commission seems to have already gone much further in this area.

ciently complement ILO harmoury of social provisions both in the incomes and collective bargaining areas.

If such action has not yet been possible it is because some opposition emerged from developing countries vis à vis payment schemes that they often consider not to be fully appropriate to their economic conditions while potentially undermining their enterprises' competiveness. No doubt it would be worth trying to respond to such queries – especially in the light of the findings that financial participation may indeed represent an interesting policy option also in more adverse economic conditions (see above subsection on wage and incomes policy). The ILO would be well placed to take such initiative considering its tripartite governing functioning.

Especially since, in a context of globalisation and increased transnational business activities, it is difficult to imagine further developments in the financial particpation area without a comprehensive debate between trade union, employer and government representatives at international level.

5. Conclusions

Financial participation is undoubtedly an important element of the European Social Model. Not only it has been developing so far in most EU-15 countries but it also shares all the values on which such model seems to be based. At the same time through its potential effects both on economic performance – in terms of productivity, profitability and competitiveness – and social developments – as a motivational and human resource instrument – it may constitute a key contributing element to the EU Lisbon agenda. The progressive steps forward of the European Commission – recently extended to the study on how to remove transnational obstacles to financial participation cross-border development – all contribute to provide a coherent framework in this area.

At the same time however the EU enlargement to the ten new EU Member States is questioning the future direction of the enlarged EU with regard financial participation. Despite interesting massive developments of employee-ownership in the privatisation process in the new EU Member States from Central and Eastern Europe this property form has been allowed to pregressively disappear, often not on the ground of efficiency and good corporate governance. At the same time profit-sharing schemes that have developed in most EU-15 countries has been totally neglected so far in the new Member States and new Candidate Countries.

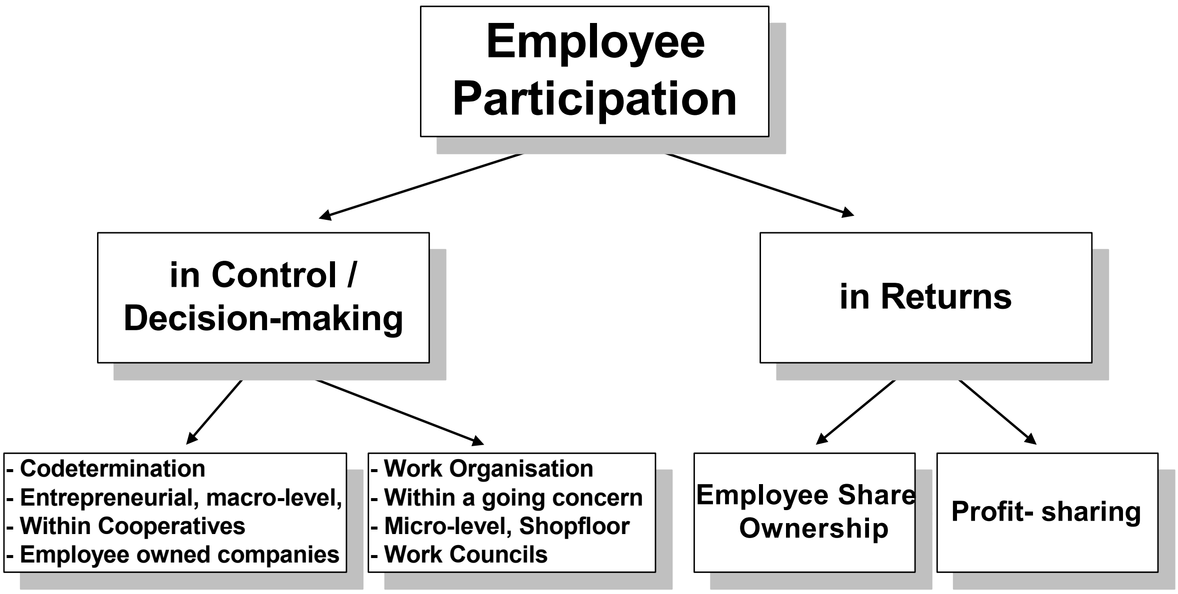
In fact the transition process in these countries seems to have been shaped and directed in ways that do not allow a significant dose of financial participation, nor do open doors for its potential future development. We might thus wonder whether these trends – the progressive dilution of employee ownership and the absence of other forms of workers' participation such as profit-sharing and participation in decision-making – will not lead in these countries to more extreme forms of capitalism, and progressively put into question the central role of workers' participation – including financial participation – within the European Social Model.

At the same time, while such developments point to the need for more voluntaristic and more binding action from the European Union – especially considering the next accession waves into the EU – the recent willingness of the European Commission to limit its legislative action may seriously limit EU further progress in this area. Time may thus have come for more voluntaristic initiave on financial participation at the International level, especially from the ILO.

The new context of globalisation and increased transnational business activities definitely points to the need for a more coherent and comprehensive framework on financial participation at international level, that may well complement initiatives and developments at other policy levels including those within the European Social Model.

IV. Systematic Overview of Financial Participation

Herwig Roggemann



1. Participation in Property Rights: Participation in Control and in Returns

The two main dimensions of *property rights* that are concerned in the context of employee participation are *control,* that is participation in decision-making, and *returns* as financial participation (Ben-Ner and Jones, 1995). Whether or not a given scheme of financial participation embraces participation in decision making depends on the prerogatives and rights that the given type of participation confers upon employees. For instance, in the case of employee share ownership, these rights are determined in part by whether ownership is direct or indirect, whether stock is held through an employee trust or cooperative, and in part by whether voting rights and other forms of immaterial participation accompany the ownership. In the case of profit-sharing, there is no necessary link to any form of employee input into company decisions at any level, although in practise these schemes are often introduced as part of a package of participatory measures, including various forms of employee information and participation in control.

a) Participation in Decision-Making

Employee participation in decision-making generally takes two forms: entrepreneurial codetermination and codetermination within a going concern (Wagner, 1993, 1995). While the first is exclusively executed indirectly by representatives chosen by the employees, the latter can be either direct or indirect.

(1) Entrepreneurial codetermination usually concerns the strategic, macro-level of decision-making in the firm. The best known examples are: German 'Mitbestimmung' (Nutzinger, Schasse and Teichert, 1987), with labour representatives occupying half of the seats on the company's supervisory board, cooperatives and socialist labour self management (see Vučić, 1972).

(2) Codetermination within a going concern on the other hand, consists of indirect participation through their representatives as well as direct by members of the work force themselves. It usually affects the shop-floor, micro-level of decision-making encompassing social questions as well as organisational matters. Well-known examples include workers councils - common in European countries like Germany (Cable and FitzRoy, 1983) and most recently also on a supranational level[41] - elected by the employees, on one hand and Japanese quality circles (Watanabe, 1991; Leibenstein, 1987) or Swedish autonomous work teams[42], on the other.

b) Financial Participation

With respect to financial participation of employees, a distinction has to be made between profit-sharing (including gain-sharing) and employee share ownership (excluding executive stock options). The distinction is important since there are fundamental differences between the two (e.g. in taxation). A third type of financial participation is through asset accumulation or employee savings plans which offer a vehicle to allocate and invest sums received in other schemes. Financial participation of employees is thus a form of remuneration, in addition to regular pay systems, that enables employees to participate in profits and enterprise results (Uvalić, 1991; Pérotin and Robinson, 1995). Although it can take a variety of forms, it is generally seen in the form of employee share ownership and profit-sharing, which are often combined. Since the main objective of this study is financial participation, participation in decision-making is not investigated any further at this point, and will only be referred to if necessary.

41 Council Regulation (EC) No. 2157/2001 on the Statute for a European Company (or Societas Europaea, SE) and Council Directive 2001/86/EC supplementing the Statute for a European Company with regard to the involvement of employees adopted on 8 October 2001.

42 Regarding the USA 'Autonomous work teams spread in the USA', Associate Press article by Sharon Cohen, Dezember 9, 1990.

2. Employee Participation in Profits and Enterprise Results (PEPPER Schemes)

The term 'financial participation' embraces all schemes which give workers, in addition to a fixed wage, a variable portion of income directly linked to profits or some other measure of enterprise performance.[43] The main feature of this bonus is that it is specifically linked to enterprise results and is not just a predetermined proportion of pay. There are two basic ways in which employers can distribute the financial results of improved enterprise performance to their employees: profit-sharing and employee share ownership.

a) Profit-Sharing

In the case of profit-sharing, part of an employee's remuneration is directly linked to the profits of the enterprise. Unlike individual incentives, this concept involves a collective scheme which generally applies to all employees. The formula, depending on the national scheme, may include profits, productivity and return.[44] Since profit-sharing schemes are related to measures of company performance in general, they are perhaps the most widespread form of financial participation.[45] The bonuses are normally paid in addition to the basic fixed wage, and provide a variable source of income. Although profit-sharing bonuses can take a number of different forms, two main concepts (Vaughan-Whitehead et al., 1985, p. 2; Uvalić, 1991) should be distinguished:

(1) Distribution on a deferred basis, commonly covered by the term 'deferred profit-sharing', with the bonus being

(a) invested in enterprise funds or frozen in special accounts for a specific period;

(b) granted as a number of shares in the company, frozen in a fund for a certain period before employees are allowed to sell them (deferred share-based profit-sharing);

(2) Direct payment of profit-sharing bonuses to the workers in cash, which is usually referred to as 'cash-based profit-sharing'.

A related form of participation is the concept of gain-sharing, designed to provide variable pay, and usually to encourage employee involvement by rewarding employees for improvements in individual and organisational performance. Gains, measured by a predetermined formula, are shared with employees, usually through the payment of cash bonuses. Gains constitute an addition to the basic salary paid to all employees, usually in order to reward the performance of individual employees or small groups of them. The formula to measure the employee performance vary considerably, the best

43 See Schneider and Zander (1990), p. 20; compare with Vaughan-Whitehead et al. (1995), p. 2 f., who encloses gain-sharing in the definition of financial participation.

44 See Schneider and Zander (1990), pp. 20, 68.

45 A positive relationship was found by Blanchflower and Oswald (1988), FitzRoy and Kraft (1987).

known examples being piece rates and productivity bonuses, but it may include other performance indicators, such as profit, productivity, costs, sales, etc. (Vaughan-Whitehead et al., 1985, pp. 2 f.).

b) Employee Share Ownership

Employee share ownership constitutes the second major form of financial participation. The necessary funds can be raised either from the company or from employees, with the latter case involving the voluntary purchase of company stock by employees (thus acquiring equity) as well as a that employees lend money to the company or the purchase of company bonds (which increases corporate debt).[46] In the case of company equity, the shares are transferred directly or indirectly to employees, who may benefit from dividends and/or the capital gains that accrue to company equity. Participation through the construction of a silent partnership or a usufructuary is rare, especially in the context of employee participation, and may result in both equity as well as corporate debt (Wagner, 1993).

Employee share ownership in practice - whether shares are held individually or in some trust - does not necessarily entitle employees as shareholders to have a say in the running of the company.[47] Employees may be issued non-voting stock, or may be issued voting shares, but have very little or no control over the management of the shares held in trust. In the latter case trustees may be appointed by management rather than be elected by the employees.

(1) Direct Purchase of Shares / Share Savings Plans

The broadest variety of models is offered by share ownership plans,[48] where shares are distributed free or sold at the market price (non-discounted) or under preferential conditions. These preferential conditions can be sale at a discount rate (discounted stock purchase plan), sale at a lower price through forms of delayed payment (usually within a capital increase), or by the grant of priority in public offerings to all or a group of employees (Vaughan-Whitehead et al., 1985, p. 2). Finally, the purchase may be effected through periodic deductions from pay, with or without employer's match or

[46] In the case of corporate debt, no share ownership is generated, and the revenue of the employees takes the form of interest and principal payments or only interest payments if a debt to equity swap is foreseen later. If employees are holding bonds from the company they receive dividends.

[47] In the majority of cases in the US and in France (outside workers' co-operatives) employee share ownership is associated with little or no employee influence on entrepreneurial decisions. Even if they hold the largest block of shares, employee shareholders are not automatically represented on the board of directors. See Pérotin and Robinson (2003), p. 8.

[48] E.g., in Great Britain, see 'Consultation on Employee Share Ownership', Treasury Public Enquiry Unit, December 1998; also Nuttall (1999). As to the 'method of choice' in Eastern Europe, see Weitzman (1991).

bonus. When the employer does add an (equal) amount in cash or shares, the plan is called a 'share savings plan'.

Other forms of direct purchase are producer cooperatives,[49] in which all the firm's shares are owned by its workforce, and employee buy-outs, under which the company's shares are purchased exclusively by its individual workers.[50] For example, Poland implemented an employee buy-out program in the context of privatisation. It took the form of so-called leveraged lease buy-outs (LLBO).[51]

(2) Broad-Based Employee Stock-Options

Employee stock options[52] unlike those granted to individual employees or small groups (especially in managerial ranks) to reward individual performance ('executive stock options'), are broad-based. The company grants employees options over shares, which entitle them to acquire shares in the company at a later date, but at a price fixed when the option was granted. The option has an expiration term and a vesting period commencing with the grant date, and can take various forms, mainly depending on grant and exercise price.[53] The possibility of gains arising from upward movements in stock prices is the primary reward emanating from options. Unlike 'conventional' options, employee stock options as a rule cannot be traded, and the holder cannot usually hedge against the risk of declines in option value. Furthermore employee stock options normally are subject to forfeiture prior to vesting, should the employee voluntarily leave the firm.

(3) Employee Share Ownership Plans

In the United States[54] the most popular form of workers' share-ownership is the Employee Stock Ownership Plan (ESOP)[55], which has been implemented also in Europe[56] and Japan[57]. An ESOP usually involves a loan to an employee benefit trust, which acquires company stock and allocates it through periodic contributions to each employee's ESOP account. The loan may be serviced by payments from the company out

49 For France, see Defourney, Estrin and Jones (1985). For Italy, see Jones and Svejnar (1985).

50 Usually dominated by managers, especially in the US form of management leveraged buy-outs.

51 See the studies by Jarosz (ed., 1994, 1995, 1996, 2000). For East Germany, where management buy-outs were prevalent, see Barjak et al. (eds., 1996).

52 See Pendleton et al. (2002), PriceWaterhouseCoopers (ed., 2002).

53 Johnson and Tian (2000) distinguish six types: premium options, performance-vested options, repriceable options, purchased options, reload options, and indexed options.

54 The scale of the phenomenon summed up by Blasi (1988), p. 2; compare also Blasi and Kruse (1991).

55 For the American ESOPs see Kelso and Hetter-Kelso (1991).

56 E. g. for the UK see Walley and Wilson (1992); for Hungary, see Galgóczi and Hovorka (1998).

57 See Jones and Kato (1995).

of company profits, out of dividends paid on the stock held by the ESOP or (in rare instances) from employee salary reductions.[58]

(4) Privatisation-Related Voucher-/Coupon-Schemes

In post-socialist countries, employee share ownership occurs in the form of shares which are distributed or sold to the workers of the company, or vouchers or coupons that are distributed to all citizens. Although the second option does not correspond strictly to the definition of financial participation, under which only the workers of the company should be involved, it can lead in practice to substantial employee share-ownership. Thus, for example, Voucher privatisation in Slovenia, Poland and Croatia (other than in the Czech Republic) provided a way of creating employee ownership in conjunction with the privatisation process. Although the privatisation framework did not subsidize employee ownership, by giving employees the right to acquire shares of their companies under favourable conditions, it also did not prevent employees from converting their vouchers into shares of their enterprise. Some companies did explicitly encourage their employees to invest in their shares.[59]

3. Asset Accumulation and Employee Savings Plans

Asset accumulation and savings plans offer a vehicle to allocate and invest sums received as salary or as remuneration in collective schemes of financial participation. They allow employees to set aside a portion of their income in an account that is, in most cases, invested in stocks, bonds or other investment choices for a period of time before being made available to the employee. Additional individual contributions by employees are possible, and sometimes an employer-contribution is received. To promote savings, governments in some countries (e.g. in Germany) match employee contributions. Although usually intended as a long-term savings programme, plans may allow for withdrawals or loans.

Commonly known as savings plans, incentive plans, or investment plans, these vehicles appear under a variety of names. They are most common in the USA, France, Germany and the Netherlands. In these countries, savings plans are usually defined contribution plans, following specific tax provisions. As a rule, the regulating legislation

[58] There seems to be some confusion about amortizing ESOP loans from the company's profits. Theoretically, it is the earnings of the ESOP shares which comprise the collateral for the loan; paid out, these are dividends, but since only ESOP participants receive this full pay-out of earnings they represent, in effect, a preferred dividend. When using the mirror loan approach (bank loan to company – company loan to trust), of course, the bank sees the entire asset base of the company as collateral for its loan, not merely the ESOP shares which is the reason for this approach.

[59] Examples are given in Uvalić and Vaughan-Whitehead (eds.) (1997, reprinted 1999).

defines the maximum amount of employee and employer contributions, eligibility criteria to prevent discrimination, and the retention periods as a precondition for receiving the tax exemption. The main aim of savings plans is asset formation, encouraging employees to save, while involving little risk for them.

4. Employee Share Ownership vs. Profit-Sharing

Table: Summary of differences between profit-sharing and employee share ownership

Dimension	Profit-sharing	Employee share ownership
Liquidity of benefit	Cash. Highly liquid. (exept when deferred)	Shares. Liquidity depends on presence of equity markets.
Immediacy of benefit (i.e. when employee can use it)	Immediate where profit share paid in cash, except where paid into company savings scheme or shares.	Deferred in most schemes (especially schemes where shares acquired at a future date), variable in privatisation schemes. Except dividends.
Link to profits	Direct link. Profit share usually directly linked to level or growth in profits.	Indirect link. Value of reward mainly linked to potential growth in share value, which is contingently related to profitability.
Link to performance period	Based on company performance in the most recent or current financial year.	Company performance *after* receipt of shares or grant of options usually most important for value of reward.
Accounting treatment	Treated as a wages item (though tax/social insurance exemptions may be available). Entered onto profit and loss account.	Separate from wages and salaries. A balance sheet item. 'Losses' to company from gains in value of options or discounts on share acquisition not usually recorded on profit and loss account.
Tax treatment	As wages item, subject to income tax and social insurance charges, although exemptions or reductions (for employee and employer) may be granted by Statute. Company tax offset usually available to company.	As balance sheet item, share schemes per se do not attract tax concessions for the company (although direct financial support to employees to acquire shares may attract concessions). Employees usually liable to capital gains tax, not income tax, where schemes have statutory basis.
Employee risk	Risk that future payments may fluctuate in value.	Risk that current share holdings/options may fluctuate in value.

Source: Pendleton et al. (2001), p. 10.

Part 2 – Country Reports

I. Bulgaria

The development of PEPPER schemes in Bulgaria has been influenced, on the one hand, by the historical commitment to a strong cooperative movement and, on the other hand, by the special circumstances attending the transition to a market economy. The main form of employee financial participation became employee share ownership, with the voucher system being the prevailing privatisation method at the beginning of transition and the management employee buy-out (MEBO) method gaining support from 1994 until 2000. Almost half of the enterprises were privatised by insiders, but employee ownership has decreased over time. Profit-sharing has developed only very recently as the private sector began to stabilise and human capital became a major factor in company success. The number of cooperatives decreased in the first years of transition, but a significant number remain, especially in agriculture.

1. General Attitude

Between 1970-1986 employees were represented only formally in the Economic Council of the enterprise. The end of the 1970s saw profit introduced as an economic tool.[60] During the 1980s, enterprises which fulfilled the plan were given the right to produce other goods and to use the profits of these goods to develop and motivate their workforce. This policy motivated enterprises to attempt to decrease planned orders and increase 'market' production. But despite these changes, schemes for employee profit-sharing were not widespread on account of administrative and tax restrictions on growth of the salary fund and the high taxes levied on profit. At the beginning of the 1980s the new concept of the owner and the managing master of socialist property was developed. According to that concept, the state has to retain ownership of the means of production, while the workforce serves as its real manager. The beginning of 'perestroika', which coincided with an accumulation of serious economic

60 During socialism the main economic function of the enterprise was to carry out its plan for the quality and quantity of goods and services at prices that did not permit the creation of profit. Consequently, profit had not been a factor in economic turnover for a long time.

problems manifested in an ominous increase in foreign debt and a reduction in living standards, spurred the development of this idea. It was restated by the new Labour Code adopted in 1986. Employees were given the right (formally, because it was implemented by regional party committees) to appoint their managers independently. The transfer of property to employees also began but this was just a formality without economic impact. Decree No. 56, adopted in 1989, made a sharp turn in that policy, veering the economy toward incorporation and small private ownership.

After transition started, in spite of the strong trade-union lobby, the privatisation policy represented in the legislative framework initially envisaged only one preference for employees but which was widened in 1992. Between 1993 and 1996 the ownership transformation process was blocked by political struggles that amongst others touched upon the question of social frictions and retaining the existing social privileges of workers with only relatively few enterprises being privatised.[61] In this context broadening preferential participation of employees in the privatisation process was proposed and subsequently adopted. Before 2000, privatisation legislation strongly supported the participation of insiders in privatisation, ia by tax incentives. However, these provisions were abolished.

Currently, three trade union organisations are recognised as representative at the national level: the Confederation of Independent Trade Unions in Bulgaria (CITUB), the Confederation of Labour Podkrepa (Podkrepa) and Promiana.[62] CITUB from early transition on has been in favour to the development of financial participation, with its leader Kastriot Petkov writing books on the issue, including concrete proposals on how to help the workers to get more involved in the capital, profits and decisions of their company. The transition period has brought about a significant change in the power relationship between social partners. In the beginning, trade unions dominated the social dialogue. The newly emerged trade unions, with tremendous popularity and influence in the society, made 'green' investments at the beginning of the transition period.[63] For example, CL 'Podkrepa' established an insurance company and made unsuccessful attempt to register a bank.[64] One of the most effective trade union associations making investments was CITUB participation in the Privatisation Fund 'Labour and Capital'. Through that successful fund, CITUB indirectly acquired a high percent-

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61 See statistical information of the Privatisation Agency at http://www.priv.government.bg/ap.

62 In the most recent census, CITUB reported 393,843 members or 13% of employees, Podkrepa 106,309 or 3.5% of employees, and Promiana 58,613 or 1.9% of employees. Compared to the 1998 census only Promiana had managed to increase its membership.

63 Trade unions inherited property from the former state trade union, which was transferred to trade companies controlled by the trade unions at the beginning of transition. Some of these companies were very profitable, e.g. the company issuing Trud newspaper (one of the most popular national newspapers) and managing holiday houses.

64 In addition to those larger investments, the trade unions possessed other smaller trade companies like printing houses, newspapers and restaurants. Some federations established foundations, educational centres and consultings as non-governmental organizations. However, these companies often proved unprofitable due to unfavourable legislation and, sometimes, to deficient management, so that many of them were sold or liquidated.

age of shares of many enterprises. Thus, the trade union activists were directly involved in the management of those enterprises, although CITUB sold its shares to other owners later. The end of the privatisation process saw their power and influence drastically decrease. In recent years, the employers' associations gave grown more powerful than the trade unions. Until 2005, employers have been represented by the following national associations.[65] Employer's organisations currently do not consider employee financial participation an important issue in either their policy or practice.

The 39-th Bulgarian Parliament which vested power in the national government under Prime Minister Simeon Sax-Coburg-Gotta (2001-2005) did exhibit interest in the questions of financial and decision-making participation of employees. Under the guidance of Prof. Dr. Ognyan Gerdzhikov, at that point President of Parliament, a comparative legal survey on the national solutions within the European Union and some adjacent states was conducted. The survey concentrated on joint-stock companies. It identified a number of national regulatory mechanisms[66] and possibly contributed to the popularity of the ideas behind them. However, the survey resulted in no relevant act of law. Also, the government under Prime Minister Simeon Sax-Coburg-Gotta was sceptical of the concept of financial participation. In an interview released by the Ministry of Social Matters in the beginning of the mandate[67] State Secretary Shuleva stated that the deep conflict of interests between shareholders on the one side (aiming at the most possible profit) and employees on the other side (aiming at the most possible wages) was only resolvable in the context of minor share participation in publicly held companies. Supported by the 40th Bulgarian parliament, the new government (since 2005) under Prime Minister Sergey Stanishev has not revised that position. Nevertheless, the current government has not as yet considered the issue of employee financial participation. Furthermore, this issue has not been on the political agenda of Parliament nor has any political party currently addressed it.

2. Legal and Fiscal Framework

There is no specific legal regulation of any PEPPER scheme but the legal framework provides neither incentives for nor restrictions against concerning employee financial participation.

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65 I.a. the Bulgarian Industrial Association (BIA) - 2,481 affiliated employers, the Bulgarian Chamber of Commerce and Industry (BCCI) - 2,262 affiliated employers, the Union of Private Bulgarian Entrepreneurs Vazrazhdane (UPBE) - 873 affiliated employers, the Union for Private Economic Enterprise (UPEE) - 660 affiliated employers, the Employers' Association of Bulgaria (EABG) - 828 affiliated employers and the Bulgarian Industrial Capital Association (BICA) - 862 affiliated employers; all according to the most recent census data.

66 The summary is available in Bulgarian under <http://www1.parliament.bg/students/95_bg.htm>.

67 <http://www.mi.government.bg/pr/memo/mdoc.html?id=88722>.

a) Share Ownership

Privatisation (1992, 1997, abolished in 2002) – In the course of privatisation pursuant to the Law on the Reorganisation and Privatisation of State and Municipal Enterprises of 7 May 1992[68] (hereinafter referred to as LRP) prior to 2002 employees with Bulgarian citizenship and permanent residency in Bulgaria were entitled to one of two methods of preferential (free or discount) share acquisition. If the privatisation organ had included the target enterprise in the list of public-owned merchant entities to be privatised by the means of voucher (mass) privatisation, each eligible individual could obtain free shares. The total value of the free shares distributed could not exceed 10% of the nominal stock of the target entity. This privilege was abolished in 1998 when voucher privatisation was virtually abandoned. If the privatisation entity had chosen the stock-sales method, eligible individuals were entitled to acquire up to 20% of the nominal stock at 50% of the assessed price. This privilege was abolished on January 2002. The share acquisition[69] itself had no tax relevance. Subsequently, dividends received were subject to the general rule on dividend taxation.

Following the respective LRP-sections came three separate entitlement provisions, hereinafter referred to as 'the 25-rule', 'the 30-rule' and 'the 35-rule'. All three are based on the so called 'MEBO-company'[70], a legal entity established by individuals of a designated status for the sole purpose of participating in the privatisation process. A general incentive for a MEBO-company was the stock exemption provided by Par. 6 Subsection 1 of the Temporary Arrangements of the amendment of the Commercial Act from 1997[71]. MEBO-companies were then permitted to maintain stock of only 10% of the minimum stock generally required for stock corporations or limited liability companies under the Bulgarian Act. A further incentive from which a MEBO company could generally benefit was the VAT exemption of the privatisation deal. Yet another incentive was provided by Section 58 of the abolished Profit Tax Law[72]. As long as the chosen privatisation mechanism (this was the case with the 25-rule) allowed the public hand to keep a minority share in a target company it was possible for this target company to receive a 100% profit tax exemption for three years after concluding the privatisation contract. For the following two years the exemption was 50 %. The '25-rule' provided for preferential payment conditions[73] applicable to the privatisation

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68 DV 1992, 38, abolished DV 2001, 42.

69 The number of free shares obtainable was defined in each case by the ratio between the individual share price as assessed by the Council of State Secretaries, on the one hand, and the sum of the latest 24 indexed gross salaries of the eligible individual on the other hand.

70 In Bulgarian: 'rabotničesko-medidžărsko družestvo'.

71 Zakon za izmenenie i dopălnenie na tărgovskija zakon, DV No. 100/1997.

72 Zakon za danăk vărhu pečalbata, DV No. 59/1996.

73 Originally quite loose (a lump-sum prepayment of 10%, a 10-year instalment payment plan and an interest rate of half the basic interest index of the Bulgarian National Bank) these payment conditions were gradually tightened up to reach the mark of a lump-sum prepayment of 25%, a 5-year instalment payment plan and the regular basic interest rate of the Bulgarian National Bank. Still, the mechanism offered substantial financial relief for low-budget investors.

of a state or municipal enterprise that had previously been commercialised into a merchant entity under the Commercial Law. At least 20% of the target company's employees had to be members, shareholders or partners in the MEBO-company. The '30-rule' contained an identical payment privilege applicable in cases of privatisation of state and municipal enterprises (or integrated substructures) that had not previously been commercialised. At least 30% of the employees of the target enterprise had to be members, shareholders or partners in the MEBO-company. Further issues were resolved in compliance with the '25-rule'. It is the '35-rule' that provided for both immediate transfer of property[74] and preferential payment conditions[75]. It applied to enterprises (or integrated substructures) of minor value that had not previously been commercialised. Thus, until March 2000, MEBO companies had significant advantages, especially concerning the acquisition price being about 36% less than for other buyers.[76]

The effective Law on Privatisation and Post-privatisation Control of 19 March 2002 proclaims in Art. 7 the equality of privatisation candidates as a general principle of Privatisation Law. The law establishes no privileges based on the status of the applicants. In particular, there are no provisions in favour of employees. The current privatisation legislation is a negation of the former LRP which provided a number of preferential measures to facilitate employee participation. These were intended to narrow the social gap between capital owners and the labour force that the liberalisation of the Bulgarian economy opened during the post-communist era.

Private Companies – Commercial Law[77] (hereinafter CL) and company law in general contain no specific regulations pertaining to employee share ownership. In the absence of statutory regulation, therefore, certain general provisions[78] will be examined here. There are no general squeeze-out and sell-out rules concerning the minority shareholders of a joint stock company. However, the Law on Public Offers of Securities obliges a shareholder who has acquired 50% of the stock of a public joint stock company and wishes to keep this majority position to make an economically justifiable public offer to acquire the remaining shareholders shares (Art. 149). The majority shareholder does not have the right to vote in the General Assembly until that offer.

74 Property rights were transferred within one month of the deal and could not be alienated within five years following the final performance of the instalment-payment plan.

75 The payment conditions themselves depended upon the economic activity of the target enterprise whereas all participating employees had the right to a 20% discount on the original price. Production plant privatisation deals were closed at a 10% lump sum prepayment, a six-year instalment payment plan and a one-year grace period. Trade object privatisation deals required a thirty-percent lump sum prepayment and a five-year instalment payment plan. They did not allow for a grace period. The yearly interest rate was set at half the basic interest rate of the Bulgarian National Bank.

76 See Ivanova and Keremidchiev, Extended report Financial Participation in Bulgaria, p. 29, according to the calculations of the authors.

77 DV 1991, 48 as amended in DV 2005, 66.

78 Since associations limited by shares are extremely rare in Bulgaria the examination will disregard them and concentrate on limited liability companies and joint-stock companies only.

This public offer is the only legitimate means of capital concentration available to the majority shareholder. Upon its expiration, he may acquire an additional 3% of the stock per year. Also, where a shareholder of a limited liability company or a joint stock company has voted against a Mergers and Acquisitions deal (Art. 263c CL) or a joint-venture project (Art. 126e Law on Public Offers of Securities) he/she has the right to have his/her shares bought by the company.

b) Profit-Sharing

Bulgarian employers do not usually link employee bonuses to the company's financial success. While not forbidden, employers generally derive no benefits from such schemes under Bulgarian tax law. However, under Bulgarian Law it is possible to offer profit-sharing solutions on an individual contract basis.[79] These may be cash-based or share-based.

c) Cooperatives

The current Law on Cooperatives[80] (hereinafter LC) became effective in 1999, replacing the 1991 Law on Cooperatives as well as the Law on the Facilitation of Cooperatives of 1947. A cooperative is incapable of joining commercial entities in the quality of a fully liable partner. In the General Meeting, the all-competent deciding organ (Art. 17 (6) LC), each member has one vote irrespective of the value of his possible capital contribution. A producer cooperative primarily pays its members so-called production dividends. These are calculated on the basis of the cooperative's profit from the sale of goods to third parties. These goods being originally produced and alienated to the cooperative by its members, the production dividend supposedly represents the proportional contribution of the individual member to the cooperative's economic result. Consumer cooperative dividends are derived from the profit the cooperative gains from the sale to its members of goods and services acquired from third persons. Here, the Internal Rules of the cooperative can play a major regulative role. Although a personal contribution is basic to the idea of a cooperative, individuals who become members are not automatically accorded the status of employees. However, as long as the cooperative is operating and is currently in need of personnel the individual member is entitled to the right of employment in accordance with his qualifications and age. Cooperatives have a limited liability (Art. 32 (1) LC). However, the internal rules of the cooperative may set supplementary member liability for debts of the cooperative (Art. 32 (3) LC). Should that be the case, the relevant information must be submitted to the court to be entered in the register of cooperatives (Art. 3 (2) 2 LC).

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[79] Joint stock company offers of any of these incentives to a Council or Board member, must be approved by the general meeting for every beneficiary on an annual basis.

[80] Law on Cooperatives of 16 December 1999, DV 1999, 113, as amended in DV 2003, 13.

d) Participation in Decision-Making

In the majority of cases employee ownership did not lead to participation in management. Currently, most employees are minority shareholders without notable influence. The rights of employees to participate in decision-making under the Labour Code[81] are extremely limited and have no significant influence on management. While the workers' meeting composed of all employees of a given business once accounted for more than 20 sections[82] of the socialist version of the Labour Code, only two relevant provisions are presently in force. These empower the workers' meeting to choose between two or more drafts of a collective bargaining agreement when the trade union organisations at the enterprise level cannot agree on a single version (Art. 51a (3) Labour Code). Also, the workers' meeting can decide the disposition of the company's social fund (Art. 293 (1) Labour Code). The employer, however, is not obliged to establish such a fund. The Commercial Law provides that an employees' representative must be chosen in corporations[83] employing more than fifty persons. This representative must be given an advisory vote at the shareholders' meeting. The company is under no obligation to recognise more than one representative as its work force grows. Also, the number of employees has no effect on the form or the force of employee representation. Thus the Commercial Law establishes a model friendly to the employer.

3. PEPPER Schemes in Practice

Apart from privatisation, no information is available on the overall incidence of PEPPER schemes in Bulgaria. Financial participation is virtually confined to privatised companies and worker co-operatives. Furthermore, these categories of firms are of diminishing economic importance since after completion of conventional and mass privatisation the number of employee-owned firms and the number of shares held by employees declined (Minchev, 2004).

a) Share Ownership

Discounted shares in Privatisation – Initially, despite a strong trade-union lobby, legislated privatisation policy offered only a limited choice to employees. Workers in the enterprise could either acquire up to 20% of the shares at half price or obtain free shares in voucher (mass) privatisation. No other preferences were envisaged in the first version of the law. There are no studies to indicate what percentage of enterprises has been privatised this way. Presumably, the proportion was low, about 4-5%.

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81 Labour Code of 1986, DV 1986, 26 as amended in DV 2005, 83.

82 Art. Art. 12-32 Labour Code were abolished in 1992.

83 Commercial Law: Art. 136 (3) (for limited liability company), Art. 220 (3) (for joint stock company) and Art. 253 (2) (for a partnership limited by shares).

Management Employee Buy-out in Privatisation – In 1994, amendments to the Law on Privatisation introduced the concept of the Society for Employees and Managers Buy-out (MEBO Companies). This rescheduled the payment period for up to 10 years, providing a one year grace period, an initial payment of 10% of the selling price, and interest on the outstanding part at half of the average annual base rate. The second major amendment giving preferential treatment to employees applied to the workforce and the leaseholders of small companies with a balance sheet value of fixed assets up to 10 million (old) leva for industrial enterprises and up to 5 million (old) leva for commercial entities by the date of submission of the privatisation proposal. They were permitted to buy the leased entities without auction at a price equal to the assessment that they could pay in a rescheduling scheme for a period of up to 6 years for industrial entities and up to 5 years for commercial entities, with primary payments respectively 10% and 30% of the assessed value. Similarly to the MEBO companies, the interest rate on the outstanding part of the purchase price was set at half of the average annual base rate.

Small but significant changes for MEBO companies were adopted in 1997 and 1998. Managers (in 1997) and inventors whose inventions were implemented by the company (in 1998) could participate in MEBO companies. Moreover, the threshold for recognition of a company as a SEMB fell from 50% to 20% of the number of employees becoming members. At the same time, some restrictions on the distribution of the SEMB capital, the type of emitted shares, the collateral for the purchase price payment, etc., were introduced. However, these presented no serious difficulties for the MEBO companies. An important breakthrough in favour of MEBO companies was made by an amendment to the legislation that enabled them to cover the outstanding part of the purchase price until the end of 2000 completely with compensatory notes received from their transactions. Other incentives for MEBO companies were a rescheduled payment of the selling price of the enterprise up to 10 years, a one year grace period after signing the transaction, low-interest credit for MEBO companies as an accumulation of the interest on the outstanding part of the price at half of the base interest rate, preferential buy-out of up to 20% of the capital of the enterprise at half of the selling price to the work force, free acquisition of up to 10% of the capital of the enterprise by employees in mass privatisation; direct buy-out of small entities according to the application of the work force, including rescheduled payments according to Art. 35 of the Law on Privatisation; use of investment vouchers for capital shares in MEBO companies in the proportion 1 voucher equals 1 leva; use of investment vouchers for payment in the course of privatisation with the MEBO in the proportion of one voucher to one leva; payment of 100% of the outstanding part of the price by the end of 2000 with compensatory papers for already accomplished transactions with MEBO companies. There were no restrictions regarding the sector for privatisation with MEBO companies, with the exception of the so called objective-oriented privatisation that was introduced in 1996. That restriction existed for the implementation of schemes for privatisation by employees in most transition countries (Bornstein, 1997). Further restrictions were planned in the draft amendment to the Law on Privatisation prepared by the government in 1996, but influential lobbies prevented the restriction of employee-management privatisation of enterprises with a balance sheet value of fixed assets up to 70,000,000 leva (or 100,000,000 old leva).

The political dynamics of granting privileges to MEBO companies clearly reveal the tendencies of privatisation policy during this period. After the first breakthrough in 1994, there were 9 privileges; by 1997 that number increased to 11. Equally significant is the quality of the respective preferences, which became quite high after 1997. The privileges described above supported the strong position of MEBO companies in privatisation vis à vis outsider buyers, due to the insiders' knowledge, especially in the military industry and foreign trade. Managers often misused the SEMB scheme in order to purchase the enterprise under value or for asset stripping before privatisation by other buyers, also at the expense of the rights of employees, when managers obliged employees to participate in MEBO companies and contribute capital, or concentrated the power and capital of the SEMB in their hands, depriving ordinary employees of their shareholders' rights.

The sales to MEBO companies during privatisation reached 1,436 or 28% of 5,165 deals. If we add other sales that also included privileges to employees (e.g. privatisation of separated parts of enterprises) almost half of the conventional privatisations have been carried out through insiders. The consequences of strongly supported sales to MEBO companies were disclosed to the public after the Agency for Post-privatisation Control was established at the end of 2002. Apart from a large number of contracts which have been changed in the direction of a reduction in payments due, roughly 10% of MEBO companies failed to pay their rescheduled instalments on time.[84] Total losses arising from breaches of privatisation contracts were BGN 1 bln. (€ 0.5 bln.)[85] Only 3 out of 20 companies privatised by MEBO and examinedin the recent study are currently not under management control (Minchev, 2004). Most employees hold minority shares, so that in only two cases are employees represented in the managing bodies of the company. The MEBO method was abolished in 2002 when the effective Privatisation Law was adopted. Although no data on the sales of shares by employees after privatisation are available, it can be fairly estimated that about 10% of enterprises privatised by MEBO may still be under majority employee ownership.

Mass Privatisation – Mass privatisation, conducted in Bulgaria between 1996 and 1998, utilised one method for establishing employee ownership. The model was that used by the Czech Republic. Investment vouchers were distributed to over 3 million people over the age of 18, for investment in 1,040 enterprises or in the private privatisation funds establsihed for the purpose. Over 80% of the investment vouchers were transferred to 81 licensed privatisation funds. Up to 10% of the capital of the enterprises designated for mass privatisation was distributed free of charge to employees according to their length of service. According to the Centre for Mass Privatisation, shares after mass privatisation were distributed as follows (Miller and Petranov, 2000):

[84] Capital, 23-27 November 2002.

[85] See Capital, 23-27 November 2002; Trud, 3 December 2002.

40.8% state property; 6.4% employees; 12.9% individual shareholders, and 39.9% privatisation funds. This data illustrates the picture immediately at the close of mass privatisation, but significant change occurred shortly after (see also Annex Table 1). Privatisation funds, initially not allowed to possess more than 34% of the capital of one enterprise, began to exchange or sell share packages amongst themselves when this restriction was abolished. In strategic enterprises, privatisation funds gained control by increased capitalisation, thus considerably decreasing the share of employees. Employee participation peaked immediately after mass privatisation wass completed in 1998, with employees owning about 7-12% of shares. Subsequently, however, these employees' shares were transferred to managers and outside owners. The vouchers remained valid until 2002, but employess could buy only minority shares.

b) Profit-Sharing

There are no comprehensive or sample studies of the forms of employee participation in profits. The general impression is that these schemes are not very popular. This is partly due to the lack of tax incentives. It also is due to the long time between general meetings (usually May through July) when the decision on profit-sharing should be made, and the end of the financial year in December when the amount of the profit to be shared is determined. Both private and public companies prefer monetary incentive schemes, e.g. monthly and annual bonuses.[86]

c) Cooperatives

Bulgaria's first cooperative society was established in 1890, but cooperative-like societies existed as early as the middle of the 19th century. In 1944, Bulgarian cooperatives numbered 4,114, with 1,614,117 individual members (out of a total population in the country of 7 million)[87] and 11,398 collective members. The popularity and scale of cooperative organisations was so significant during that period that, in the opinion of some liberal economists, the cooperative movement acquired the status of an official state ideology which, transformed into a lifestyle, prevented the development of liberal economic ideology, thus becoming the precursor of socialism (Avramov, 2001). The transition period was a difficult one for cooperatives. They were dismissed as a remnant from the past and as an impediment to free entrepreneurship. Restitution had the most destructive impact. A land reform model for restoring land to former owners and heirs led to the liquidation of many existing cooperatives in agriculture as well as other sectors of the economy. The new Law on Cooperatives required them to re-register, and this procedure was complicated. Significant restrictions on the activities of credit cooperatives drove them into illegal practices.

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86 A study carried out by NEW and Hay Group, covering about 30 of the largest companies with foreign participation in Bulgaria, indicates that 95% of them use short-term incentive schemes; see Capital Careers, 23 February 2001.

87 It should be taken into account that one citizen could participate in several cooperatives.

Statistical data (see also Annex Table 2 and 3) on the number of cooperatives shows an increase to 7,570 in 2003 from 18 in 1989, representing roughly 1% of all registered companies. More than half of these were agricultural. Until 1993, when statistics reported cooperatives separately from the private sector, they accounted for 1% to 1.5% of all investments and about 2.5% of industrial production. According to a survey of agricultural farms made in 2003, there are 5,300 legal entities and sole traders in this sector. From this number, 2,900 are agricultural cooperatives cultivating on average 600 ha land. More than half of agricultural land uner production is owned by cooperatives. According to the data from the two largest cooperative unions, representing 17% of all cooperatives, the Central Cooperative Union (954 cooperatives with 210,000 members) and the National Union of Worker Producers' Cooperatives in Bulgaria (320 cooperatives with 20,000 members), 95% of their member cooperatives are workers' cooperatives.

4. Evidence of the Effects of PEPPER Schemes

Comparative studies on the efficiency of different ownership types, including employee ownership, have not been conducted in Bulgaria. The only way to estimate the economic viability of employee owned enterprises is to use relative data. A study by Jones and Klinedinst (2003) shows that the influence of employees over the decision-making process in enterprises of little import except with respect to safety and health issues.

Annex

Table 1: Possible alliances between shareholders after mass privatisation (1996-1998)

Possible alliances	Number of enterprises	Percentage of enterprises for mass privatisation
Individual shareholders, possessing over 50% of one enterprise	64	6.18
Individual shareholders and one PF, possessing over 50% of one enterprise	173	16.71
Two PF, possessing over 50% of one enterprise	418	40.39
Three PF, possessing over 50% of one enterprise	271	26.18
Four PF, possessing over 50% of one enterprise	84	8.12
Five PF, possessing over 50% of one enterprise	20	1.93
Six PF, possessing over 50% of one enterprise	4	0.39
Seven PF, possessing over 50% of one enterprise	1	0.10

Source of information: Keremidchiev's calculations, based on the published records of the Auction Commission for the three auction sessions of the mass privatisation.

Table 2: Main data for cooperatives in transition period

	1989	1990	1991	1992	1993	1994	1995	1996	1997
Registered firms	1534	3491	30660	202250*	368703	454963	n.a.	n.a.	447714
Registered coops	18	23	1676	1722*	4545	5739	n.a.	n.a.	5693
% Coops out of all reg.	1.2%	0.7%	5.5%	0.9%*	1.2%	1.3%	n.a.	n.a.	1.3%
% Industrial output coops	n.a.	2.5%	2.8%	1.7%	2.4%	n.a.	n.a.	n.a.	n.a.
% Investments coops	n.a.	1.5%	1.5%	1.1%	1.2%	n.a.	n.a.	n.a.	n.a.

Source: NSI. * As per 12.02.1993.

Table 3: Main data for industrial cooperatives

	1980	1983	1984	1985	1986	1987	1988
Number of industrial cooperatives	179	181	184	186	186	181	228
Number of industrial enterprises	2105	2164	2164	2196	2067	2159	2201
% of coopera-tives out of industrial enterprises	8.5%	8.4%	8.5%	8.5%	9.0%	8.4%	10.4%
Number of personnel in industrial cooperatives	92005	92871	93040	92103	92026	90884	97361
Number of personnel in industrial enterprises	1350588	1395810	1393053	1395912	1413365	1429060	1442461
% of person-nel in coop-eratives out of total industrial personnel	6.8%	6.7%	6.7%	6.6%	6.5%	6.4%	6.7%
Average an-nual wage in industrial cooperatives, BGN	1842	2022	2084	2125	2214	2259	2517
Average an-nual wage in industrial enterprises, BGN	2285	2520	2598	2717	2881	3030	3254
% of wages in cooperatives out of indus-trial enter-prises	80.6%	80.2%	80.2%	78.2%	76.8%	74.6%	77.4%

Source: NSI.

Taxation Issues

Bulgarian tax legislation provides incentives to employees[88] with respect to share-based profit-sharing, dividend income and cooperatives. The general annual tax rates range from 10% to 24%. Dividends are taxed on the basis of a source-tax mechanism at a flat rate of 7 %[89]. The taxation is final, so that dividend payments are excluded from the annual personal income tax refund calculation which takes place in the case of tax residents; depending on the total yearly income of the individual this may result in a net tax advantage or disadvantage. No tax is due when dividends are 'distributed' under share-based profit-sharing schemes, such distributions being free of both progressive income and dividend taxes.[90] The Corporate Income Taxation Act allows cooperatives to deduct production and consumer dividends from their taxable profit, provided that these dividends are paid by March 25th of the following year. Consumer dividends of cooperative members are exempt from the personal income tax while production dividends are taxable according to the general provisions. For self-employed persons, the general annual tax progression applies, with 10% of gross income accepted by the tax authorities as business expense. No monthly tax prepayments are due. A comparative analysis of the applicable general taxation rules shows that, except for share-based profit-sharing, employees would generally benefit from the low-tax dividend model.[91]

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88 For managerial staff see: cash-bonus taxation applicable to employed management staff (Art. Art. 19 and the following of the Law on the Income Taxation of Natural Persons); cash-bonus taxation applicable to self-employed tax-resident management staff (Art. 22 (1) d of the Law on the Income Taxation of Natural Persons); cash-bonus taxation applicable to self-employed non-resident management staff (Art. 34 (4) of the Law on Corporate Income Taxation). Compared to the regular personal income tax rule for resident employees, the employed management staff cash-bonus tax mechanism exhibits no deviations: the cash bonus has to be taxed in the month of payment according to the applicable monthly progression rate.

89 Since 1 January 2005. Before that the applicable flat rate was set at 15%; see Art. 34 (1) of the Law on Corporate Income Taxation.

90 Art. 34 (3) of the Law on Corporate Income Taxation in connection with Art 12 (1) 13 of the Law on the Income Taxation of Natural Persons.

91 Tax base reduction opportunities typical for the progression models are here ignored.

II. Croatia

Despite the fact that the economic and political system of Croatia, while it was a part of the former Yugoslavia, was based on employee participation for more than 40 years, today its role is relatively minor. Employee stock ownership created in the early stages of privatisation is steadily diminishing; the position of employees, previously strong, has weakened. There is little public support for measures which would reverse this decline. ESOP models, defined as any organised programme involving large numbers of employees as shareholders in the enterprise, is almost the only form of employee financial participation that has been developed and gains momentum after privatisation; but ESOPs are rare and lack broad support. Profit-sharing is rare. Cooperatives, once a fixture in the Yugoslavian system, are now a minor presence. Nor does there seem to be much political support for employee financial participation; any concept or practice associated with the former self-management system is distrusted.

1. General Attitude

As a part of Yugoslavia, Croatia had a long and rich experience with the self-management model which originated in that country, and which involved, at least theoretically, full employee participation in both decision making and financial results.[92] At the beginning of the transition, the newly independent countries generally presumed that the self-management model was incompatible with a market economy.[93] The possibility of incorporating some elements of self-management into the new system was not considered in Croatia. Some enterprises did retain self-management bodies during the first stage of privatisation (1992-1994). This tended to give Croatian employees a positive attitude toward both employee participation and their expectations from privatisation.[94] Thus there was an ideological foundation already in place, at least on the

92 It is difficult to speak about participation in ownership, because the self-management system was based on a 'non-ownership' concept.

93 After 30 years of dynamic development, the Yugoslav self-management model entered a deep crisis in the 1980s. The discussion about the reasons for the crisis has never been concluded. It was not clear whether the collapse of Yugoslavia was to a great extent due to the long-term non-sustainability or inferiority of the self-management model, or to other factors (e.g., political and ethnic). Although the fundamentals and the long term sustainability of the self-management system developed within Yugoslavia have been under discussion throughout the 1980s, the discussion was not continued in the countries which emerged after the dissolution of former Yugoslavia. See, e.g. Knežević (1985), Horvat (1986) and Milovanović (1990).

94 On the one hand, employees were convinced that they were the ones who created (or at least decisively contributed to the creation of) the assets/value of the enterprises in which they were em-

employee side, which favored the development of both employee ownership and profit-sharing. Even before its dissolution with the '*Marković* Laws' Yugoslavia had introduced some elements of a market economy and private ownership into self-managed enterprises, with the intention of improving the existing self-management system. Early Croatian privatisation legislation annulled or partially revised several privatisations based on the '*Marković* Laws', introducing at the same time employee share ownership to a broader extend. During the first stage privatisation, 41.78% of the initial nominal value of the privatised enterprises was acquired by employees and other buyers; the remaining shares went to state-owned funds: the Croatian Privatisation Fund, the State Agency for Savings, Insurance and Bank Rehabilitation, the Croatian Pension Fund, and the Croatian Health Insurance Fund. The new Privatisation Law of 1996 provided no special provisions or preferential conditions to employees – only to victims of war or political oppression. Since 1999, privatisation has been partially reversed.

Trade unions had no part in the design of the privatisation models, nor did they promote a stronger position for employees.[95] Not until the first two stages of privatisation had been completed did some unions and union leaders begin to advocate employee ownership as a means of privatising remaining state-owned assets, as well as for restructuring distressed enterprises, and to propose models for doing this. Employees are represented by numerous trade unions organised at different levels for various purposes. At present there are four major trade union confederations, as well as a number of smaller associations and independent trade unions. This proliferation was the Croatian response to long experience under a monolithic trade union imposed by the Communist Party. After declining at the beginning of the 1990s, union membership has remained stable. While there are no statistics on this issue, a rough estimate of trade union membership ranges from 20% to 50%. Employers, represented by the Croatian Association of Employers, have a stronger position in most issues involving the interests of employers and employees. The fact that employers are represented by a single organisation and employees by many only partly explains this disparity in power. On the issue of employee financial participation, employers and their organisation remain publicly non-committal – neither positively in favour nor adamantly opposed.

Croatian governments did not support employee privatisation beyond the first stage; instead, they focused their efforts on attracting outside investors, even at the price of lower output, less employment, diminished assets and worse business results in general. While this policy was entirely consistent with the ideological orientation of the right

ployed, and hence they should have the (possibly even exclusive) right to participate in the ownership or distribution of the assets of the enterprise. On the other hand, the employees believed that only those who work create value, and therefore should have the right to participate in the distribution of profit.

95 The Statute of Parliament 2000 authorizes social partners to participate in the work of Parliamentary committees, thus giving them direct influence over the drafting of laws dealing with such matters as employment and industrial relations.

wing governments in power during the first decade of transition, it is less easy to explain why the Social Democratic governments, in office from 2000-2004, made virtually no changes in the area of employee participation. Nor has the present government shown any serious intention of introducing measures to promote or at least to regulate employee financial participation. Some business spokesmen, representing firms that already have employee ownership in some form, have publicly advocated greater employee participation in the privatisation of the remaining state shares. They have also requested clearer regulation and support of existing schemes. No positive feedback on these proposals has been forthcoming from either the government or political parties.

2. Legal and Fiscal Framework

Employee financial participation is at present not explicitly regulated. Privatisation legislation in the past, however, has supported employee share ownership. Various schemes of financial participation, including profit-sharing and ESOPs,[96] occur in individual firms despite the absence of state regulation. Amendments to the Privatisation Law, now being drafted, are expected to bring ESOPs into the regulatory fold.

a) Share Ownership

Privatisation (1989, abolished 1991; 1991) – In 1989 and 1990, the last Yugoslav government, under Prime Minister Marković, introduced several pieces of legislation (e.g. the Law on Social Capital)[97] that made private enterprise and the privatisation of existing 'social' enterprise possible.[98] The Croatian Law on the Transformation of Enterprises Under Social Ownership 1991[99] (hereinafter referred to as the 'Transformation Law') required enterprises which issued 'internal shares' or were converted into limited liability or joint stock companies under the '*Marković* laws' to report to the Croatian Privatisation Fund within 30 days. As a consequence, some of these transactions were revised. The Transformation Law gave employees (including managers and former employees) the right to buy shares at a discount proportional to their years of employment, starting at 20% and adding one percent for every working year up to a maximum of 60%. Employees who paid for their shares in cash were given an addi-

[96] In this context, the term ESOP is applicable to all schemes where employees make an offer to buy shares of the company, the purchase is funded by special credit, and a new company is formed in order to administer the shares.

[97] Službeni list SFRJ, No. 84/89, 46/90.

[98] These laws gave priority to privatisation by insiders (employees and managers). Before the dissolution of Yugoslavia, a small number of enterprises in Croatia were privatised according to the Marković laws. After Croatia gained independence, the Marković laws were suspended in 1990 and then abolished in 1991.

[99] Of 23 April 1991, Official Gazette of the Republic of Croatia, No. 19/91, as amended.

tional discount of 10%. Payment could also be made in instalments spread over five years.[100] After having paid 5% of the total price, the employee received all his or her discounted shares outright. Amendments to the Transformation Law in 1993 entitled employees to buy no more than 50% of total shares with a value not to exceed 1 mln. €. One-third of the remaining shares were transferred to state pension funds and two-thirds to the state Privatisation Fund with the purpose to be publicly tendered at market value.

After most enterprises had been privatised under the provisions of the Transformation Law in 1996, a new act, the Privatisation Law (PL)[101], was adopted, which provided no special provisions or preferential conditions to employees.[102] The Transformation Law, however, was not repealed, and after 1996, some enterprises were still utilizing it. In companies where small shareholders owned a significant amount of stock, so-called small shareholder associations were established. Although these did not take the form of registered associations and their membership was unstable, they did gain some influence in some enterprises because of a close relationship with trade unions. Since privatisation was partly reversed in 1999, many shares of state enterprises still remain to be privatised.[103] After the bankruptcy of 22.2% of all privatised firms, the remaining assets were transferred back to the state Privatisation Fund. By 1999, 379,030 out of 641,152 sales contracts of employees who were buying discounted shares in instalments had been broken. Recognizing that the objectives of privatisation had not been achieved, a new law, the Law on Revision and Transformation and Privatisation, went into effect on 16 May 2005. The privatisation of 1,556 enterprises was investigated under this law; procedural irregularities were discovered in all but 75.

Private Companies (2003) – According to Art. 233 (2) of the new Company Law[104] from 2003 (hereinafter referred to as CL), a company can issue special employee stock with a value not exceeding 10% of registered capital. Employee shares are non-voting until fully paid for. Further, Art. 313 CL stipulates a 'conditional capital increase' for the purpose of fulfilling the employee' acquisition right. In order to facilitate employee acquisition, Art. 234 CL exempts the company from the general prohibition against borrowing in order to acquire its own stock. This exemption is granted on condition that a reserve is created so as not to endanger equity capital by the sale of shares to employees. Since employees – including those who became shareholders during the course of privatisation – are usually minority shareholders, provisions protecting this class are also relevant. A 3/4 majority of votes representing equity capital is required

[100] This period was later prolonged to 20 years.

[101] Of 14 March 1996, Official Gazette of the Republic of Croatia No. 21/96, as amended;

[102] Instead Vouchers were distributed to 230,000 persons who had suffered under the former socialist regime: refugees, displaced persons, war veterans, war invalids, families of dead or missing soldiers, and political prisoners; these, together with employees, made up the category of small shareholders.

[103] Privatisation is presently regulated by the Transformation Law of 23 April 1991, the Privatisation Law of 19 March 1996 and the Law on Takeover of Joint-Stock Companies of 17 July 2002.

[104] Of 23 December 1993, Official Gazette of the Republic of Croatia No. 111/93, as amended.

to change the Articles of Association. Shareholders holding at least 10% of the equity capital have a voice in decisions made by the General Meeting on liability of members of the Board of Directors or of the Supervisory Board (Art. 273 CL); they can also lodge a claim at court to remove a board member for cause. Shareholders owning at least 5% of shares can call the general meeting. A majority shareholder who holds at least 95% of total shares can buyout minority shareholders, at fair compensation, if the general meeting so resolves (Art. 300 CL).

b) Profit-Sharing

There is no legal regulation of profit-sharing and hence no incentives. Although individual enterprises offer monetary incentives, especially to managers, bonuses are usually not linked to company profit. They are regarded as wage compensation and taxed accordingly.

c) Cooperatives

Cooperatives are regulated by the Law of Cooperatives[105] and by the Law on Obligations of 25 February 2005. In the absence of specific regulations, the Company Law of 23 December 2003 applies. Members (at least three physical persons or legal entities are needed to establish a cooperative) must directly participate in the activities of the cooperative; their contributions can be either in cash or in kind. Unless the founding document provides otherwise, the contributions of members must be equal. Cooperatives are managed by their members and, unless the agreement provides otherwise, each member has one vote. The governing bodies of the cooperative are the general meeting, the supervisory board and the general manager, the latter serving as its legal representative. Cooperative property is jointly owned by its members; these are liable for the obligations of the cooperative generally only to the extent of their contribution. Profits are divided among members as directed by the founding agreement and the Articles of Association.

d) Participation in Decision-Making

Participation in decision making is expressly regulated by both the CL and by the Labour Law[106]. These laws almost completely correspond with counterpart EU legislation. Employees of a private company employing at least 20 regular employees have the right to a voice in decisions which affect their economic and social rights and interests, under conditions and procedures prescribed by the Labour Law. Employees of such companies are entitled to elect one or more representatives to the employees' council by means of a free, direct and secret ballot. The function of the council is to

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105 Of 23 May 1995, Official Gazette of the Republic of Croatia No. 36/95, as amended.

106 Of 8 June 1995, Official Gazette of the Republic of Croatia No. 38/95, as amended.

protect and promote the interests of employees vis à vis the employer.[107] If no employee's council has been established, the trade union assumes its powers. According to Art. 158 of the Labour Law, at least one[108] employee representative is to be a member of the Supervisory Board in companies employing an annual average of more than 200; also in companies which are public institutions, or in which the state owns at least 25% of shares. It should be noted that this provision is in conflict with a company law regulation on the establishment of a supervisory board.[109]

e) Draft Legislation (2005/2006)

Amendments to the PL are planned to provide several different schemes for selling shares to employees on preferential terms.[110] According to the present draft, the State Privatisation Fund would be authorized to sell shares to a joint stock company on condition that the latter offer these shares to employees on the same or better terms. The ESOP model is an additional option. The management and employees of a joint stock company could form a new company ESOP limited liability company. The new company will take a credit from the bank, based on the pledged shares and pay off the shares to the Privatisation Fund as a single payment. If none of these schemes suit, the Privatisation Fund can sell shares directly to employees; shares thus acquired are voting shares. Enterprises that at the time of privatisation were not under social ownership, but administered by their managers and work force, according to 'rights to administer' are a special case. They can transfer these rights back to the company, which – according to the draft – would increase the company's capitalisation.The new shares created would be assigned to the Privatisation Fund, which would then offer them for sale to those employees who were with the company at the time of privatisation.

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[107] The employer has to inform the employees' council of the companies' results, amount of overtime work, protection and safety measures, etc. (Art. 144 of the Labour Law). He has to consult the employees' council on labour regulations, employment plans, reassignment of employees and dismissals, introduction of new technology and organizational modifications, annual leave plans, schedules of working hours, planned night shift work, compensation for inventions and technical innovations, and programmes for surplus work force (Art. 145 of the Labour Law). Furthermore, the employer needs the approval of the employees' council for decisions on the dismissal of an employee whose working ability is reduced or who is directly in danger of becoming disabled, the dismissal of an employee who is a representative of the employees on the Supervisory Board, the dismissal of a male older then 60 years of age or a female over 55, decisions on the collection, use and delivery of information concerning employees to third parties, and the appointment of a person authorized to supervise the collection of personal information concerning employees (Art. 146 of the Labour Law).

[108] A higher number of representatives can be stipulated by a special law, e.g., Art. 17 of the Railway Law prescribes that three out of nine members of the Supervisory Board of the Croatian Railway Company must be elected by employees.

[109] For details see Barbić (2003), p. 212.

[110] The draft law is prepared by the legislative committee of Parliament in the course of harmonisation with the EU law and is supported by trade unions and employers' associations; see the website of the Parliament <http://www.sabor.hr/default.asp?mode=1&gl=200309170000001&jezik=1&sid=>, Log-in: 12 December 2005 (in Croatian).

3. PEPPER Schemes in Practice

There is little evidence of employee financial participation in Croatia. State agencies such as the Croatian Privatisation Fund, the Ministry of Economy, and the Croatian Chamber of Commerce do not collect statistical data on these practices; little scientifically-based research has been conducted. The most popular model is employee share ownership, followed by programmes having elements similar to the ESOP. Profit-sharing occurs in a very few individual firms. Western European firms conducting business in Croatia seem not to use employee participation schemes. However, Western experts helped to design ESOP models in Croatian firms.

a) Share Ownership

Employee minority shareholding in privatisation – No data is available[111] on how many enterprises were privatised by employees under the '*Marković* laws'; even less is known about how many of these early privatisations survived the following decade of transition. In any case, the number was very small. Employee ownership might have established a commanding presence during the first stage of privatisation (1991-1995).[112] Employees and former employees were entitled to buy up to 50% of shares at a discount and pay for them in instalments. But many employees did not buy their maximum quotas.[113] By 1995, small shareholders owned (bought or subscribed) about 20% of the nominal value of the enterprises privatised during this first stage (Jelušić and Perić, 1999; Tipurić, ed., 2004). During the second and third stages, support for employee participation ceased and employee ownership gradually declined and that share had fallen to only 12% in 1998 with the decline continuing up to the present moment. Some authors (Gregurek, 2001) cite this regression as evidence that the 'small shareholder' participation model completely failed. After the first stage of privatisation, many small shareholders sold their holdings to buyers seeking to acquire majority ownership. This was actually a rational move for those not employed by the particular enterprise, e.g. pensioners, former employees, or public sector employees. Their motive was mainly financial from the beginning. However, employee minority share-

111 Due to the fact that Croatia went through the war and economic crisis between 1990 and 1995, there was no systematic data compilation and those data that are available are often not reliable (Šonje and Vujčić, 2000).

112 By the end of first-stage privatisation, 2586 enterprises, mostly small and medium-sized, with an estimated total asset value of 81,389,769,170 Kn., had been privatised. The average value of shares acquired by an individual was 52,130 Kn. Most of those shares were actually subscribed for sale to small shareholders on instalment. No annual statistics on these sales are available.

113 It is known, however, that more than 600,000 small shareholders bought only a portion of the discounted shares to which they were entitled. Although small shareholders, employees in particular, signed up to buy a significant number of shares on the instalment plan, many failed to fulfil their subscription contracts, forfeiting unpaid shares to the state.

holders powerless to influence decisions made by the majority owners also sold their shares easily. Sometimes majority owners pressured them to sell.

Employee Stock Ownership Plans – The ESOP was not among the models originally selected to privatise the former 'social' enterprises. During the privatisation process, however, models spontaneously developed which had certain ESOP features, or which came to be formally designated by that name. Since this form had no official or legal definition and was unregulated, each enterprise was free to develop its own version. Some well-known and successful Croatian enterprises (e.g. Pliva, Zagrebačka banka, Kraš, Dalekovod, AD Plastik) have adopted models having ESOP elements. ESOP-like plans fall into two categories: those intended to transfer majority share ownership to the employees (e.g. AD Plastik, Dalekovod) and those which had no such intention (e.g. Zagrebačka banka, Pliva). The only study of the Croatian ESOP made thus far was based on survey data collected at the end of 2003 (Tipurić et al., 2004). This is relevant to financial participation in general because the basic definition of ESOP was so broad as to include most forms of financial participation.[114] The survey included 552 enterprises: 205 were small (more than 15 employees, thus excluding 'micro'-firms); 211 were medium and 136, large. The sample, which included both sectors and regions, was large enough to provide a reliable overview of all three categories. It found that employees owned 10% of shares in 68% of enterprises reporting; in only 5% of firms did employees own more than 90%. Employees held a majority share (over 50%) in 12% of enterprises. It is noteworthy that large enterprises reported the highest percentage of majority ownership, and small firms the lowest, although the difference was slight – between 10.3% and 13.2% (see also Annex Table 1). These findings could support the view that significant employee ownership tends to transform small firms into partnerships, or tempt employees to sell their shares to managers.

Programmes in support of employee share ownership were found in 9.4% of enterprises (52 out of the 552 total surveyed).[115] Obviously this number is not the same as the number of enterprises with majority share ownership. Some enterprises in this category may not currently have such a programme; others may, even if not majority owned and with no intention of becoming so. Although some ESOPs were already established by 1992, the majority of those identified in the survey were initiated in 2001 or later. This confirms that the ESOP model was not a part of Croatia's original privatisation concept,[116] but developed and gained momentum after 2001. The study further shows that ESOP programmes are most frequently found in medium-sized and especially large-scale enterprises. This can be explained by the specific features of

114 In this research ESOP was defined as an 'organized programme of larger involvement of employees in the enterprise ownership'.

115 In many cases analysed in the study, ESOP programmes were stopped or completed, and some programmes had only a few ESOP characteristics in their design.

116 Only nine out of 52 cases of ESOP programmes found in the research were started before 1996. Those first programmes did not have genuine characteristics of ESOPs, but were registered as such because of the broad definition used in this research.

small and large-scale privatisations. Most small enterprises were completely privatised during the first phase of transition; their ownership structure was fixed at that time. There has been neither the desire nor the opportunity to alter the original structure by a means as relatively complex as the ESOP. Large enterprises were privatised much later so their ownership has not had time to concentrate. The survey also asked questions about who initiated ESOP programmes and why. Managers were mentioned most frequently in more than 55% of cases, or more than 63% when middle managers are included. Owners and their representatives (boards of directors, general meetings) took the initiative (probably sometimes jointly with management) in 29% of cases. Employees, through trade unions, worker councils and small shareholders associations often initiated various programs to support employee ownership (jointly in some 35% of cases). In small enterprises, managers and owners were initiators in equal numbers; medium-sized firms had the most mixed process while in large enterprises, management played the dominate role. Unions often took an active part in initiating ESOPs in large enterprises; owners seldom.

Also a statistically significant relationship was found between dominant employee ownership (small shareholders) and the presence of an ESOP. It is not possible to determine which came first – the ESOP or majority ownership. Did broad-definition ESOP programs result in the acquisition of more shares by employees during privatisation? Or did the ESOP transform minority shareholder employees into a majority? A chicken-and-egg question, though the majority of ESOPs were introduced after first-stage privatisation was over. As for employee share percentages (see also Annex Table 2), the smallest were found in enterprises in which employees had acquired more than 80% of their shares through ESOPs or during privatisation. That is to be expected since ESOP is a mechanism for acquiring significant share ownership over time; the privatisation period was too short to achieve this goal, especially in medium and large firms. Where the ESOP was used to gain ultimate control of the firm, crossing the 50% ownership threshold greatly reduced motivation to purchase more shares. In any case, the distribution data shows that ESOPs in Croatia have different goals and lengths of maturity.

In conclusion, ESOP programmes, broadly defined, can be divided into three categories, according to their founding purpose. These purposes include: (1) Enabling employees to pay for shares issued during the first phase of privatisation (1992-1995). These early plans did not have the characteristics of genuine ESOPs. Usually they were a combination of MEBO and ESOP. Top management usually took the lead in establishing them; their objectives once achieved, management (and even employees) often lost their initial enthusiasm. (2) Preventing hostile takeovers, or to keep control in the hands of insiders (mainly management). (3) Motivating employees to improve their work performance and to identify with the enterprise. These plans were introduced in large, relatively stable enterprises which had exited from first-phase privatisation with a mixed ownership structure and no majority owner. Employee majority ownership was not a goal.

b) Profit-Sharing

Profit-sharing as customarily practiced elsewhere does not exist in Croatian enterprises – at least no mention of it is found in legislation, legal documents or collective agreements. One explanation for this may be the absence of state regulations in this area; another, that profit-sharing is associated with the Communism self-management system where employees had the autonomous right to decide how the profits of their enterprise were to be distributed – and usually they decided to direct a goodly part back to themselves as wages. Also the Croatian tax system discourages the direct transfer of profits to employees. Such a transaction would trigger a double-tax, firstly on the enterprise as profit, and secondly on the employee, as income. Some firms did transfer some part of their profits to employees even after the end of first-stage privatisation. But these practices did not have the features of genuine profit-sharing. Usually they took the form of wage increases in the most successful firms. A direct link with profit-sharing is most evident when a portion of wages is made dependant on financial results, but such instances are rarely reported.

c) Cooperatives

According to official statistics, at the end of 2003, there were 2,071 cooperatives (all types) registered in Croatia, but only 878 of these were going concerns. Such a ratio between enterprises officially registered and actually in operation is not unusual; indeed, the ‘activity ratio’ (42.39%) was significantly higher than the average for all enterprises in Croatia (only 17.77%). While only 2.7% of total enterprises were cooperatives, they accounted for 5.9% of operating enterprises. Cooperatives in productive sectors had an even higher ‘activity ratio’. Even without solid proof, this could indicate that Croatian cooperatives surviving the 1990s were not founded on a *pro forma* basis, as were many ‘conventional’ enterprises, and that they are more stable and have better chances to survive in the market. However, if the size of the work force is considered, it is evident that the cooperative sector employs very few people. One operating cooperative employed an average of only 3.8 employees, while the average for an operating company was close to 72 employees. This shows that the majority of Croatian cooperatives are not production-oriented but engaged in trading and intermediary activities. Also the low employment averages are certainly related to the fact that cooperatives do not usually hire their own members – quite the contrary, employees do not usually have membership status. Thus the majority of cooperatives in Croatia do not qualify as a business form based on employee participation.

4. Evidence of the Effects of PEPPER Schemes

The only available evidence of the effects of employee participation on enterprises is a general study by Tipurić (2004), quoted above, and several case studies.[117] The Tipurić study is based on the subjective opinions of managers; it is not an objective appraisal of effects. The managers were asked how satisfied they were with the results of their ESOP programmes. About 56% described themselves as *satisfied* and 19% as *very satisfied*. Only 14% expressed dissatisfaction. The high degree of satisfaction might be explained by the fact that (as earlier shown) managers themselves played leading roles in the establishment of most Croatian ESOPs. Interestingly, the most dissatisfied were managers in medium-sized firms, while the most satisfied were managers in large concerns.[118] The managers were further asked to evaluate the degree to which they thought ESOP programmes improved business results. Their answers did not indicate a significant impact. The majority checked the response stating that ESOPs had a small influence. Overall the managers believe that ESOP has a positive impact, but on a scale of 1 to 5, the average score was 2.77, slightly less than the median value of 3.[119] Differences in responses between managers of small, medium and large enterprises were negligible on this question.

Another interesting comparison is the different responses to this question given by managers of firms which have real ESOPs and those which do not (see Annex Table 3). The responses of the latter group fell lower on the scale, with an average rating of 2.45. This was lower than the rating of managers with ESOPs, but the difference was not significant. Managers value ESOP most highly for its contribution to increased productivity, and least for increasing capitalisation. It also should be noted that managers do not consider ESOPs as a means of raising new capital, but as a tool for motivating employees to perform better and more efficiently, thus increasing company profits. Managers of firms without ESOPs consistently rated all of these factors lower on the scale, their average falling between 2 and 3. This negative impression might be attributed to lack of knowledge and information about ESOP programmes. But it could also signify lack of enthusiasm for introducing new ESOPs into Croatian enterprises. (Non-ESOP enterprises outnumber ESOP enterprises ten to one.)

Finally managers were asked how much ESOP programmes contributed to employee participation in decision-making, Managers of ESOP enterprises were not strongly convinced that ESOPs had a significant effect. On a scale from 1 to 5, their average estimate was 2.72 (well below the median). Managers of large firms were slightly more

117 Although the Tipurić study is confined to ESOPs, as explained earlier, ESOP in Croatia is broadly defined so as to encompass also other forms of financial participation in use; thus it is generally relevant.

118 The average mark of satisfaction with the results of ESOP programmes (on a scale from 1 to 5) in large enterprises was 4.5, in small enterprises 3.73, and in medium-sized enterprises 3.50.

119 It could be presumed that the majority of respondents giving their marks treated the middle answer as neutral, although it contained an expression that spoke about positive influence.

optimistic, but their average estimate was only 2.82. It is interesting that managers without ESOPs estimated its influence on decision making more highly than managers who actually did - the former's average estimate was 2.87. This could mean that managers with ESOP experience are better informed about its influence and effects, or that managers lacking ESOP experience over-estimate (and perhaps fear) its potential influence in this area. Managers of ESOP firms give the ESOP highest marks for its positive influence on the firm's public image, and after that, for improving their employee involvement in accomplishing the firm's goals. They do not believe that the ESOP contributes to attracting superior managers and professionals. Again this is consistent with the earlier observation that in most cases managers initiated the ESOP with the intention, direct or indirect, of maintaining their control over the enterprise.

Several conclusions on the effects of financial participation may be drawn: The transition process and its transformation of ownership have not significantly improved the efficiency, productivity or profitability of Croatian enterprises. On the contrary, output in the national economy, as measured by GNP, has been falling for more than a decade. This decline could be attributed to war and the damages inflicted by war; on the other hand, the majority of small, medium and large enterprises have also had poor results, even in those parts of Croatia not affected by the war. Employment has also fallen while unemployment has boomed. In the period 1990-97, employment fell by almost 500,000 (from a total of 1,509,488 workplaces in 1990) mostly in industry and services. Recovery in the Croatian economy began, according to different indicators, between 1998 and 2001 (Croatian Chamber of Commerce, 2004). The results of this recovery, however, have been less spectacular than the decline during the 1990s. It could be inferred that even if the basic privatisation model included elements of employee (financial) participation, these did not make a significant contribution, at a general level, to the successful transition of the Croatian economy and its individual enterprises.

Considering that majority or at least significant employee ownership was achieved most often in small enterprises, it should be noted that small enterprises in Croatia show significantly worse business results than medium-sized or, especially, large enterprises. Since there are no studies distinguishing firms in which employees hold a majority stake and those in which they do not, and since the majority of Croatian firms are privately owned, it cannot be assumed that small firms with majority employee ownership have worse business results than those with conventional structures. The majority of medium-sized and large (formerly self-management enterprises) have not as yet made the necessary changes and revisions in their organisational structure and business strategy. Their most immediate concern was survival, and organisational changes mainly focused on cost cutting, work force reduction, and plant closings. In this situation, employee participation, even if some elements of it existed, could not have affected business results to any significant extent. So again, we are left without evidence as to whether employee participation has a positive or negative influence on enterprise success.

Annex

Table 1: Employee share in ownership (%)

% of ownership held by employees	Small-sized enterprises	Medium-sized enterprises	Large-sized enterprises	Total
< 20%	82.5	73.0	69.9	75.4
20 – 50	5.9	10.4	14.0	9.6
50 – 80	4.9	5.2	8.8	6.0
> 80 %	5.4	6.6	4.4	5.6
n.a.	2.4	4.7	2.9	3.4
Total	100	100	100	100

Source: Tipurić et al. (2004).

Table 2: Distribution of ESOP programmes according to the proportion of ownership held by employees (%)

% of ownership held by employees	Small-sized enterprises	Medium-sized enterprises	Large-sized enterprises	Total
< 20%	27.3	38.1	15.0	26.9
20 – 50	18.2	14.3	40.0	25.0
50 – 80	18.2	14.3	25.0	19.2
> 80 %	18.2	4.8	15.0	11.5
n.a.	18.2	28.6	5.0	17.3
Total	100%	100%	100%	100%

Source: Tipurić et al. (2004).

Table 3: Average values of performance indicators for different groups of enterprises

	Increase in capital	Increase in productivity	Increase in profits	Increase in market value of shares
Small-sized enterprises	2.36	3.27	2.91	3.00
Medium-sized enterprises	2.62	3.43	3.33	3.25
Large-sized enterprises	2.21	3.25	3.05	2.79
Total enterprises with ESOPs	2.41	3.33	3.14	3.02
Enterprises without ESOPs	2.19	2.93	2.75	2.50

Source: Tipurić et al. (2004).

Taxation Issues

As previously mentioned, no legislation explicitly regulates the taxation of employee participation schemes. Tax provisions important to this class of benefits are found in the Income Tax Law of 3 December 2004 (ITL), and the Profit Tax Law of 3 December 2004 (PTL). Art. 30 ITL makes all shares transferred to employees as well as executed stock options part of taxable income. More generally, all compensation received by an employee from his employer is considered taxable income under ITL. Dividends as well as gains from the sale of shares are exempted from income tax, so once employee ownership is created, future gains from those origins are not taxable. Under PTL, there are no exemptions for profit-sharing schemes. Consequently company profits allocated to employees (cash-based or deferred) will be taxed twice: first with profit tax, and then with income tax.

III. Cyprus

Neither employee ownership nor profit-sharing is present in the economy of Cyprus. The country has developed financial institutions, with more than 50% of households holding shares as financial assets, and a well developed cooperative sector with more than 50% of the population being cooperative members. The industrial relations system, based largely on voluntary regulations that allow room for joint initiatives, is at the same time characterised by relatively high union density. Nevertheless, employee participation, either in the form of financial or decision-making, has not been on the agenda of the government or social partners.

1. General Attitude

The long tradition of tight regulation of financial markets, capital controls, and limited financial assets available to households has changed since the mid-1990s. A modern capital market has evolved through the Cyprus Stock Exchange (CSE), which launched its official operations in March 1996 in accordance with the Cyprus Stock Exchange Laws and Regulations passed by the House of Representatives in 1993 and 1995. Nevertheless, the existing scepticism of the population towards financial markets is mainly rooted in the boom and crisis of the CSE.[120] With regard to the average size of enterprises and units, in 2000 only 70 companies in Cyprus employed more that 250 employees.[121] Self-employment has been a permanent feature with self-employed persons accounting for 20% of the active labour force.[122] Voluntarism has been developed through the Industrial Relations Code and operates via National Tripartite Bodies such as, amongst others, the Labour Advisory Board, which deals with the main issues of industrial relations, and an equally important Economic Advisory Committee which deals with economic policy issues. The tripartite bodies work as integrated functions

[120] By October 2001, the market was approaching the 100 level, having fallen from 800 at the peak of a short-lived boom in 1999. During 2002 and 2003 the market continued a long-term decline, with brief turns to growth, reaching a level of 80 in late 2003. In 2004 and 2005 the market remained calm, with the index unable to break out of the range 80 - 90.

[121] 58% of the enterprises employed one person, 37% 2-9 persons, 4% 10-49 persons and only 1% exceeded the limit of 50 employees (this amounts to 99.9%), see Census of Enterprises 2000 (Statistical Service of the Republic of Cyprus, 2001).

[122] It has also been observed that salary and wage earners undertake small-scale entrepreneurial activity, and are thus 'multiple-jobholders' - especially with regard to the development of the services sector.

of the Ministries.[123] The voluntarism in industrial relations is coupled with relatively high union density estimated at 65-70%, and similarly high levels of coverage by collective agreements.[124]

Social partners in Cyprus are well organised and play an active role in the development and implementation of social and economic policy. Trade Unions are mainly organised at industry level and belong to strong federations or confederations, the most important being the Cyprus Workers Confederation (SEK, affiliated to the ETUC) the Pancyprian Federation of Labour (PEO) and the Democratic Labour Federation (DEOK).[125] Employers are also organised into industry or branch level associations, most of which are members of the Cyprus Employers' and Industrialists' Federation[126] and the Cyprus Chamber of Commerce and Industry. While the social partners shape the evolution of industrial relations, employee financial participation has not been an issue on their agendas. During the 1990s only SEK initiated a stance in favour of employee representatives' participation in decision-making through the participation of labour representatives at the board level of public sector and semi-public sector institutions and organisations, but without success.

The aims of the economic policy of the government in the last decade have not embraced the idea of financial participation of employees, favouring voluntary arrangements in industrial relations. In the context of the pre-accession period national policy makers have focused on priorities related to the compulsory transposition of the *acquis communautaire*, thus leaving aside issues such as the development of PEPPER schemes. The process of harmonising national with European law has recently led to debates concerning the evolution of the voluntary-based system of industrial relations, but has not yet touched upon issues of employee financial participation. With the minor exceptions of the Laws transposing the directives on the Involvement of Employees in the Activities of EC-scale Undertakings, EC-scale Groups of Undertakings and European Companies transforming EC directives 94/45/EC and 2001/86/EC this is also true for participation in decision-making.[127] Neither the government nor the social partners have included the issue of promoting financial participation schemes in their

123 A Redundancy Board and a Central Board for Annual Holidays with Pay complete the set of national tripartite bodies.

124 According to Ministry of Labour estimates 41% of employees have their pay and working conditions defined by sectoral collective agreements (approx. 74,000 employees), 6% of employees have their pay and working conditions defined by agreements in the semi-governmental sector (approx. 10,000 employees), 25% of employees have their pay and working conditions defined by company collective agreements (45,000 employees) and 17% of employees have their pay defined by agreements in the public sector (approx. 33,000 employees). The government set the minimum wage and the minimum standards to cover segments of the remaining 11% of employees (approx. 20,000) who are not covered by collective agreements.

125 There are also other powerful individual unions, such as the Public Employees' Union (PASYDY), the Bank Employees' Union (ETYK) and the Teachers' Unions (POED and OELMEK). Nearly 98% of white-collar civil servants are members of PASYDY.

126 Founded in 1960 OEBE is a Pancyprian independent Organisation and member of UNICE.

127 However, at the moment there is no European Company registered in Cyprus.

agendas. Political forces and the trade unions, which could have promoted the idea of employee participation, may first have to implement the idea of employee participation in decision-making and then - or in parallel - consider the issue of financial participation. However, the process of the transposition of EU directives suggests the issue may gain further momentum.

2. Legal and Fiscal Framework

The Cypriot legal system is based upon the same principles as those applicable in the United Kingdom and all laws regulating business matters and procedures are based essentially on English Common Law.[128] The institutional and legal framework generally does not - at least intentionally - create incentives for, but neither do they prevent, the development of PEPPER schemes.

a) Share Ownership

Registered companies in Cyprus are governed in the main by the Cyprus Company's Law (hereinafter referred to as CL), Chapter 113 of the Laws of Cyprus, as amended, which is identical to the UK's former Companies Act 1948. Under the CL, companies can be divided into companies limited by shares and companies limited by guarantee[129]. Companies which are limited by shares can be subdivided into private companies and public companies. There is no law in Cyprus on share option schemes for employees but these may be included in private employment contracts or may be decided upon by the company so as to give these options to employees as part of an incentives scheme. The CL does not contain special rules on employee profit-sharing and contains only a mere notion of employee share ownership: The provisions of the Second Council Directive 77/91/EEC of 13 December 1976 were adopted by the national legislation and specifically in the CL. Therefore, in deviation from the general prohibition to acquire own stock, Art. 57a CL permits a company to acquire its own shares without requiring a special resolution of the general shareholders assembly[130], if the shares are acquired for the purpose of being transferred to the company's employees[131] or to the employees of an associate company. In order to facilitate the acquisition of shares by employees Art. 53 CL permits that the company may advance funds, make loans, or provide

128 English case law is cited in the Cypriot Courts and is of persuasive authority.

129 In the majority of cases, companies of this nature are incorporated as non-profit making organisations. Companies limited by guarantee can be registered with or without share capital and the liability of each member is limited to the amount agreed on in the memorandum of association to be contributed in the event of the company going into liquidation.

130 As the general provision for a company acquiring its own shares stipulate.

131 The term 'employee' also includes directors holding salaried employment or office in the company.

security, with a view to acquisition by employees of the company or employees of an associate company.

b) Profit-Sharing

There is no prohibition in the Cypriot legal system with regard to profit-sharing by companies with their employees. However, there is no explicit regulation linked to that either.[132]

c) Cooperatives

The Law on Cooperatives (hereinafter Coop Law) that defines the types of Cooperatives and their hierarchy originates in 1914 but was updated in 2000 to conform to EU provisions.[133] The law provides that a Cooperative can be registered either as a limited liability company or as an unlimited liability company (Art. 6 Coop Law). In the latter case, unless the Cooperative goes into liquidation, the members' liability is limited and they cannot be sued personally for any liabilities, debts or obligations of the Cooperative. Although there are no specific provisions which give privileges to cooperative members as opposed to cooperative employees, in practice, most employees are members since membership gives access to loan facilities (Art. 14 (6) Coop Law). The Profits of Cooperative Credit Institutions from operations with members are tax exempt. In 2001 the Cooperative Movement reached a settlement[134] concerning the harmonisation of the Cooperative Credit Sector with the *acquis communautaire*. With regard to state aid this process foresees that the profits of Cooperative Credit Institutions resulting from operations with members will continue to be exempt from corporate income tax while those from operations with non-members will not.

d) Participation in Decision-Making

Industrial relations in Cyprus are based upon the Industrial Relations Code, which is a joint agreement between the two major labour confederations (PEO and SEK) and the Cyprus Employers' and Industrialists, signed in April 1977. The CL does not contain any special provisions concerning employee participation in control and decision-making in corporations. With regard to board-level representation the practice in state and semi-state companies has been for the government to appoint from time to time

[132] There is, however, the possibility that a company may agree to implement bonus schemes with its employees according to their performance or for percentages (commissions) according to the sales that their department has made.

[133] The current Law on Cooperatives is based on No. 22 of 1985 and 68 of 1987 which were amended by 190/89, 8/92, 22(1)/92, 140(I)/99, 140(I)/2000, 171(I)/2000, 8(I)/2001, 123(I)/2003, 124(I)/2003, 144(I)/2003, 5(I)/2004 and 170(I)/2004).

[134] The European Union has granted a transitional period until the end of 2007 for full harmonisation of the Cooperative Credit Institutions with the *acquis communautaire*.

high-level trade union officials, mainly from the confederations, to the administrative boards of state-controlled organisations, although this is not required by law, but is rather a legacy of state management. A new and emerging influence comes from the European Union, i.e. employee participation in decision making at a Community level has to some extent been safeguarded by the implementation into Cypriot national law[135] of Council Directive 2001/86/EC on supplementing the Statute for a European company with regard to the involvement of employees. Other social and labour legislation issues, such as employee rights concerning information and consultation as regulated in Member States, are within the scope of existing national provisions, as these apply to public limited-liability companies.

3. PEPPER Schemes in Practice

No comprehensive information is available on the overall incidence of PEPPER schemes in Cyprus. Interviewing social partner representatives failed to locate a single case.[136] Further research is needed to clarify the existence of any PEPPER schemes, or the reasons why employee financial participation is not yet developed despite a legal, institutional and taxation environment that is not against (i.e. provides no disincentives to) the development of financial participation schemes. There are no cases of securities issued by a company and offered to employees of that company.[137] Nevertheless, employees are not restricted in their acquisition of shares; in fact it is a common phenomenon, especially in public companies listed in the Stock Exchange, for employees to buy the shares of the company which employs them. This might be due to the absence of any tradition of employee financial participation in Cyprus combined with the relatively recent emergence of the stock market in a small economy dominated by small businesses. Profit-sharing is not practiced in Cyprus while other forms of monetary incentive schemes are occasionally used in companies practicing modern human resources methods. Neither the literature review nor the interviews with social partner representatives enabled us to trace any practices of profit-sharing.

135 By virtue of Law No. 277(I)/2004.

136 The only exception were stock option schemes only available to top managers, i.e. not broad based stock options and as such not a PEPPER scheme.

137 Even in the developed financial and banking sector the only scheme traced refers to loans to employees to buy shares during the stock exchange boom period in 1999. The dominant pattern in that period referred first to the banks informally or unilaterally supporting loan taking by their employees to invest in the Cyprus Stock Exchange in general, not only their own stocks – although a priority was given to the latter. At the latest stage after the stock market crash of 2001 the issue became one of deleting bad debts and curtailing high loan rates to help employees to minimise losses and maintain their share presence in the Stock Exchange. This has been a recurring issue in the bargaining procedures of the banking sector.

Cooperatives – The Cooperative Movement was introduced in Cyprus at the beginning of the 20th century.[138] In 1937 the Cooperative Central Bank was founded, the purpose of which was the accumulation of funds and self-financing within the Cooperative Movement.[139] During the period 1936-1974 the Cooperative Movement experienced a significant growth which came to a halt with the Cypriot-Turkish conflict.[140] In 2002 the cooperative sector in Cyprus incorporated 673 entities, 652 at primary level (with physical persons as members, and with a minimum of 12 persons), 11 at secondary level (with members being both individuals - at least 12 - and primary level cooperatives, or five primary level cooperatives) and 1 at the tertiary level (with only secondary level cooperatives as members), overall involving 387,960 persons. Today the Cypriot Cooperative Movement is considered to be one of the strongest and best-organised cooperative movements worldwide. This strength is expected to continue in the context of Cyprus' membership to the European Union. Through harmonisation with the *acquis communautaire*, the DCD is promoting the participation of the Cooperative Movement through Producers Organisations in the liberalisation of agricultural markets. The elimination of current monopolies offers the Cooperative Movement important opportunities for further development.

4. Evidence of the Effects of PEPPER Schemes

There are no studies that deal with the effects of PEPPER schemes with regard to its impact upon Cypriot business and industrial relations practices.

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138 To cope with the economic problems created after the First World War, in 1925 the government established the Agricultural Bank, whose main purpose was to provide long-term credit to farmers. In 1935 the first Commissioner was appointed and by 1936 the Department of Cooperative Development (DCD) was founded which played a decisive role in the development of the Cooperative Movement.

139 The bank accepted the surpluses of 'prosperous' societies as deposits and granted loans under favourable terms to smaller, less well off societies; in return the Cooperative Societies lent funds to their members, mainly in the form of short-term credits.

140 The Cooperative Movement, in order to help refugees to reactivate, established new large cooperative societies and/or reactivated existing ones operating in the industrial sector. Unfortunately, this action failed and had a negative effect upon the financial status of the movement. The result was the dissolution of these societies in the early 1980s.

Annex

Taxation Issues

In the summer of 2002, the House of Representatives of Cyprus enacted a series of new laws amending the existing tax legislation. Personal income is taxed progressively at a rate between 0% and 30%. Interest, dividends, profits from a permanent establishment abroad (under certain conditions), lump sums received by way of retiring gratuity and computation of pension, capital sums accruing to individuals from any payments to approved funds (e.g. provident funds) and profits from the sale of securities[141] are completely exempt.[142] On the other hand, bonuses paid to employees for their performance are not exempt from income tax. However, under the Capital Gains Tax (Amendment) Law No. 119 (I) of 2002, effective from 1 January 2003, gains accruing from the disposal of shares listed on any recognised Stock Exchange are exempt from capital gains tax.

In July 2002, as part of the Income Tax Act No. 118(I) of 2002, Parliament approved a uniform 10% corporate tax rate, to apply to both onshore and offshore[143] companies. There is no longer a distinction between local companies and international companies if management and control of the latter is exercised from Cyprus. Thus, the taxable profits of all Cypriot companies will be taxed at the rate of 10% which gives Cyprus the lowest corporate tax rate in the EU. The taxable rate for semi-governmental organisations (such as the Cyprus Telecommunications Authority) is 25%. Profits from the disposal of shares, debentures, bonds and other securities of companies or other legal entities, and dividends in Cyprus and abroad, 50% of interest income[144] as well as - under certain conditions - profits received in Cyprus from permanent establishments abroad are not subject to taxation.

According to tax law, it is more profitable for employees to receive dividends than wages since they pay no taxes on dividends; it is the employer company that is obliged to pay taxes on dividends.

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141 Securities is defined as shares, bonds, debentures, founders' shares and other securities of companies or other legal persons, incorporated in Cyprus or abroad and options thereon.

142 Apart from the above-mentioned exceptions there are certain tax deductions. Therefore, the whole amount of contributions to trade unions or professional bodies and donations to approved charities (with receipts) are deductable and so is 20% of rental income.

143 The Cypriot Government have worked to create a favourable offshore tax regime and the almost 50,000 offshore companies registered in Cyprus since 1975 attest to the success of this programme. However, the island's entry to the EU in 2004 meant a restructuring of the tax regime, which took place on 1 January 2003.

144 However, this exemption does not apply if the interest income was derived from the ordinary trading activities of the company.

IV. Czech Republic

The country which has granted far the fewest concessions to insiders through privatisation is the Czech Republic. Despite some tradition[145] of both financial participation of employees and employee participation in decision-making, the Czech privatisation framework did not anticipate any special price reductions, credit facilities, or preemptive rights for employees. In contrast to the comprehensive approaches of, for example, Poland, Czech policy favoured the voucher concept; no specific schemes for employees were developed. After the split with Slovakia in 1993, the importance of creating an institutional and legal foundation to support entrepreneurial activities and maintain the transformation process was not understood. The resulting corporate governance and enterprise structures were – and still are – unfavourable to the evolution of employee participation in general. Of the existing, rather restrictive, regulations on employee share ownership and (share-based) profit-sharing, only the former have been implemented, although to a very limited extent. Nor have they so far been accompanied by a comprehensive incentive system. At the same, time the cooperative sector has declined in importance.

1. General Attitude

In 1989 the private sector of Czechoslovakia was one of the smallest in the communist world; it employed only about 1.2% of the labour force and produced a negligible fraction of national output (all estimates fall well below 3% of GDP). At the end of the communist experiment, the necessary macroeconomic reforms were put in place; however, these contributed to the division of Czechoslovakia in 1993. Although privatisation was begun during the reform, its results were only realised after the split; therefore the Czech and Slovak Republics took slightly different paths. Nevertheless, in both countries industrial cooperatives continued to produce a small share of GDP while the design of privatisation was adverse to creating significant employee ownership. The reasons for this development are mainly to be found in the historical circumstances obtaining at the beginning of the ownership transformation. Nacent political and economic reforms in Czechoslovakia, unlike, for example, in Poland, were terminated by the Soviet invasion in 1968. Czechoslovakia was left with a strong central presence in state owned enterprises along with very weak, docile official trade unions. Within state enterprises, workers had little if any power. Even the partial reforms of 1988-89 left employee participation extremely weak, while the state planning authorities still had

[145] Concerning historical development see Kotrba (1997, reprinted 1999).

power to impose obligatory requirements on enterprises. Large-scale privatisation is the most known programme undertaken in the Czech Republic. Although the privatisation framework did not subsidise employee ownership by giving employees the right to acquire shares in their companies under favourable conditions, it also did not prevent employees from exchanging their vouchers for shares in their enterprise – an option some companies explicitly encouraged.[146] Furthermore voucher privatisation was designed so as not to reserve a given portion of shares for employees at nominal price. Rather, the individual projects could specify this option and the amount reserved. Since shares were traded below their nominal values, however, nobody exercised this option (see Annex Table 2).

Trade unions do not actively promote employee participation, nor do they consider doing so in future.[147] After the outcome of voucher privatisation the confidence of the general public in share ownership and similar programmes is negligible, if not non-existent. They see employee financial participation in the near future as extremely limited in both scale and scope. Also, a unified programme would have to be in place, something like ESOPs in the USA, to give to the firms a clear, integrated model to follow. A similar picture is given in the case of the Czech Association of Employers/ Entrepreneurs SPČR (Svaz podnikatelů ČR)[148]: they have no official stand regarding employee participation models and neither possess data nor investigate how frequent it is or what its scope is amongst their members. Nowadays the involvement of employees in decision-making within the Czech economy takes place through tripartite negotiations rather than through direct participation by individuals or groups of employees in company management.[149] There is a group representing workers' interests within the labour union network, as well as a group representing employers. These groups are concerned with both the sectoral and macro-economic levels. They meet with the government regularly in tripartite negotiations of crucial issues of economic policy. While participation in decision-making – as part of the *acquis communautaire* – has been put on the agenda, financial participation of employees has not.

Labour-management played a significant role in the Social Democratic Party's election programme in both 1990 and 1992. Employee Stock Ownership Plans (ESOPs) were an important element of the 1992 programme of the 'Liberal Social Union', and also included in the programme of the Communist Party (Kotrba, 1995). Until the summer of 1990, Employee Share Ownership Plans (ESOPs) were discussed within the gov-

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146 See Kotrba (1997, reprinted 1999), p. 132. E.g. ZPS Zlín, a machinery producer focused on exports to the most developed Western market. Its employees, retired employees and local citizens formed an Association of Shareholders of ZPS, which played an important role as one of the largest shareholders of the company.

147 Such was the basic line in an interview with Ing. Fassman, a representative of ČMKOSs (Českomoravská komora odborových svazů), the leading association of major trade unions.

148 The opinion given in an interview with JUDr. Hejduková, a representative of SPČR.

149 Although in companies with more than 50 employees there is supervisory board representation, employees behave quite passively in using this device. It is rather the centralised structure of Labour Unions that attempts to affect what is going using the tripartite negotiations.

ernment, and employee ownership was included as a potential privatisation method in some early 1990 government documents. After the June 1990 election victory of the Civic Forum, a movement broadly oriented towards introducing a market economy, ESOPs and labour-management proposals lost support as private-property-based reforms gained in popular appeal. Moreover, the government committed itself to the voucher privatisation method which would enable everyone to acquire ownership in privatised companies, not just their own employees. Today employee participation is no longer a political issue – none of the democratic parliamentary political parties includes this issue in their programmes. The last time it was raised as a political issue was at the end of the 1990s, when Social Democratic Prime Minister Miloš Zeman was trying to push forward the agenda of increasing employee financial participation. Since that time, politicians have been silent about the issue.

2. Legal and Fiscal Framework

The Czech legal framework does not contain any specific employee financial participation measures or any particular law or regulation designed to regulate specific issues pertaining to PEPPER schemes, as in some other countries. The only form of corporate ownership the law makes available to employees are – to a limited extent – regulations on share acquisition by employees and profit-sharing in joint-stock companies.

a) Share Ownership

Privatisation (1990) – Mass privatisation, in principle, allowed employee shares and ownership to emerge. For each firm assigned to the mass privatisation, the firm's management had to submit a privatisation plan depicting for how the firm could be privatised. This proposal could involve any combination of all available methods of privatisation (e.g. voucher scheme, domestic direct sale, foreign direct sale, public auction or tender, free transfer, or employees' shares). It was possible for anyone other than the firm management to submit a competing privatisation plan for all or part of each enterprise. The supervising ministry and the Ministry of Privatisation decided on the winning project (foreign sales had to be approved by the government). Finally voucher privatisation itself provided another way of creating employee ownership within the privatisation process. In the design a small portion of shares was proposed and reserved for employees (see Annex Table 2).

Private Companies (1989, 2000, 2004) – In 2000,[150] Art. 158 of the Commercial Code (herein referred to as CC)[151] was revised in line with the *aquis* to abolish any type

[150] Law No. 370, effective as of January 1, 2001.

[151] CC of 5 November 1991, Sb. 1991 No. 513; last amended by the Law of 3 April, 2005, Sb. 2005, No. 216.

of special share; it also eliminated 'employee shares' as a special type of share. Instead, from now on, joint-stock companies could add to their Articles of Association provisions allowing their employees to buy company shares at a discount. Previously issued 'employee shares' had to be converted into regular shares by decision of the general shareholders assembly by January 2003.[152] Since, according to Art. 186a para. 3 ff. CC, dissenting shareholders must be bought out in a public offering, employed shareholders were given the de facto opportunity to cash-out their shares (Štenglová et al., 2004, § 158). Acquisition of shares on preferential conditions according to Art. 158 CC – introduced into the Commercial Code and replacing 'employee shares' – is limited to current or retired employees.

As an exception to the general prohibition against acquiring its own stock, Art. 161a para. 3 CC, introduced in 2004, permits a company to acquire its own shares in order to sell them – in accordance with the Articles of Association[153] – to company employees of the company. In this case the shares must be transferred on preferential conditions to the employees within twelve months of acquisition. If the transfer is not carried out within the stipulated time period, Art. 161c CC requires that the shares be sold or the share capital will be decreased accordingly; if the company does not comply, a court can order its liquidation (Art. 161c para. 2 CC). Furthermore, current legislation permits joint stock companies to issue new shares granting employees favourable conditions in the context of so-called mixed capital increases, i.e. the capital increase of a company issuing new stock financed by the company's own capital. According to Art. 209a para. 3 CC, 50% of the purchase price must be paid before registration of the increased capital in the commercial register, while the remaining 50% may be paid for by instalments. According to Art. 203 para. 3, 209 para. 2 lit. d) CC, shares issued to be acquired by employees shall not be considered to constitute a public offering, provided that the relevant employees are identified in the decision of the general shareholders assembly on the capital increase. In order to facilitate the acquisition of shares by employees, the legislation also permits the company to fully pay for the stock acquired by its own employees of the. The restrictions of the preferential conditions for the purchase of shares by employees are enumerated in Art. 158 para. 2 CC. As in the previous regulation, the overall value of the granted discount for the issued shares may not exceed 5% of the enterprise's equity capital and must be covered by the company's own resources (Eliáš et al., 2004, § 158). In addition, Art. 161e para. 3 of the Czech Commercial Code contains a regulation excepting a company from the general prohibition against leveraging the acquisition of its own stock if these shares are to be sold – in accordance with the Articles of Association[154] – to its own employees (Štenglová et al., 2004, § 161e). Thus share acquisition by the employees of a particular company may be leveraged by the company's discounting the purchase price within the aforementioned limits, by credit financing, by providing collateral, or by a combination of these three preferential methods.

152 According to Part VIII No. 25 of the amending Law No. 370.

153 As required by Art. 158 CC.

154 As required by Art. 158 CC.

An issue to be mentioned in the context of employee share ownership is a new regulation introduced in 2005 for publicly traded joint stock companies (subject to regulation by the public securities rules), where a share holder owning at least 90% of total shares is permitted to make a final buyout offer to remaining shareholders (squeeze-out).[155] In such a case, minority share holders, who may be company employees who acquired the shares during privatisation or on preferential conditions, would be obliged to sell their shares to the major shareholder. Thus minority share holder employees may be forced to sell out to a majority shareholder.

b) Profit-Sharing

Nothing in the Czech legal system prohibits companies from profit-sharing. The only explicit regulation provided is Art. 178 para. 4 of the Commercial Code which states that in accordance with the Articles of Association employees may be entitled to a share of company profit (cash-based profit-sharing). According to Art. 158 CC, the Articles of Association may also stipulate that profits allocated to employees be used exclusively to purchase shares on preferential conditions or to offset the discount granted to employees for this purpose (share-based profit-sharing) (Štenglová et al., 2004, § 178; Eliáš et al., 2004, § 158). Share-based profit-sharing is also mentioned in the context of capital increases. A capital increase generally requires the approval of the general shareholders assembly. However, Art. 210 CC – in accordance with the Articles of Association – assumes that this decision will be delegated to the management board. Art. 210 para. 4 CC regulates a capital increase by the issuing of shares to be transferred on preferential terms to employees. It emphasizes that this option is especially suitable in cases where the general shareholders assembly has previously directed that profits allocated to employees be used exclusively to purchase these shares. These benefits are all taxable at the progressive personal income rate of 15% to 32%. Therefore as personal income rises, the incentive to provide additional benefits progressively decreases. Benefits from profit-sharing, for example, may be as much as 17% less than the same amount in dividends paid to shareholders.

c) Cooperatives

Cooperatives were being treated in a separate programme and could not be subject to mass privatisation. At the end of 1991, Parliament passed Law No. 42, known as the 'Transformation Law'. Although the practical application of the Transformation Law brought foreseeable problems to agricultural cooperatives for several years, the change towards new modern market conditions continued. The old cooperatives were either being wound up, or transformed into new cooperatives having their own goals based upon their own decisions and activities (Šubertová, 1996). According to Art. 239, 240 CC[156], a cooperative as a voluntary association of natural and/or legal persons, is a le-

155 See Art. 183i ff. CC introduced with the last amendment of April 3, 2005, Sb. 2005, No. 216.

156 Cooperatives are legally defined in Art. 221-260 CC.

gal person; every member of a cooperative has a right to participate in management decision making, with each member having one vote. The cooperative is liable for obligations to the extent of its total assets; members are not liable unless its Articles of Association stipulate that by decision of the general meeting some or all of its members have to cover losses up to a maximum of three times their share (Art. 222 CC). Each member is entitled to a share of the profit of the cooperative – unless its Articles of Association stipulate otherwise – according to the investment of the respective member; the amount of distributed profit is set by the general meeting (Art. 187 para. 1 lit. f) CC). Furthermore, Art. 259 CC stipulates that in the event of liquidation, each member receives a liquidation quota according to his share. Distributed profits are taxed as capital gains, (i.e. like stock profits); their taxation rate therefore depends upon the recipient's income bracket.

d) Participation in Decision-Making

Art. 200 CC requires joint-stock companies with more than 50 employees to have one-third of its supervisory board composed of employee-delegated members. There are no special rules on employee participation in decision-making with respect to PEPPER schemes or privatisation matters. With regard to employee shareholding the general rules of the CC concerning shareholders rights apply.[157]

3. PEPPER Schemes in Practice

No comprehensive information is available on the overall incidence of PEPPER schemes in the Czech Republic. Unlike its Slovak counterpart, the Czech Statistical Office has recalculated existing historical data so as to reflect only the Czech part of the former Czechoslovakia. Therefore, the development of overall enterprise can be at least inferred (see also Annex Table 5), as well as the economic effect of the division.

a) Share Ownership

Privatisation – At the beginning of the transition, the most significant number of companies controlled fully or predominantly by employees were found in the newspaper sector. Employees, usually led by their management, had 'privatised' state-owned newspapers by collectively switching to a newly founded employee publishing company and announcing to their readers that the newspaper would continue to publish

[157] Stating that stocks as well as shares grant the right to shareholders to take part in the administration of the company, to receive dividends and, in the case of the liquidation of the company, a liquidation quota. For limited liability companies see Art. 114, 122, 123, 125 ff., for joint stock companies see Art. 178, 179, 180 ff. CC.

under a slightly altered version of the former name. Usually the publishers agreed to sell or lease their remaining rights to the new publisher. Due to the very competitive newspaper market which emerged in the early 1990s, and the lack of vision as to how employee owned companies should be operated in the long run, almost all the important employee owned newspapers ended up being sold to foreign publishing groups.[158]

Although the vast majority of so called privatisation projects (proposals concerning the method of privatisation) containing an element of employee shares were submitted by managers of state-owned companies, the average employee stake across all firms foreseen in the projects was 4.4%.[159] As a result, out of 1,688 state enterprises transformed into joint-stock companies, 480 proposed and received approval to privatise part of their shares as employee shares, but only 171 eventually gave shares to their employees. However the major hindrance to the implementation these projects anticipating employee shares was unintended: The rules of privatisation required that shares be bought at a nominal price (typically 1,000 CZK) with employees having an option at a guaranteed price; the improper evaluation of company assets set at book value often led to an overvaluation of equity capital, and in some cases the stated equity capital exceeded the real value of the firm by ten or more times.[160] As a result, firms officially overvalued had no interest in buying their employee shares from the Fund of National Property.[161] Consequently, employee share ownership remained insignificant, representing only 0.31% of privatised assets (see Annex Table 1).

In the framework of voucher privatisation the portion of shares allocated to employees was only about 1.5% of the total shares under consideration. However, almost no shares went to employees for the same reason as in the case of the privatisation projects described above: After the trading of shares started employees had the opportunity to buy these from the National Property Fund for a nominal price. However, almost all shares were traded below their nominal values and hence nobody exercised this option. Voucher privatisation in principle provided another way of creating em-

[158] Starting with Mlada fronta sold to the French publisher Hersant, and ending with Lidove noviny sold to the Swiss publisher Ringier, employees decided to sell first a part of their shares, and later the majority of them to outside owners. In late 1990, none of the national dailies were controlled by employees. Communist Právo is locally owned.

[159] Not more than 7 companies planned employee holdings of more than 30%; only 3 of the 988 projects approved for the first wave of voucher privatisation in the Czech Republic contained the proposition that employees would receive more than 50% of the shares (Kotrba, 1997, reprinted 1999).

[160] The valuation problem is reflected by the stock market; some of the 1,000 CZK face value shares were traded at prices around 50 CZK, others for several thousand.

[161] In a few cases undervalued companies (e. g. Čokoladovny, partly sold to Swiss Nestle), which were later traded at 2,000 to 4,000 CZK per 1,000 CZK face value share, exercised their right to buy all their employee shares as given by the privatisation project.

ployee ownership by exchanging citizens' vouchers for shares of the enterprise where they worked[162] and some companies explicitly encouraged employees to do so.[163]

Private Companies – A number of companies (privatised, private or joint venture) introduced employee ownership in several forms. Some have issued 'employee shares' others have given employees the right to buy new issues of regular shares.[164] For example, not only newly established companies in the Czech banking sector have used 'employee shares' to motivate employees to make the enterprise more profitable.[165] The second largest bank in the country, Komerční banka, offered its employees subscription rights to a limited portion of a new share issue at a discount of 50% from the market price.[166] Even though more than 60% of employees took advantage of this option, their ownership - less than 1% - remained insignificant. A similar proportion of shares was sold to employees in Československá obchodní banka, and in some smaller banks like the Pragobanka. As for stock options, these are generally confined to top management (especially in banking or the network utilities). Stock options were sometimes used in small, new-technology-based start-ups (especially in IT); however, no information on their scope or relative importance is available.

b) Profit-Sharing

Although existing law allows for profit-sharing, in practice implementation is rare.[167] Most probably the reason is that the existing stipulations had their origin in the harmonisation of the Slovak legal system with the *acquis communautaire* of the EU rather than in a policy decision of the legislator. Consequently, although profit-sharing (as discounted employee shares) would be possible under Czech law, there are no tax incentives for the use of these possibilities, e.g., special tax breaks for employee shares do not exist. Currently, most profit-sharing plans which exist are found in foreign companies.

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162 Although this second option does not correspond strictly to the definition of financial participation, under which only the workers of the company should be involved, it can lead in practice to substantial worker share-ownership.

163 See footnote 146.

164 After 2000, due to a legal change, all employee shares as a specific category were converted into ordinary common or preferred stock. Consequently, it is almost impossible to trace development since 2001 inasmuch as employee shareholders may sell or transfer their shares without restriction.

165 For a detailed report see Kotrba (1997, reprinted 1999), p. 132 ff.

166 This offer turned out to be unfavourable due to the collapse of the Czech stock market during the period of subscription which caused the market price to fall below even the level of the subscription price for employees.

167 Again, to our knowledge the only widely practiced mechanisms are those that allow the trade unions to negotiate a compensation formula that sets additional benefits (e.g., 13th salary or similar benefits) in the case where the firm meets an agreed profit target. This is not a PEPPER Scheme though and constitutes rather an expected part of wages, which may be explained by the past dependency and presence of 'yearly bonuses' even in the command economy.

c) Cooperatives

Initially cooperatives accounted for about 4% of the total number of registered firms but within two years this figure fell to 3% where it has remained. Cooperatives have not played an important role in the productive sector of the Czech economy (see Annex Table 3 and 4). Out of more than 2.3 million registered enterprises at the end of 2003, only 13 thousand (i.e. 0.6%) were cooperatives. The two sectors with the most cooperatives are agriculture (1.4% in 1996 and 1.2% in 2003) and housing[168] (1.5% in 1996 and 2.3% in 2003). The total number of cooperatives rose from 0.5% to 0.6% between 1996 and 2003. This was mainly due to an increase in housing cooperatives. Another rapidly increasing category of cooperatives were 'Savings and Loans cooperatives' caused by a 'Savings and Loans' boom that, unfortunately, was often nothing but a financial fraud and most of these Savings and Loans cooperatives ended up stripped by the management without any assets ('tunnelled'), often leaving just liabilities for the other members of the cooperative. The position of cooperatives in industrial production is also reflected by Courbis and Welfe (eds., 1999). A comparison of shares in industrial production for different ownership forms in 1992 shows not only the marginal importance of cooperatives in industrial production (which itself only accounted for about one third of total GDP) but also the differences between the Czech (1.5%) and Slovak (1.6%) Republics at the time of their separation. Nevertheless, cooperatives were not part of the enormous shift in production from the state sector into the private one.

4. Evidence of the Effects of PEPPER Schemes

There are almost no studies on the performance of cooperatives or employee co-owned firms in the Czech Republic. The only microeconomic firm-based information available is from an investment study of Lízal and Svejnar (2002).[169] Their findings are in line with the other facts presented here. In their sample covering all industrial enterprises, the number of cooperatives appears to have remained constant or undergone a slight decline between the early 1990s and 1998. In the Czech Republic, as in other Central European countries, individual, cooperative and limited liability categories tend to comprise smaller firms started with relatively low capitalisation. Lízal and Svejnar's comparison of investment/capital, investment/labour and investment/production ra-

[168] The housing cooperatives cannot be regarded as being in the productive sector nor really as voluntarily formed as the law on housing initially required the owners of individual flats to form housing cooperatives even when they would rather not do so; now, it is also possible to form so-called communities of owners of flats.

[169] Lízal and Svejnar (2003) were interested in the effect of privatisation. Naturally, as cooperatives have not changed ownership, their performance is not evaluated in this study and cooperatives are included in the reference category with no ownership change and hence their results do not provide additional information to their 2002 study for our purposes.

tios across thirteen principal ownership/legal-form categories of firms from 1992-98 shows that foreign-owned companies (relatively few) tend to invest the most and domestically owned cooperatives the least. Cooperatives and state-owned record the lowest investment ratios for all indicators for virtually every year. In addition, Lízal and Svejnar argue that cooperatives, and to a lesser extent smaller and medium sized private firms, were rationed in their access to credit, while the majority of firms, including state-owned and larger privatised firms, were not. There is no difference between small and large cooperatives; both appear to be credit rationed.

Annex

Taxation Issues

Although discounted employee shares and profit-sharing are permissible under Czech law, there are no tax incentives to encourage their use, e.g. no special tax breaks for employee shares. The most important regulatory acts applying to financial participation of corporate employees is the Law on Income Tax[170] which regulates both personal and corporate income taxes. These include a uniform 15% dividend tax rate (formerly 25%); a uniform corporate income tax rate, which continues to decrease over time (at over 50% in the early 1990s, it was at 26% in 2005, and will decrease to 24% in 2006) and a progressive personal income tax ranging from 15% to 32%.

[170] Law No. 586/1992 Sb. on Income Tax.

Table 1: Employee shares in mass privatisation

Employee shares	Number of shares	Number of companies
Approved in the 1st wave	2,757,100	220
Purchased in the 1st wave	1,112,406	82
Approved in the 2nd wave	2,416,870	260
Purchased in the 2nd wave	920,856	89
Approved in total	4,173,970	280
Purchased in total	**2,033,262**	**171**
All joint stock companies privatised	**748,218,044**	**1,688**

Source: Kotrba (1995).

Table 2: First wave of voucher privatisation, allocated distribution, Dec. 31, 1992

Method	Shares*	In %
Intermediated Sale	6,099	1.6
Vouchers	238,345	62.2
Direct Sale-Foreign	6,683	1.7
Direct Sale-Domestic	6,647	1.7
NPF Temporary Holdings	59,354	15.5
NPF Permanent Holdings	327	0.1
Free Transfer	43,406	11.3
Employee Shares	**5,846**	**1.5**
Other	16,540	4.3
Total	383,247	100

Source: Kotrba, 1995. *Based on nominal value, the number is in millions of Kčs.

Table 3: Share in industrial production (%), firms with more than 25 employees, 1992

Ownership	*Czech Republic*	*Slovak Republic*
Private	13.2	2.1
State	79.7	94.3
Foreign owned	4.0	1.5
Cooperatives	**1.5**	**1.6**
Other	1.6	0.5

Source: Courbis and Welfe (eds., 1999), p. 36.

Table 4: Registered units, end of year

	1996				*2003*				*Change*	
Sector	*Total*	*%*	***Coops***	*% of total*	*Total*	*%*	*Coops*	*% of total*	*#*	*%*
Total	1,468,940	100	6,806	0.5	2,325,977	100	13,076	0.6	6,270	92
Agri-cult.	120,542	8.2	1,676	1.4	133,879	5.8	1,651	1.2	-25	-1
Hou-sing	242,940	16.5	3,618	1.5	426,402	18.3	9,598	2.3	5,980	165
Sav-ings& Loans	10,872	0.7	38	0.3	70,379	3.0	131	0.2	93	245

Source: CSO.

Table 5: Number of businesses, by selected legal form, as of Dec. 31 each year

		Selected legal forms		
Year	*Total*	*State-owned enterprises*	*Joint-stock companies*	*Private entrepreneurs in business under Trades Licensing Act*
1990	178,993	3,505	658	1) 124,455
1991	955,647	3,737	2,541	1) 891,872
1992	1,118,637	3,272	4,076	982,075
1993	1,250,216	2,920	4,813	1,044,635
1994	1,118,534	1,522	6,017	856,509
1995	1,321,096	2,270	7,564	1,000,375
1996	1,468,940	1,886	9,255	1,103,732
1997	1,627,626	1,621	10,353	1,223,195
1998	1,781,334	1,312	11,697	1,327,891
1999	1,963,319	1,214	13,009	1,425,743
2000	2,050,770	1,117	14,092	1,471,291
2001	2,121,562	1,054	14,845	1,523,051
2002	2,223,745	995	15,260	1,607,151
2003	2,325,977	899	15,903	1,671,031

1) Those in business in compliance with Act No.105/1990 Coll., on Private Enterprise of Citizens.

Source: CSO.

V. Estonia

Employee financial participation has made little progress in Estonia. PEPPER schemes did not develop during the period of independence between the two world wars or under the Soviet regime. Although employee participation in decision-making had some role in state enterprises during the Soviet era, it was later dismissed as a relic of that system. Employee ownership was briefly popular as a tool for privatising publicly owned assets in the early stages of privatisation, but this turned out to be a temporary expedient. Neither was employee financial participation considered relevant to the solution of employment and social problems.

1. General Attitude

Historically, employee participation has been associated with the cooperative movement, and later, as already stated, to early-stage privatisation. The cooperative movement started at the beginning of the last century with agricultural cooperatives and reached its peak during the first period of independence, with cooperatives in different branches such as fishing, insurance, crafts, agriculture and consumer cooperatives (Krinal, 2001). However, these cooperatives were not owned by employees. Under socialist rule, Estonia had a large consumer cooperative sector. After the start of privatisation, consumer and supply cooperatives mostly remained in the hands of their members, although some related firms became subsidiary companies to central cooperatives. New forms of semi-private enterprises, 'people's enterprises' and leased enterprises, were introduced in the early stage of privatisation under Soviet law and, later, also according to Estonian law. These semi-private forms gave employees certain decision-making rights, but financial participation was limited.[171]

[171] In people's enterprises, the representative meeting of employees was authorised to decide upon the distribution of profit, development strategy, and reorganisation, the rules for the risk fund and social fund and election of the general director, the council and the auditing commission. The council was authorised to decide upon the distribution of surplus and to approve the composition of the management board. The risk fund was collectively owned by employees, and an employee leaving the enterprise was entitled to a share from the risk fund proportional to the sum total of his salary earned during the employment period; additionally, part of the surplus could be paid out as dividends, although the enterprise was still in state ownership. In leased enterprises under Soviet law, the employees' meeting also had the right to decide on important issues and to elect the management, but these rights were reduced under Estonian law when the right to apply to the state for leasing was no longer limited to the working collective. After leased enterprises were bought out, employees became shareholders.

Nevertheless, they provided a convenient vehicle for takeovers by employees and/or management in the course of privatisation. It is assumed that leased enterprises were a major source of employee ownership in Estonia (Jones, Kalmi and Mygind, 2003, p. 10). These forms may still exist; they should be counted since § 509 (6) of the Commercial Law allows leased enterprises, collective enterprises and small state enterprises to be converted to limited liability companies and joint-stock companies.

In the privatisation of small and medium-sized enterprises, employees were given a pre-emptive right to buy the enterprise at the initial price.[172] When all privileges were abolished in 1993, small enterprise privatisation was almost completed; an estimated 80% of enterprises had been taken over by insiders (Mygind, 1996, p. 240). The privatisation programme for large enterprises, finally adopted in 1993, followed the German Treuhand model, and contained no preferential rights for employees. Privatisation vouchers, introduced in 1993 and distributed amongst all permanent residents of Estonia according to their length of employment, could be used at public tenders to finance up to 50% of the purchase price. These were mostly used for the privatisation of land and housing; only 28% were used to purchase shares of enterprises (Mygind, 2000).[173] According to the Law on Agricultural Reform of March 1992, former owners who were entitled to restitution, municipalities and employees based on the number of their working shares became co-owners, or were granted pre-emptive rights in the privatisation of land. By purchasing shares under preferential conditions and founding co-operatives, many agricultural employees became co-owners and thus obtained participation rights.

By the end of 1998, 8.3 billion EEK capital vouchers and 7.1 billion EEK compensation vouchers had been distributed (Ministry of Finance). The two types of vouchers[174] could be used for privatisation of both real estate and enterprises (see also Annex Table 2), but by 1998 vouchers worth only 336 million EEK had been used at small enterprise auctions, and vouchers worth 1,693 million EEK in large enterprise tenders (Mygind, 2000, based on Ministry of Finance). March 1995 saw the biggest investment fund crash. The resulting losses to investors exceeded the losses caused by the banking crisis of 1992-93. This was an important reason why investment funds did not develop in Estonia as in other countries utilising voucher schemes. Investment funds accumulating vouchers had no defined legislative role. By June 1996, there were six privatisation investment funds accumulating vouchers; their value constituted only 1% of the total value of distributed vouchers (Kein and Terk, 1997).

172 According to the Law on Privatisation of State-Owned Service, Trade and Catering Enterprises from 29 December 1990.

173 Privatisation vouchers could have been used for payment from August 1994 to 1 December 2000 (§ 29 (2) PL).

174 Capital vouchers were distributed to all residents based on the number of years of employment and compensation vouchers were distributed to owners (or their heirs) of property nationalised in the early Soviet period if they did not want this property back or if it was not possible to return this property.

Currently, social partners are represented by the Confederation of Estonian Trade Unions (Eesti Ametiühingute Keskliit) and the Estonian Employers' Confederation (Eesti Tööandjate Keskliit). They do not have equal power; the trade unions traditionally are the weaker party. Recent debates between social partners on employee participation were triggered by the necessity to transform the *aquis communautaire* into Estonian law. The most recent debate between the social partners took place in connection with the draft law on the Involvement of Employees in the Activities of EC-scale Undertakings, EC-scale Groups of Undertakings, and European Companies transforming EC directives 94/45/EC and 2001/86/EC. Since the government was not willing to play the role of arbitrator and the social partners could not agree upon a compromise solution, bipartite consultations ended without resolution. Nevertheless, Parliament adopted this law on 12 January 2005 to meet the deadline and thus avoid EU sanctions.

Until now, the idea of employee financial participation could not be successfully promoted. The Legal Secretary at the Confederation of Estonian Trade Unions, Ms Tiia Tammeleht, declared in an interview that the question of financial participation of employees is currently not on the agenda of the Confederation.[175] The Estonian Employers' Confederation is strongly opposed to any extension of employee participation rights. However, it should be noted that recent discussions have focused only upon employee participation in decision making, not financial participation and that as such they are at the beginning of a broader debate on the lack of participation rights of employees in Estonia, which becomes evident if compared with neighbouring European states.

The aims of economic policy of the government since 1993 have been contrary to the idea of participation of employees, ia of financial participation, favouring the principles of laissez-fair doctrine and protection of national elites. The current unemployment rate, especially amongst the young and elderly, and the high costs connected with employment have caused the government to focus upon more urgent employment and social problems, with the participation rights of employees relegated to second place.[176] The government is passively waiting for the trade unions to produce an initiative to improve the situation, but the trade unions are not planning to address this issue either. PEPPER schemes have not been on the political agenda of Parliament. Only one political party has addressed this issue: the Social Democratic Party. The Social Democrats have been the opposition party for the last five years, currently holding only 6 of 101 seats. Several times they have proposed amendments to the Commercial Code regarding the representation of employees on the management bodies of corporations, but these initiatives have been rejected by those with other political interests. These circumstances make it unlikely that Estonia will adopt new legal regulations on employee participation soon. However, as the discussion on transformation of EU direc-

175 Interviews with Mr. Kaadu and Ms. Tammeleht conducted by Ms. Johanna Korhonen in January 2006.

176 Mr. Tiit Kaadu of the Ministry of Social Affairs affirmed in an interview that the Ministry acknowledges the lack of legislation concerning employee participation, but has other priorities.

tives shows, the issue will be addressed and even new legislation could be adopted if an EU legal act on financial participation of employees were issued.

2. Legal and Fiscal Framework

There is no specific legal regulation of any PEPPER scheme in Estonia at present. The legal framework generally does not – at least intentionally – create incentives for, but neither does it prevent the development of PEPPER schemes. More complicated forms of employee participation such as ESOPs would require new laws, regulations, and tax incentives.

a) Share Ownership

Privatisation (1990, abolished in 1993) – Employee ownership of shares in enterprises purchased during privatisation is decreasing. Although privatisation in Estonia can be considered as virtually complete,[177] enterprises in the energy sector as well as public utilities are still partially state-owned; they could be put up for sale in the future.[178] The current Privatisation Law (as amended on 14 November 2001) offers no privileges to employees or other groups of potential buyers. It is based upon the provision for the termination of activities of the Privatisation Agency, and thus on the termination of major privatisation proceedings, while the few privileges employees had under Estonian law were abolished as early as 1993.[179] Thus the present situation leaves little if any room for the emergence of employee ownership. Under the privatisation laws now in effect, employees are not entitled to participate in the decision making process during the privatisation procedure itself. However, rights to participate in decision making in the new company (e.g. the right to vote at a general meeting, the right to call a general meeting, etc.) are attached to shares acquired by employees in the course of privatisation.

Private Companies – Estonian Commercial Law does not contain special rules on profit-sharing or on employee share ownership with respect to acquisition, limitations

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[177] The Estonian Privatisation Agency was closed on 1 November 2001 (§ 11 (1) PL) after completing the last big privatisation deal selling AS Eesti Raudtee (Estonian Railways). Future smaller privatisation proceedings are anticipated and therefore a new 'government agency organising privatisation' (§ 4 (1) PL) has been established.

[178] For this reason, the laws regulating privatisation (Privatisation Law of 17 June 1993 (herein referred to as PL), Law on Ownership Reform of 13 June 1991 (hereinafter referred to as LOR), and Law on Land Reform of 17 October 1991 (hereinafter referred to as LLR)) are still effective.

[179] Initially, pre-emptive rights, which often also led to the possibility of buying assets or shares under value, were the most popular mechanism. With regard to privatisation in the industrial sector, most influential political forces were opposed to buy-outs by employees.

on the number of shares, or issuance of employee stock for any specific undertaking; therefore, general rules apply. Some employees still hold shares purchased during privatisation and thus have the rights attached to these securities according to company and securities law. In Estonia, company law is primarily laid down in the Commercial Code of 15 February 1995 (herein referred to as CC) and securities law in the Securities Market Law of 17 October 2001 (herein referred to as SML).

Most legal entities are corporations, of which limited liability companies are the most popular (see Annex Table 1). Since employees who became shareholders often acquired minority shares in newly founded limited liability companies and joint-stock companies during early privatisation, provisions concerning the rights of minority shareholders and shares acquired during this period are of special importance. Pursuant to §§ 515 (1) and (2) CC, rights attached to shares issued before 1 September 1995 which do not comply with the provisions of the Commercial Code remain valid, whereas rights not attached to shares are void. Minority shareholders of a joint-stock company can be bought out by the majority shareholder holding at least 9/10ths of the shares upon resolution of the general meeting with at least 95% of the votes represented by all shares; a fair compensation to minority shareholders in this case is secured by the provisions regarding takeover bids (§§ 363 2 (2) and 363 7 (1) CC) and the right to lodge a claim with a court (§§ 363 8 (2) and (3) CC). Minority shareholders have no corresponding sell-out right, i.e. they cannot demand that the majority shareholder buys their shares if they wish to sell them.

If securities issued by a company are offered solely to the employees or managers of that company, the prospectus need not be made public and registered (§ 17 (1) 2) SML). This means that the employees and management are not entitled to compensation pursuant to § 25 SML if they suffer losses as a result of the volatility of acquired securities.[180] Furthermore, if a company provides investment services solely to its employees and management, it does not have to be registered as an investment firm (§ 42 (1) SML). Thus it can conduct investment activities without a licence (§§ 48 ff., SML). It is not obliged to report transactions (§ 91 SML) or to have additional reserve and risk funds (§§ 93 ff., SML), and there are no additional requirements for managers (§ 79 SML).

b) Profit-Sharing

Special legislation on profit-sharing with regard to employees does not exist; therefore, there are neither direct incentives nor direct restrictions. For employees it is preferable to receive distributed profits under a corresponding scheme rather than wages/salaries since they do not have to pay income tax on profits or dividends. Nevertheless, the

[180] This seems to be justified since management and employees might have insider knowledge, but it could be argued that employees, unlike managers, do not necessarily have full information as to the financial situation of the company. Notably, employees are not deemed insiders, but rather as third persons who could receive information from insiders, under the same law (§ 191 (1), (3) SML).

resident company pays income tax at the rate of 18.24% on distributed profits (§ (4) ITL), whether the distribution is monetary or non-monetary (§ 50 ITL), which creates a disincentive for implementing profit-sharing schemes.

c) Cooperatives

The development of commercial and non-profit cooperatives led to new special laws on each form.[181] In the context of this report, commercial associations regulated by the Law on Commercial Associations of 19 December 2001 (hereinafter referred to as LCA) are relevant. According to the new law, a commercial association is a flexible form for the association of physical persons or legal entities not owned by the state, whereby each member has one vote (§ 1 LCA); majorities in voting and management structure are similar to limited liability companies.[182] This new legislation brings advantages since liability can be limited[183] and profit[184] can be distributed, features not typical for the cooperative as a business form. However, if liability is limited, the association capital must be at least 40000 kroons (§ 1 (3) LCA); this is the minimum share capital of a limited liability company (§ 136 LLC). The number of commercial associations is quite small and decreasing, the reason probably being the high administrative expenses and additional requirements for management. Financial support for agricultural commercial associations for organisational and administrative expenses is provided for by §§ 59-61 of the Law on Rural Development and Agricultural Market Regulation of 11 October 2000.

d) Participation in Decision-Making

Rights to participate in decision making were granted to employees of EC-scale Undertakings, EC-scale Groups of Undertakings and European Companies,[185] as a result of

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[181] For this reason, the structure of statistics changed in 2001, so that figures before and after 2001 are not comparable. In 2003, there were 19,369 non-profit associations (including former housing cooperatives) and 855 commercial associations.

[182] Although each member has one vote at the general meeting, the regulation on delimitation of power between the general meeting and the management board is not detailed. Thus, a limited liability company could be preferred to a commercial association because the legal regulation is explicit and unambiguous.

[183] Generally, members are not personally liable, but personal or additional liability can be stipulated in the Articles of Association during foundation, or by amendment of the Articles of Association which requires approval by over 75% of the members (§§ 1 (2) and 13 (1) LCA).

[184] The profit is generally transferred to the reserve, but it can also be distributed amongst members according to their participation in the activities of the association or in proportion to their contribution if it is stipulated in the Articles of Association and if at least 1/20 of the net profit is transferred to the reserve (§§ 29 and 30 LCA).

[185] According to the Law on Involvement of Employees in the Activities of EC-scale Undertakings, EC-scale Groups of Undertakings and European Companies which was adopted on 12 January 2005 after a long controversial debate between the social partners.

EC directives 94/45/EC and 2001/86/EC.[186] In such companies, the nomination of employees' representatives onto the Special Commission for Negotiations, the European Work Council, the SE Special Commission for Negotiations, and the SE Council or Administrative Council is required. Although Estonian company law is so strongly influenced by German law that rulings by German courts can be used to interpret provisions of the Estonian CC (Klauberg, 2004, p. 1), special rules on the participation of employees in management and decision making contained in a special German law (Betriebsverfassungsgesetz) were not considered by the Estonian law-makers.[187] If employees are also shareholders, they have voting rights in each company form, although they generally have no influence on resolutions of the general meeting since they are, in most cases, minority shareholders.[188]

3. PEPPER Schemes in Practice

No comprehensive information is available on the overall incidence of PEPPER schemes in Estonia. Despite the lack of specific legislation on employee financial participation, research shows that individual Estonian enterprises – If only to a limited extent – use various financial participation schemes (employee shares and profit-sharing) based on the Articles of Association or internal rules. Privatisation opened up possibilities for employee ownership, although this wave turned out to be quite short-lived because there were no political forces which were interested in strengthening employee participation. The small privatisation was the most important method for employee takeovers in the early 1990s. However, in most cases the managers took the initiative and often de facto controlled the enterprises. The domination of managers explains the relatively fast change away from employee ownership to management ownership, which were observed both in quantitative studies and in case studies.

a) Share Ownership in Privatisation

While initial legislation on small privatisation, introduced in the spring of 1991, favoured insiders, in June 1993 the last privileges of insiders were abolished and control of the privatisation process, including small privatisation, was taken over by the Estonian Privatisation Agency. It is estimated that approximately 80% of the first wave of

186 'On employee involvement required in the case of establishing a European company'.

187 For details on participation in decision making in a European context see Tavits (2004).

188 Minority shareholders representing at least 10% of the share capital are entitled to demand a general meeting (§ 171 (2) 3 CC for limited liability companies and § 296 CC for joint-stock companies) and to lodge a claim with a court for the removal of members of the management board or supervisory board for good reason (§ 184 (5) CC for limited liability companies and § 319 (5) CC for joint-stock companies).

450 small enterprises were taken over by insiders before the change in policy.[189] Subsequently, while insider ownership continued as an element in the privatisation process, its importance declined. At an individual level, employee ownership seems to be most stable in small enterprises, and more small enterprises have a fairly equal distribution between their employee owners than larger enterprises. Based on the sample, the estimate for the overall economy shows that 29% of employees were owners in 1995; this figure had fallen to around 25% in January 1997 (Jones and Mygind, 1998).

The Estonian Privatisation Agency put large enterprises up for open tender. The offer price was only one criterion for choosing the buyer; the proposed business plan as well as guarantees for investments and employment also played an important role. Employees were not given any preferential treatment. Since the managerial group had often accumulated some capital, it was possible for them to begin to secure loans in the rapidly developing system of private banks. Furthermore, as of the summer of 1994, domestic capital suppliers were allowed to buy by instalment and domestic buyers could use vouchers as partial payment. Thus, by this stage, alliances between managers and a broad group of employees were no longer necessary. In addition, foreign capital gained increasing access during this large privatisation stage. As of the spring of 1996, foreign investors could also buy by instalment and pay with vouchers. In consequence, broad groups of employees had less and less opportunity to acquire majority shares in companies they were employed with. By 1999, only a few large enterprises were still owned by the state.[190]

An overview of the distribution of ownership in a sample of 666 Estonian enterprises (Jones and Mygind, 1998) shows the development of privatisation prior to January 1995. Employee ownership made up the largest share of privatised enterprises in the early privatisation period up to 1992 (38% of the enterprises in the sample). Manager ownership then took the leading position from 1992 to 1993. Finally, domestic outsider owned firms dominated privatisation from 1994 onwards (see also Annex Table 3). Only a small number of start-ups were owned by employees. In January 1995, employee ownership was most widespread in agriculture (39%) and lowest in transport (3%). Manager ownership was most widespread in fishing, mining and wood production (27%) and lowest in trade (6%). However, by January 1997 the share of manager ownership for the whole economy increased to 26%, and for trade to 13%. At the beginning of the privatisation process, the sample showed 28 employee dominated enterprises with more than 100 employees. By January 1997, this number had fallen to nine. For similar enterprises with fewer than 100 employees, the numbers fell from 60 at the time of privatisation to 42 in January 1997. Normalised for the whole economy, employee ownership in 1995 was proportionately higher in large enterprises (17%) than in small (10%), but by 1997 the proportion of employee ownership in large enter-

[189] According to the first version of the law, employees had the right to buy the enterprise at the initial price, which in most cases was well below the market value of the assets (Mygind, 2000).

[190] At the end of 1998, 483 large enterprises had been sold through the EPA by direct sale at a total price of around 4.7 billion EEK or 400 million US$. The investment guarantees amounted to 4.6 billion EEK and the owners took over liabilities of 2.2 billion EEK.

prises had fallen to 7%. The number of management dominated enterprises, especially small ones, increased. Domestic outside majority owned enterprises expanded their share, especially in large enterprises. Even in enterprises with majority employee ownership, on average 46% of the employees were non-owners in 1995, with this percentage increasing over time. The participation rate for all enterprises varies significantly across sectors, from 78% in agriculture to less than 10% in hotels, restaurants and transport.

A transition matrix for Estonia (see also Annex Table 4, Jones and Mygind, 2005) shows the change between the first known ownership type after privatisation, or when the firm started as a new entity, and the last year for which information was available. Enterprises which were foreign owned at the start were foreign owned in the last year of record. Foreign owned enterprises have a quite stable ownership structure with a total 'ownership-change' rate of only 14%. Firms with external domestic ownership from the start had a higher rate of 'ownership change', i.e. 26.7%, with 19.1% having converted to management ownership. Of firms that were initially management-owned, 23.6% have changed ownership type; most of these to outside ownership (15.7% to domestic and 5.7% to foreign). Only 2.1% have changed to employee ownership. However, the movement away from employee ownership[191] proceeds at a very high rate, with more than seven in ten cases changing.[192] Employee ownership has quite a low concentration compared to the ownership of the single largest owner. Changes away from both employee and former employee ownership are accompanied by steep increases in concentration. In general, the concentration rate is increasing, and the steepest increases parallel shifts in ownership (Jones and Mygind, 2005).

In cooperation with the Estonian statistical office, a survey on the ownership structure of 722 companies (a stratified random sample with overrepresentation of medium to large-sized companies) was conducted in January 2005 (Jones and Mygind, 2005). The results show a further decline in employee ownership (see also Annex Table 5). Only 14 or 2% of the companies had majority ownership by employees in January 2005. (If we include companies with insider majority where other employees own more than managers, the number increases to 3%). In 78% of the companies there was no employee ownership, while 20% of the enterprises had a minority employee share. Most often these minority shares were less than 10% of total shares, however, in 7% of the enterprises employees own 20-49.9%. Only 4% of foreign dominated companies had employee minority shares, while 10% of the companies dominated by managers had employee shares. Surprisingly, the survey shows that employee ownership is randomly spread over the different industries. There is no significant variation on size and thus no tendency for a higher percentage of employee ownership in smaller firms. Agriculture, with 39% of the enterprises in January 1995, was the sector with the highest rate

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[191] It is surprising that ownership by former employees is more stable than ownership by current employees. However, continued ownership by employees who have left the firm can be taken as an indicator of inertia, which also functions as a barrier to future ownership changes.

[192] In about half of these cases, 71.7% move to ownership by management (this includes 35.4% of the initial group), compared to 28.3% to outside ownership and 8.1% to former employees.

of majority employee ownership after privatisation. 78% of the employees in agriculture were owners. As in other sectors, employee ownership decreased after privatisation, but more enterprises remained in employee ownership than in other sectors.

A recent case study of employee owned firms[193] confirms the general decline in employee ownership. The causes of this decline are: (1) retention of shares by former employees, (2) the inability of new employees to acquire shares, and (3) managers purchasing employees' and/or newly issued shares.

b) Profit-Sharing

Profit-sharing is not common in Estonia, but other forms of monetary incentive schemes are used in more than 50% of cases, with the individual enterprises being found especially in such branches as IT and real estate sector. Profit-sharing is used only in a few firms, while monetary incentive schemes are especially prevalent in foreign owned enterprises (Mygind, 2002). Some information on profit-sharing in Estonia was found in the Estonian management survey,[194] with only 13 instances being reported out of a sample of 220 firms.

c) Cooperatives

A large number of enterprises originated from former collectives (Kalmi, 2003, p. 122). Supplier and consumer collectives were typically privatised by sale to outside owners, while agricultural collectives went to employees. Some new firms were established as cooperatives in employee ownership. They changed the business form to limited liability company or joint stock company and later followed the same trend as other employee owned companies, which means that they have been taken over by managers or outside owners. By January 1990, there were more than 2000 cooperatives with about 7 % of employment (Arkadie et al., 1991, p. 258). The number of cooperatives peaked in 1993. Since then many cooperatives have been converted into other legal forms.[195] According to the Statistical Office of Estonia, there were 2943 cooperatives in August 1993. Since then many cooperatives have been transformed to other legal forms; in July 1998 there were 2124 cooperatives in the enterprise register, but only 769 of them were registered as profit earning cooperatives. In 2003, there were 19,369 non-profit

[193] Reported in Kalmi and Mygind (2003), 12 case studies of employee owned firms have been performed in Estonia showing the variation in privatisation methods leading to employee ownership; the studies cover the period from before privatisation to around 2000.

[194] Done by Mygind in cooperation with the Estonian Statistical Office (ESA) with 181 interviews in November/December 1997 and 31 interviews in summer 1998. The total response was 220 including 8 of the pilot surveys, however in most questions the total number of answers (N) is a little lower.

[195] By January 1990, there were more than 2000 cooperatives with about 7% of employment; there were 2,943 cooperatives in August 1993 and in July 1998 there were 2,124 cooperatives in the enterprise register, but only 769 of them were registered as profit earning cooperatives (Statistical Office of Estonia); see also Arkadie et al. (1991), p. 258.

associations (including former housing cooperatives) and 855 commercial associations.[196]

4. Evidence of the Effects of PEPPER Schemes

Empirical research on the effects of PEPPER schemes in Estonia has been limited. The available evidence of the impact of employees' financial participation in Estonia concerns the economic performance of employee owned enterprises and was taken from a sample of 666 enterprises covering the period 1993 to 1997 with detailed ownership information and financial variables.[197] The analysis shows that private enterprises had 13% to 15% higher productivity than state enterprises. The productivity of enterprises owned by foreign investors was 19% to 21% higher, of management owned enterprises 15% to 31% higher, and of employee owned enterprises 13% to 24% higher than that of state owned enterprises. These results are noteworthy both because of their high reliability and because standard theory would not predict such high efficiency under insider ownership. Profitability measures for the early years show insider ownership scoring quite high, while, especially with respect to return on assets, foreign ownership scores quite low. However, this might be explained by the fact that the high levels of assets had not yet started to pay off. The surprisingly high profitability scores for state owned enterprises might be explained by the dominance of some natural monopolies (e.g. telecommunications and energy) which in 1997 were doing quite well. There are no significant differences between domestic and foreign ownership in the private sector.

At the early stage of transition, state owned enterprises and most majority employee owned enterprises cut employment to a lesser degree than other types of enterprises. At the same time, majority employee and management owned enterprises hired more new employees than other types of enterprises. Foreign owned enterprises are relatively capital intensive, while insider owned enterprises are the opposite. Because insiders, especially in small enterprises, often had first choice, it could be expected that they would skim the cream; nevertheless, there was no significant evidence that insiders took over the most profitable enterprises (Jones and Mygind, 1999). Insiders did, however, acquire their enterprises at a relatively low price, especially in the early small

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196 The above mentioned (2. c) distinction between commercial and non-profit cooperatives in 2001 leading to special laws on each form resulted in a change of the structure of statistics; therefore the figures before and after 2001 are comparable only to a certain extent.

197 The analysis by Jones and Mygind (2002), on total factor productivity including relevant factors such as size, sector, location, fixed enterprise effects, etc. is based on panel-data for the period 1993 to 1997. Although more recent data was available, the authors chose to use the early data because, as noted above, employee ownership was much more common in the early years.

privatisation phase. Foreign investors, on the other hand, with better access to capital, have been able to buy capital intensive enterprises.

A case study which included employee owned firms[198] showed that all twelve companies faced considerable problems in the early stages of transition which in turn led to declining sales. It is remarkable that all of the companies except one undertook considerable reactive restructuring by cutting back employment despite their ownership structure. Lack of capital prevented strategic restructuring in two cases, but the remaining ten firms restructured despite a lack of capital. Two enterprises increased their investment after foreign takeover. In a survey of 220 enterprises (Mygind, 2002) managers were asked about their sources of finance. For all companies, internal savings were the most important. Employee owned enterprises, however, were most clearly dependent upon internal savings. The problem of obtaining external financing and the general low capital intensity of insider owned firms were also reflected in the results on investment. These showed that insider owned enterprises had low investment per employee, while enterprises with foreign and external domestic ownership had high investment levels.

The gap between the salaries of the management compared to the salaries of other employees was large in foreign owned enterprises and small in employee owned, no majority and state owned enterprises.[199] The average wage for all employees was higher in new than in privatised companies. However, the lowest level was found in cooperatives, probably because of quite low levels of pay in the agricultural sector. The gap between the salaries of managers compared with other employees was lowest in employee owned enterprises and highest in management owned enterprises.

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198 Reported in Kalmi and Mygind (2003); see above.

199 When looking at the social impact of employees' financial participation concerning the level of wages and the wage differences between different groups inside the companies, the pay for the lowest employee was very low even by Estonian standards, even though the researchers asked about full time wages, the responses may cover part time employees.

Annex

Table 1: Business forms, non-profit associations and foundations

	2001	2002	2003	2004
Sole proprietor	19443	20563	21464	21830
General partnership	305	318	342	365
Limited partnership	468	601	630	660
Limited liability company	43266	49060	54387	59767
Joint stock company	7862	7412	6743	6241
Commercial association*	933	910	855	775
Branch of foreign company	331	356	365	388
Non-profit association**	15886	17774	19369	21293
Foundation	436	502	570	638
Total	88930	97496	104725	111957

Source: Statistical Office of Estonia.

*Former profit earning cooperatives **Former non-profit cooperatives

Table 2: Use of vouchers

Nominal value in million EEK	1994	1995	1996	1997	1998	Total
Housing	500	1979	660	283	120	3542
Real estate	0	30	204	470	1342	2046
Small enterprise auctions	14	25	75	80	142	336
Large enterprise tenders	16	726	218	490	243	1693
Public offer	0	704	666	940	0	2310
Compensation fund	26	513	528	252	183	1502
Total	556	3977	2351	2515	2030	11429
market/nominal voucher value	0.20	0.17	0.18	0.35	0.28	

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

Table 3: Relationship between time of privatisation/start and initial ownership, Jones/Mygind (1999)

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

Only private companies are included. We do not have the timing-information for all companies. Therefore, the number of enterprises is lower than in the total datasets.

*25 foreign new enterprises established before 1992 are not included in the table because they were added later to the initial random sample.

Table 4: Privatisation/start-2002 ownership transition matrix: first year as private by last year recorded

Total

\last Year first year	Foreign	Domestic	Manager	Employee	Former employee	Total	Change
Foreign	114	10	9	0	0	133	14.3%
Domestic	11	132	37	0	0	180	26.7%
Manager	8	22	107	3	0	140	23.6%
Employee	6	22	35	28	8	99	71.7%
Former emp.	0	4	3	2	15	24	37.5%
Total	139	190	191	33	23	576	

Privatised

\last Year first year	Foreign	Domestic	Manager	Employee	Former employee	Total	Change
Foreign	45	4	1	0	0	50	10.0%
Domestic	8	106	15	0	0	129	17.8%
Manager	2	11	56	2	0	71	21.1%
Employee	1	12	15	11	3	42	73.8%
Former emp.	0	4	2	2	12	20	40.0%
Total	56	137	89	15	15	312	

New

\last Year first year	Foreign	Domestic	Manager	Employee	Former employee	Total	Change
Foreign	69	6	8	0	0	83	16.9%
Domestic	3	26	22	0	0	51	49.0%
Manager	6	11	51	1	0	69	26.1%
Employee	5	10	20	17	5	57	70.2%
Former emp.	0	0	1	0	3	4	25.0%
Total	83	53	102	18	8	264	

Source: Jones and Mygind (2004). 1. Former employee ownership defined as domestic dominant with concentration <20% in or for 1999. 2. Only firms with domestic dominant ownership and with information on concentration in 1999 are included; their number fell from 649 to 568. Companies included, for which we have data only for some years, e.g., 1997-2000.

Table 5: Degrees of employee ownership distributed by dominant owner

January 2005	Percentage of shares owned by employees						
Dominant Owner	0%	0.1-9.9%	10-19.9%	20-49.9%	50-99.9%	100%	Total
State	1						1
Foreign	185	7	2				199
Domestic	229	29	13	19			299
Manager	146	30	14	28			218
Employee				5	13	1	19
Total	**561**	**66**	**29**	**52**	**13**	**1**	**722**
% of firms	77.7%	9.1%	4.0%	7.2%	1.8%	0.1%	100.0%

Source: Jones, Kalmi and Mygind (2005).

Taxation Issues

General tax provisions are contained in the Taxation Law. The imposition of special taxes is regulated by the Income Tax Law of 15 December 1999 (hereinafter referred to as ITL), the Value Added Tax Law and the Social Tax Law. The financial participation of employees falls under the jurisdiction of the ITL. There is no corporate income tax. Personal income tax is withheld from gross salaries at the rate of 24% in 2005 (§ 4 (1) ITL); this rate will decrease to 22% in 2006 and 20% in 2007. In addition, the employee must pay a 33% social tax and make a 2% pension fund contribution, both of which are also withheld from gross salaries. Another tax affecting salaries is an unemployment insurance payment of 1% of gross salary, which is withheld from the employee's gross income, and an additional 0.5 % of gross salary, which is paid by the company. However, the employee is not obliged to pay income tax on dividends, unless these are paid by a foreign legal entity, an association, or from a pool of assets which does not have the status of a legal entity (§ 18 (1) ITL); instead, the resident company pays income tax at the rate of 18.24% on distributed profits (§ (4) ITL), whether the distribution is monetary or non-monetary (§ 50 ITL).

From the viewpoint of taxation, it is preferable for employees to be designated as self-employed rather than as wage earners since this gives more opportunities for tax deductions. For higher ranking employees and those with management experience, a combination of self-employment with the funding of a limited liability company further lowers taxation with the most significant advantage being the fact that no corporate income tax is imposed in Estonia; the disadvantage is the additional administrative work and possible administrative costs, which can be minimised if the employee has corresponding experience.

VI. Hungary

In Hungary employee ownership has been the most frequent form of employee financial participation with the Hungarian Employee Share Ownership Programme (ESOP)[200] still being prevalent. Although it spread quickly in the early phase of privatisation, the relative weight of this ownership form in the whole of the economy is not significant. With privatisation complete, the number of ESOP companies has been decreasing relatively quickly. Other PEPPER schemes in the context of privatisation as well as in the context of incentive plans, including profit-sharing, have taken place only to a limited extent. They did not receive any economic policy support – and consequently pro%ral registration systems do not exist. An exception is the 'Approved Employee Securities Benefit Programme' introduced by tax laws in 2003. At the same time traditional forms like cooperatives play an insignificant role in the economy and in employment as well.

1. General Attitude

Employee ownership in Hungary began with the Workers' Councils of the 1956 revolution.[201] It continued with the reforms of 1968 ('New Economic Mechanism') which introduced a set of new elements of incentives and became full-fledged in 1984 with the partial employee ownership of companies, when 'market co-ordination' (Kornai, 1985) replaced the re-distributive and bureaucratic socialist economic system. As a first step in the reform measures of 1968, profit-sharing was introduced, which became part of the centrally set wages in state-owned companies.[202] One of the antecedents of employee ownership in Hungary was the Enterprise Business Partnership (VGMK), possible from 1982.[203] Finally in 1984 the self-government of companies was institu-

200 'Munkavállalói Résztulajdonosi Program' (Employee Share Ownership Programme), MRP – by its Hungarian abbreviation, ESOP hereafter, is a form of employee ownership based on the US ESOP.

201 The idea then was that the state would retain ownership but Workers' Councils would manage the companies and be competent in making strategic decisions including hiring and firing CEOs, selected by competition (Szalai, 1994, pp. 11-12).

202 By the time of the change of the regime, however, the use and size of profit-sharing was a matter of bargain between the enterprises and economic regulatory organisations and was used to minimize company taxes and had nothing to do with actual economic performance.

203 VGMKs were 'intrapreneurial' businesses of core workers in which on the one hand work organisation was improved through the greater autonomy of workers and on the other hand workers could earn extra incomes which helped the companies to retain key employees in the context of labour market competition (Neumann and Borbély, 1988).

tionalised.[204] The first important step towards the introduction of a market economy in Hungary was the Law on Business Associations of 1988 which allowed large State companies to be transformed into limited liability companies and joint-stock companies. Even before the transformation, during the period of 'spontaneous privatisation', a decree of the Ministerial Council[205] allowed employee ownership by means of *property notes*. The growing need for legal control of privatisation resulted in the adoption of a privatisation law and the establishment of the State Property Agency. Employee-ownership was mostly a policy priority in the interests of social justice and equity thus it could only become a realistic option when privatisation demand shrank and/or the popularity of privatisation seemed intolerably low.[206] The privatisation rule that – as a result of company power relations – no enterprise could be sold against the will of the local management was maintained throughout the privatisation period.

Trade unions participated at a national level in the promotion of the various forms of employee ownership. Local unions, however, were often surprisingly passive and limited action to declaring their interest in employee buy-outs but did not play any role in organising the procedure; in other cases, however, local trade unions actively lobbied for preferential shares as well as for ESOP buy-outs. In addition to influencing privatisation decisions, unions usually had at least one of their leaders as a member of the organising committee and the ESOP trust. Subordinates saw ESOP and other durable buy-out schemes as a tool to preserve their workplace. An important number of employees regarded employee ownership as the only acceptable form of privatisation in order to avoid foreign ownership. At the expense of meeting tough profit requirements, ESOPs were a good possibility to enable the management to preserve the comfortable position they had gained in the 1980s when some of the ownership rights were exercised by Enterprise Councils and Assemblies made up of company managers and subordinates.[207] Furthermore, the cooperation of managers and subordinates in ownership was in line with Hungarian traditional intra-enterprise relations.

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204 State enterprises were managed by Enterprise Councils or Assemblies elected by the workers. Transferring part of the ownership rights to these bodies further increased company autonomy vis-à-vis Communist party-state regulation, and put the management in quasi owner position without real control by owners.

205 Decree of the Ministerial Council No. 94 of 1988 on Property Notes. Companies could issue such property notes free of charge for employees only using the after tax profit, up to a maximum of 10% of the total assets of the company. However, such property notes were issueable only until May 15, 1993. Later they were transferred either into shares or companies were obliged to buy them from their owners. See Boda and Neumann (1999), p. 40.

206 With the appearance of mass unemployment in 1991, employee ownership increasingly seemed to be a tool for the company to continue operations and for keeping human resources and jobs.

207 According to the memories of a former leader of the Rész-vétel Foundation representing ESOP companies, about half of company managers used an ESOP as the cover for a management buy-out. Half of the rest of the managers realised over time that they did not really have to share ownership with their subordinates. The remaining one quarter behaved in a 'fair' way (Boda, Neumann and Vig, 2005)

Since the end of privatisation in 1998 lobbyists have been fighting without any success for political support and financial encouragement for ESOPs 'outside privatisation' as well as to make the technique applicable in cases of liquidation. Furthermore, in contrast to the international trend of the individual account-based pension system, plans to encourage tying employee ownership to pension fund membership have so far gone unnoticed. Another important effort of lobbyists was to amend laws (ESOP and tax laws) to make sure that the unfavourable economic environment would not undermine the operation of existing ESOP enterprises.[208] The latest example is placing outpatient health care services and the organisation of ESOP companies on the privatisation agenda. Nevertheless, there is a great deal of uncertainty around the programme, not least because of the recent referendum on the ban on the privatisation of the health care system. On the whole, in Hungary there is no policy on employee ownership. While most of the political parties (both on the left and the right) declare their commitment to the issue, concrete economic policy decisions are still missing. It seems that what has been achieved in terms of employee participation needed the élan of privatisation that mobilised and divided the whole society.

2. Legal and Fiscal Framework

The Hungarian Labour Code states that an employer may grant any benefit to its employees if it is provided in a non-discriminatory manner.[209] In Hungary, the legal framework of financial participation of employees embraces both, profit-sharing and employee share ownership. However, specific (legal/tax) incentives for profit-sharing do not exist, neither for employees nor for employers. Company law regulates employee shares, including stock options, explicitly and recently an 'Approved Employee Securities Benefit Programme' including specific incentives has been introduced.

a) Share Ownership

Employee privatisation on preferential terms (1991, 1995) – The privatisation law of 1991 contained various preferential privatisation techniques. In 1995 a new Law on Privatisation[210], still in force, reduced some of the allowances for employees, but at the same time offered new forms and techniques, i.e. privatisation on deferred terms, em-

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208 Early regulations focused on asset acquisition, and questions of distributing and balancing power at that time did not allow the operational problems to be addressed.

209 Section 5 of Law XXII of 1992 on Labour Code.

210 Law XXXIX of 1995 on the Realisation of Entrepreneurial Property in State Ownership. In practice, one of the problematic issues was how to secure financial sources for preferential privatisation. Another issue was that the State Property Agency was organised in a business entity form (joint-stock company) and was not part of the State administration. Thus, its decisions were not challengeable as administrative decisions.

ployee privatisation on preferential terms, *'Egzisztencia'* credit and ESOPs. In the context of privatisation three financial techniques for acquiring employee ownership on preferential terms exist: (1) price reduction, (2) purchase by instalment and (3) purchase on credit. Thus it is possible to grant a discount of up to 150% of the annual minimum salary. However, the nominal value of shares acquired this way may not exceed 15% of the company's registered capital and the discount granted may not be above 50% of the purchase price. This allowance can be used either individually, or in an organised form.[211] Payments on deferred terms for privatised property may be granted for a maximum period of fifteen years.[212] The interest rate on such credit cannot be less than 50% of the current official national bank interest rate while ownership passes to the buyer with the payment of the first instalment. Furthermore Hungarian citizens may take up to 50% of the property that they wish to acquire and as a maximum up to 50 million HUF as an *'Egisztencia' credit*[213], regardless of the number of buyers.[214] The law also sets up criteria for the eligibility of taking such credit, e.g., that the property bought on credit may be alienated only with the consent of the credit institution until the credit is repaid and that the same applicant may take credit only once within three years.

Employee stock ownership programme (1992) – In Hungary [215] the American ESOP system had a strong influence on the drafting of the law regulating the establishment and functioning of ESOPs. Basically the Hungarian ESOP followed the American 'trust' model (Luxne and Szucs, 1993, p. 9; Boda and Neumann, 1999, p. 45). However, there is a major difference between the two systems: while in Hungary the ESOP is a privatisation form with the organisation ceasing to exist as soon as all the securities are paid for and their ownership is transferred to the employees, in the United States, an ESOP is an organisation that administers the securities of employees and does not cease to exist when the credit is repaid.[216] Hungarian literature distinguishes between so-called 'privatisation' and 'non-privatisation' ESOPs (Szakértői Munkaközösség: ESOP, 1990, pp. 49-50). In the case of the former, the ESOP or-

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[211] Section 55-57 of Law XXXIX of 1995 on Realisation of Entrepreneurial Property in State Ownership.

[212] Section 46 (2) of Law XXXIX of 1995 on Realisation of Entrepreneurial Property in State Ownership.

[213] Governmental Decree No. 28 of 1991 on 'Egzisztencia' Credit and Deferred Payments Benefits; see below c).

[214] Section 58 (3) of Law XXXIX of 1995 on Realisation of Entrepreneurial Property in State Ownership. This rule applies to ESOP credits as well.

[215] Regulated by Law XLIV of 1992 on Employee Share Ownership Programme, which entered into force on July 14, 1992, amended with Law CXIX of 2003.

[216] For the ESOP organisation that exercises ownership rights, basically the American 'trust' model was used (see Boda and Neumann, 1999, p. 45; Mocsáry, 1998, p. 63). Another difference between the American and Hungarian regulation was that under the 1992 ESOP Law there were no 'fairness' rules (this led to disproportionately large manager ownership); however, this was changed with the 2003 Amendments. It should be also noted that the ESOP Law does not differentiate between employees and managers.

ganisation buys the property of the State Property Agency or of municipalities and there are incentives related to this form. In the case of the latter, shares or business shares that are not at the disposal of the State Property Agency are sold, e.g., already existing securities or securities issued in the case of capital increase also foreseen by the ESOP law. The only difference between both forms is that there are no specific incentives encouraging companies or employees to establish non-privatisation ESOPs.

Participants of an ESOP have to be employed by the given company for at least half of the official work time and need to have an existing employment contract with the company for at least six months.[217] An employee can be a member of only one ESOP organisation at a time, though it is possible that within one company two ESOPs exist since there is a threshold of 40% employee participation. Until an amendment of the law in 2003 retired employees had to secede from the ESOP[218], now they can decide if they wish to remain a member. New employees or old ones who did not want to join the organisation at the time it was established can become members of the ESOP at any time. The employees of the company elect a three member organising committee whose duty is to negotiate with potential sellers (company) and creditors (e.g. banks)[219] and subsequently to prepare the credit application and purchase offer. The committee is also responsible for the preparatory legal work relating to the establishment of the ESOP organisation, e.g. drafting the proposal of the statutes.[220] At the statutory meeting ESOP members elect its board, as with the establishment of the organisation the organising committee ceases to exist. Upon registration the organisation becomes a legal entity, being a non-profit organisation under the supervision of the Office of the Public Prosecutor[221] with the members' meeting as its highest decision-making organ.

The organisation ceases to exist when the ownership of all shares is transferred to the participants of the ESOP, unless the employees decide that the ESOP organisation should remain, which requires them to develop regulations for the period after repayment (e.g. rules of marketing shares).[222] The organisation has full liability for its obligations. Members of the organisation are not liable for the debts of the organisation except with the securities already allocated to them. Until the shares are transferred to

217 A longer period up to a maximum of five years can be required by the statute of the ESOP organisation; see Section 1 (2) of Law XLIV of 1992 on Employee Share Ownership Programme.

218 Because of long repayment periods this was disadvantageous for these employees, as they could not have their share of the profit (Mocsáry, 1998, p. 68).

219 The committee also prepares a feasibility study, in which it examines the financial situation of the company checking if the company will be able to carry the financial burden of the programme; the study has to be countersigned by the representative of the company.

220 At least 40% of the employees of the company have to agree on the establishment of the ESOP organisation and adopt the statute of the organisation.

221 Id. Section 11; it may pursue only limited economic activity (see note 38).

222 As a result of legal regulations, the overwhelming majority of ESOP organisations ceased to exist after the loans were repaid. Furthermore, the established forms of operating the asset (such as setting up a limited company) involve considerable costs (Boda, Neumann and Vig, 2005).

the participants of the ESOP[223] the organisation is the owner of the shares. With regard to the exercise of property rights, participants have voting rights in proportion to their registered shares, but up to a maximum of 5% of the property acquired by the ESOP organisation.[224] However, in many issues related to decision-making in an ESOP organisation the law gives a wide discretion to the members of the organisation to establish 'internal' rules in this field. Rights of participation that result from the ownership of shares by the ESOP organisation are exercised through the representative of the organisation, however the articles of incorporation can stipulate differently.

In the case of 'privatisation' ESOPs only credit is available to employees on preferential terms, however, the own resources of the organisation must be at least 2%.[225] If the securities of limited liability companies or joint-stock companies in majority state ownership are sold by the State Property Agency the ESOP organisation can offer preferential credit or an instalment payment plan.[226] The terms of the credit[227] are as follows:

Amount of credit	**Own resources (in % of the amount of the credit)**	**Duration (years)**	**Grace period (years)***
Up to 5 million HUF	2	15	3
Above 5 million HUF	15	15	3

* During the grace period only the interest on the credit has to be paid.

Tax exemptions for 'privatisation' ESOPs allow the company to offer tax allowances for the property sold to the ESOP organisation prescribed by the Corporate Tax Law (Lukács 2004, 9.5.2.5). Accordingly, up to 20% of the amount paid to the ESOP organisation can be deducted from the company's tax base. ESOPs were not subject to corporate profit tax until December 31, 1996. However, following this date, the income of ESOP organisations falls under the rules of the Law on Corporate Tax and Dividend Tax, and accordingly 16% tax is paid on the taxable income of the organisation.[228] However, two special rules apply when calculating the tax base of ESOPs: (1) the tax base should be reduced by the amounts paid in by private persons as their own contribution to the ESOP organisation and by the amounts of subsidy paid in by other private or legal persons, or by the employer company (otherwise these amounts should have been accounted as income). (2) at the same time, the tax base has to be increased by the acquisition value of the shares given to the ownership of participants of the

223 As in the Anglo-American model, following the payment of shares employees may dispose freely of his/her shares (Boda and Neumann, 1999, p. 26).

224 Section 7 (6) of Law XLIV of 1992 on Employee Share Ownership Programme.

225 Section 8 (2) of Governmental Decree 28 of 1991 on 'Egzisztencia' Credit and Deferred Payments Benefits.

226 Section 15 (1) of Law XLIV of 1992 on Employee Share Ownership Programme.

227 Section 8 (2) of the Governmental Decree No. 28 of 1991 on 'Egzisztencia' Credit and Deferred Payments Benefits.

228 Section 2 (2) (e) and 19 (1) of Law LXXXI of 1996 on Corporate Tax and Dividend Tax.

ESOP – on the pretence of transferring means without compensation, that amount is accounted among expenditures (reducing the profit) according to the rules of accounting.[229] According to Personal Income Tax Law, the securities transferred from the company to employees are tax free, such securities are not considered as income.[230] However, at the time of sale of such securities by the employee, the income from this sale is considered a capital gain and taxable at a rate of 20%.[231]

Private Companies (1988) – Employees' shares were first introduced by the Law on Business Associations of 1988[232] and still exist under the current version of the law[233]. They are registered shares and can be issued free of charge or at a reduced price in accordance with the provisions of the Articles of Association of the joint-stock company, e.g. in the context of a Long-Term Incentive Plan or a broad-based Stock Option Plan. Employees' shares may be issued with a simultaneous share capital increase of the joint-stock company, up to a maximum of 15% of the increased share capital. A joint-stock company may pass a resolution on the issue of such employees' shares which entitles their holders to dividends from after-tax profits to be distributed amongst shareholders prior to the shares belonging to other categories or classes of shares, but following shares granting preferred dividends. In the event of the death of an employee or the termination of his/her employment relationship, excluding the case of retirement, his/her heir or former employer shall have the right to transfer the employees' shares in question to other employees of the company within a period of six months. If this deadline expires without success, at the first shareholders' meeting thereafter the company shall withdraw the employees' shares in question with a corresponding reduction in its share capital, or shall decide to sell such shares after transforming them into ordinary, preference or interest-bearing shares. Thus, the limited transferability of this kind of share reduces its value.[234] The company issuing such shares can distribute them for free or give discount for their purchase, which makes this form of financial participation very attractive for employees. However, there are no tax incentives related to this form of share acquisition (Lukács, 2004, 9.5.1.3). From January 1, 2003 income received in the form of securities is no longer regarded as an allowance in kind. The applicable rules of taxation are determined by the legal relationship between the private person and the provider. In the case of securities provided by employer to employee, such income is considered as income from employment, and the pertinent tax rules have to be applied.[235] Thus, in case of employ-

[229] See Foldes 573 (2005).

[230] Section 18 (4) of Law XLIV of 1992 on Employee Share Ownership Programme.

[231] Section 66 of Law CXVII of 1995 on Personal Income Tax; Securities acquired from already taxed personal income of the participant of the programme are not taxable.

[232] Section 44 of Law VI of 1988 on Business Associations.

[233] Section 187 (1) of Law CXLIV of 1997 on Business Associations.

[234] According to research undertaken by the National Employment Office of Hungary, employee share ownership is insignificant in Hungary. Interview with Dr. L. Neumann (Budapest, February 10, 2005).

[235] See Informant of the Tax and Financial Control Administration (APEH) on the Rules on Securities Allowance in Force from January 1, 2003. Source: Hungarian CD Jogtar (Feb. 28, 2005).

ees' shares, the difference between the purchase price and the sale price falls under personal income tax.

Approved Employee Securities Benefit Programme (2003) – In the beginning of 2003 new legislation[236] entered into force allowing companies to set up state-recognised, tax-qualified stock plans. The organiser of the Employee Securities Benefit Programme has to submit an application for the recognition of the programme as an approved programme to the Ministry of Finance which informs the competent Tax Authorities about its decision. To be approved, the programme must meet a catalogue of conditions, e.g., that only securities issued by the applicant company or by its majority shareholder may be offered in the programme and the statutory threshold levels of at least 10% employee participation and a management share of less than 25%, with less than 50% of the total share value. At the time of sale, the employee is subject to tax on the spread between the exercise price and the sale price. Such capital gain is taxed at 20%, separately from other income.[237] Companies have no withholding or reporting obligations in connection with employee stock option or purchase plans. The first HUF 500,000 of the shares that have met the vesting requirements are not taxable at exercise or vesting. Any shares deemed non-qualified are taxed as normal employment income.[238] Once employees exercise the shares, the shares must be held in a security account overseen by a custodian, and there is an obligatory three year vesting period which ends on December 31 of the second year subsequent to providing the securities.[239] Following this, they have the same rights as any other shareholder from the same class.

b) Profit-Sharing (1992)

Except for section 5 of Law XXII of 1992 on the Labour Code, which states that an employer may grant any benefit to its employees if it is provided in a non-discriminatory manner, no regulations exist. Specific incentives do not exist, neither for employees nor for employers. There is no tax allowance or other kind of state subsidy in the case of profit-sharing, every kind of benefit and allowance paid to employees falls under the Personal Income Tax Law and there is also no allowance for employers. Apart from the lack of incentives, the origin of this form of financial participation as an evolution of pay systems is not common to socialist economic systems and explains its absence.

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236 Law CXVII of 1995 on Personal Income Tax; Decree of the Ministry of Finance No. 5 of 2003 on the Procedure of Registration of Approved Employee Securities Benefit Programme, and on the Rate of Administration Service Fee for the Initiation of the Procedure.

237 While personal income tax is payable because the shares are regarded as earned income, no social security contribution must be paid (earlier share benefits were regarded as in-kind benefits, belonging to the highest income tax bracket (44%), and the social security contribution was also payable).

238 Personal income tax in Hungary is based on a progressive scale from 18% to 38%.

239 Section 77/A, 77/C of the Law CXVII of 1995 on Personal Income Tax.

c) Cooperatives

In the same way as the previous Law on Cooperatives of 1992[240], the Law on New Cooperatives[241] requires a minimum of five persons (both natural and legal persons)[242] to establish a cooperative.[243] Unlike the 1992 Law the new Law does not place much emphasis on the property notes representing shares in the cooperative. It only states that the membership and membership rights and duties are represented by property notes representing rights in the cooperative. The new Law obliges the cooperative to keep a register of members and their contributions. However, the Law states that irrespective of their contribution, members have the same rights in the cooperative. The members' meeting decides on the dividend (on the proposal of the board of directors and the supervisory board) based upon economic cooperation with the members. The highest decision-making body of the cooperative is the members' meeting; it is convened by the board of directors and any issue may be put on the agenda on the initiative of at least 10% of all the members. Concerning quorum rules, at least half of the members have to be present, and if there is no contrary provision in the law, in the articles of foundation or in the decision of the members' meeting, decisions are made with 50% plus one vote of the members present at the meeting, with public voting. The board of directors (or if there are less than 50 members it might be the chief executive officer) elected by the members' meeting manages the everyday activities of the cooperative. It forms the working structure, exercises employer's rights and makes decisions regarding every issue that is not in the competence of other organs. Regarding taxation of the cooperative as an organisation, it is subject to the Law on Corporate Tax and Dividend Tax, and pays 16% tax on its realised profit. According to the provisions of the Law on Personal Income Tax, representing shares in the cooperative are considered securities and any income related to them is taxed accordingly.[244]

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240 Law I of 1992 on Cooperatives (the 'old' law).

241 Law CXLI of 2000 on New Cooperatives.

242 The Law does not allow the number of legal person members to be higher than that of natural persons, except if the majority of members are cooperatives.

243 At present both laws on cooperatives are in force, the 'old' one of 1992 and the 'new' one, that entered into force on Jan. 1, 2001; following this date, cooperatives can be established only in accordance with the provisions of the new Law. Cooperatives that existed prior to this can function in accordance with the old Law until Dec. 31, 2006; however, they have to decide by this date whether they will keep on functioning as a cooperative (in this case they have to adjust to the provisions of the new Law), transform into another form of enterprise or cease to exist.

244 Section 34 of Law CXVII of 1995 on Personal Income Tax. For tax rate see g) Taxation Issues.

3. PEPPER Schemes in Practice

In Hungary in recent years employee ownership has been on the decline (Boda, Neumann and Vig, 2005).[245] Employees mostly tended to sell their shares as quickly as possible, especially if their ownership amounted to only a few percent, in order to realise what may be called 'a one-off privatisation bonus' rather than to hold on to their shares and demand participation in strategic and ownership decision making. More stable forms of employee ownership (majority shares packet, ESOP) were created where managers could promise fair treatment and promote the image of a company using redundancy measures only as a last resort. Empirical studies[246] investigating the privatisation process found that the main goal of the management in all cases was to keep the whole enterprise as one unit and by supporting employee ownership to avoid external ownership control, thus retaining their decision-making autonomy. Chances for the participatory form to be workable are greater if the relative capital need of the company (assets per head) is low and there are fewer employees. Full employee ownership is created where the activities of the enterprise are highly complex (high rate of non-repetitive products); also, there is a significant correlation between the demand for skilled labour by the company and the share of employee ownership.

a) Share Ownership

Employee privatisation on preferential terms – Between 1990 and 1992 employee ownership *on preferential terms* was created in 540 companies in compliance with the Asset Policy Guidelines and privatisation laws, typically at a level less than 10% (and nowhere more than 15%) of employee ownership share[247]. It was popular during the early so-called simplified privatisation to employees of small and medium-sized enterprises (Lukács, 2004, 9.5.1.1). In terms of privatisation as a whole, the 15%-shares of the assets of the various enterprises amounted to a significant total value. To give a sense of the order of magnitude, immediately after privatisation there were altogether HUF 13.9 billion worth of employee shares in the 9 privatised electricity companies[248]. In addition, according to expert estimates, between late 1989 and June 1992, i.e. prior

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245 A panel survey made between 1992 and 2000 analysed the data of about 400 industrial production companies; in 1995 the share of employee ownership was 20% in the sample weighed by categories of number of employees and geographical location (Jánky 1999).

246 In 1993, on the request of the State Property Agency the findings of an empirical study were summarised. The study covered five early cases of ESOP programmes (Bodan and Neumann, 1999); Rozgonyi and Jávor (1996) researched the employee buy-out in five enterprises with different profiles in 1996.

247 Magyar Hírlap, 13 August 1992; unfortunately, there are no available statistics on assets acquired by the management and subordinate employees through preferential purchase, still it is quite certain that in the later phase of privatisation employees in almost all enterprises were offered preferential purchase terms.

248 ÁPV Rt. Annual Report 1996.

to the passing of the ESOP bill, employee and management buy-outs took place in about 30 firms (Karsai, 1993).

Employee Stock Ownership Programme - According to State Privatisation Company (ÁPV Rt.) records, between 1992 and 1999 287 ESOP purchases took place at a nominal value of about HUF 51 billion (Boda, Neumann and Vig, 2005). On average, in the early years (between 1989 and 1992) 85% of the employees became owners of their companies in buy-out transactions (Karsai, 1993)[249]. At the time of privatisation there were nearly 80,000 employees at the 247 enterprises involved in these transactions (Kubik and Matolay 1998).[250] The heyday of the ESOP was 1993 and 1994 with most transactions taking place at that time after a slow start; then an amendment to the law in 1995 put an end to the purchase of majority ownership on preferential terms.[251] On the whole, in 47% of cases recorded by the Rész-Vétel Foundation, the ESOP was a full or majority owner, and in 24% an owner with controlling rights (owning 25 to 50%).[252] The greater the capital a company had, it seems, the smaller was the share of ownership bought out by the employees[253], although studies show that the huge majority of ESOP buyouts were in practice management buy-outs (Galgóczi and Hovorka, 1998, p. 4).

However, during the last few years no new ESOPs have been established, partly because this form was linked to the privatisation of state property, and partly because of the lack of tax and other benefits related to the 'refreshment' of membership of ESOP organisations.[254] Restrictions concerning the scope of entrepreneurial activity prescribed by the law on ESOPs were also an impediment to their flexible functioning and further development (Mocsáry, 1998, p. 69). The new amendment to the ESOP law states that: 'the organisation can pursue other economic activities only to help to

249 Surprisingly enough, the high participation rate of employees (50-70%) is independent of the fact that the cash collateral for the loan came from individual payments or company assets.

250 Participation was limited only by rules that were set by the employees themselves (for instance minimum service period). Where no individual payment was needed because the costs of buying were taken over by the company, almost all employees became owners, as in the majority of ESOP cases.

251 Over these two or three years, the average share of assets bought by ESOP organisations gradually decreased: while in 1993 80% of buy-outs were majority buy-outs only 66% belonged to this category in September 1994 and 48% at the end of 1995.

252 Rész-Vétel Foundation, Summary of ownership purchase by ESOP organisations 1995.

253 Ibid. At the beginning, ESOP was a privatisation technique typically used in medium and small sized companies. Nearly two thirds (65%) of the businesses involved were medium size companies employing 100 to 1000 and hardly more than half of the companies had as much own capital as HUF 100 to 500 million and as few as 5% of them had over HUF 1 billion worth of capital.

254 It also happened that the management used the employees to gain ESOP related benefits during the establishment of the organisation. Following the purchase of shares the management restructured the company (at the same time slicing the old company), relocating some employees to newly established companies that were separate legal entities, so that the ESOP membership of these employees ceased. Also, there can be abuse during the distribution of securities, as this issue is allowed by the law to be regulated in an agreement made by the members of the ESOP organisation (Mocsáry, 1998, pp. 68-70).

achieve its goals.'[255] Between 1993 and 1995, the ownership structure did not change much in the majority of ESOP companies bought through loans as the debtors could not sell their shares before full repayment of the loan. From 1996, however, both inside ownership and the ownership share of subordinate employees shrank considerably. Furthermore, according to the ESOP law, by-laws regulate the eligibility criteria for joining the ESOP organisation at a later time. In most of the companies, financial support for down payments was a one-time act limited to privatisation and late-comers were required to pay immediately.[256] As a result of legal regulations, the overwhelming majority of ESOP organisations ceased to exist after the loans were repaid.[257] According to HCSO data, in the first quarter of 2005 there were – including newly founded ones - only 151 ESOP organisations remaining.[258]

In summary it can be said that in 1998, the final year of privatisation, as little as one % of the assets of companies other than financial institutions was in management or employee ownership in Hungary. Furthermore, ESOP company employees make up as little as 1.2% of employment by legal entity economic organisations (limited liability companies and joint stock companies) (Laky, Neumann and Boda, 1999). Of course, if one considers only privatised assets, the share of management and employee ownership was higher, especially in late 1993 when it amounted to 12%[259]. By September 2000 around one third of companies had repaid their loans. In over half of them employees remained the owners of their company, but when the ESOP organisation ceased to exist, employee ownership was converted into individual small ownership and employees disposed of their shares freely and individually. Thus, these companies are not different from those in which employees are individual owners[260]. Loan repayment accelerated the shrinking of employee ownership: there are external owners in about half of the unencumbered companies, which is a sign of post-privatisation sale.[261]

255 Section 16 (1) of Law XLIV of 1992 on Employee Share Ownership Programme.

256 There is almost no by-law that provides that shares remaining in the organisation's ownership should be used as a fund to finance newcomers' preferential or free of charge purchase. These rules tend to lead to the creation of 'exclusive' ESOP organisations (Boda, Neumann and Vig, 2005).

257 Between 1995 and 1999 the share of large ESOP companies employing over 1000 dropped to half. The share of companies in majority ESOP ownership decreased from the initial 58% to 38% by September 2000, and that of companies with 25 to 50% ownership share ensuring the right of control decreased from 29% to 2% in the respective period (Boda and Neumann, 2002).

258 After mass privatisation was over there were about 300 ESOP organisations in 1998 and 252 in the first quarter of 2001.

259 In Mihályi's calculations, in 1993 assets sold by ESOP technique as per the contract price made up 16% of total annual privatisation revenue, and 32.0% of domestic sales (Mihályi, 1998).

260 The two kinds of employee ownerships became even more similar with the amendment of the ESOP law in 2003, which allowed retiring employees to keep part of their ownership.

261 Research findings suggest that the occurrence of post-privatisation sale is not greater in ESOP buyers than in other domestic buyers (Árva and Diczházi, 1998).

Private Companies – According to a study from 1992[262], up to mid-1991 the State Property Agency issued permission for 20 companies to issue free shares.[263] While employee shares might amount to 10% of the total value of privatised enterprises these forms of ownership were far from being stable as owners sold as soon as possible.[264] Trade unions pushing the management for preferential shares supported the resale by employees so actively that they looked for brokerage firms themselves.[265] The review of the current practices of long term incentives (Boda, Neumann and Vig, 2005) is based upon data from the above mentioned consulting firms. 37% of HayGroup clients gave their employees shares in 2004[266]; 90% of these enterprises have adopted the income policy of their foreign mother company and have supported the various forms of share benefits in their incentive policy. In these forms of participation, however, mostly managers were favoured as the aim of these long term incentives generally were to make top managers identify with the long term goals of the company, retain the key top managers and supplement employees'.[267] The majority (66.5%) of enterprises using employee share benefits offer employees Stock Option Plans; the share purchase programme is fairly widespread (33.4%). Stock Option Plans most often (62%) involve buying equity shares at the stock exchange, and 30% provide shares by issuing equity shares after commercialisation. Stock Option Plans last for a minimum of 1 to 3 years and a maximum of 5 to 6 years, and the option ensures on average a 30% supplement to the employee's basic wage. The actual levels are determined on the basis of job and position, and in 67% of cases companies used some kind of performance criteria. These findings are confirmed by information from Hewitt Inside Kft, stating that in 2004 26% of enterprises used one long term incentive or another; most of them (80%) launched Stock Option Plans, and many (30%) used performance shares.

Approved Employee Securities Benefit Programme – In the two years since the legislation only 7 or 8 companies have applied and have been granted permission for

262 Data of the State Property Agency analysed by Laky (1992).

263 Preferential shares ranged from 1.15% to 16.3% of the company's registered capital (preferential shares were free or sold for 10, 50% or 60% of their nominal value.) Most commonly, employees could buy at 50%, payable by instalments. Company regulations on the purchase of preferential employee shares usually favoured managers as the limit was specified as a percentage of base wages.

264 There are no statistics on the sales of employee shares and only case studies provide information on what happened to them. The intention of employees to sell quickly was especially obvious in companies in which the share became, or were expected to be, quoted at the exchange market, and their value rapidly grew to several times higher than at the initial public offering (for instance: EGIS, MATÁV, MOL etc.).

265 See Magyar Hírlap, 2 May 1998; e.g., in the electricity industry the trade union concluded a deal on the preferential terms of employee ownership with the Privatisation Ministry prior to privatisation.

266 Source: Hay income level study 2004, Hay Group 2005, Hay Executive Compensation Report, Hay Group 2005.

267 No data is available on employees participating in company programmes. The low penetration of participation, however, is seen in the HCSO labour force survey data. Less than 1% or only 281 of 30,000 respondent employees received employee shares. Unpublished data, Hungarian Central Statistical Office (hereafter: HCSO) 2004.

Employee Securities Benefit Programmes, and the number of participating employees is not more than a few thousand. Typically the companies are relatively large multinational enterprises in Hungary that adapt the share benefit programmes designed by their headquarters for all their subsidiaries. Similar to the procedure made possible by Section 77/A and B, both adaptation of benefit schemes and application for permission is carried out by consultants or law firms hired by the enterprises. Usually they are permanent clients and the firms are familiar with both the practices of the multinational company abroad and the operational circumstances, incentive and wage systems in Hungary. The permission procedure itself is 'client friendly' in the sense that the application is submitted only after it has been previously reviewed by the authority and corrections have been made; thus so far none of the applications have been refused. The Ministry of Finance, however, checks only formal requirements and has no information on the underlying economic and incentive logic.

From the applications submitted by companies it appears that the typical scheme is a free share programme. An exception is the pioneering 'two for the price of one' practice of Henkel. According to the staff of the Ministry of Finance, the amount of the benefit depends upon position in the hierarchy rather than on performance indicators (Boda, Neumann and Vig, 2005). In the Ministry's evaluation, the main motivation for using the scheme is low taxes, which is also available with other in-kind benefits (for instance support of voluntary insurance payments, tax free up to the amount of the minimum wage – currently HUF 57,000 per month – and which can be used immediately for health care services).

b) Profit-Sharing

In traditional Hungarian state socialism[268], profit-sharing was a flexible element of income in addition to the basic wage and many domestically owned companies still use this practice. Multinational or foreign owned companies, however, pursue their own methods developed inside the mother company. Some foreign owned companies in Hungary apply the American incentive model which is highly profit-oriented and focuses on incentives for the management (thereby creating huge differences within the company) while others use the European model of incentives which creates smaller differences and serves longer term interests. According to Hewitt Associates, about 80% of the enterprises in Hungary use short-term incentive tools that go beyond the simple sales premium.[269] 20% of them use profit-sharing. In most cases (in 67% of

[268] See Bódis, Emberierőforrás-gazdálkodás: módszerek, problémák, törekvések [Human resource management: methods, problems, aspirations], web page visited: January 12, 2005 <http://www.rezler-foundation.hu/docs/bodislajosharom.doc>.

[269] The incentive systems of 50 companies were surveyed in 2003, the majority of which were large ones in terms of sales and number of employees. The majority (66%) were foreign owned, 20% were production, 27% were service providers and 27% were trading companies. In their systems, the contingent wage included short and long term incentives and social and other benefits. A similar study by the HayGroup analysed wage data of 201 mostly foreign owned companies (82%).

companies) the basis of entitlement is one's position in the hierarchy, but many places (23% of the enterprises) set other criteria as well. According to the survey, however, only 10% of entitled employees receive a share of the profits. A more frequent form of short-term incentive is the performance bonus, which is more democratic in the sense that it is payable to all employees at half of the companies. Also, a variety of bonuses paid on the basis of some kind of indicator other than profits are more frequent than profit-sharing.

c) Cooperatives

Between the two world wars there was a considerable cooperative movement in Hungary. Credit cooperatives, which financed craftsmen, agricultural trading and crop manufacturing cooperatives were especially important. In the command economy, cooperatives, like the state sector, were put under central control and were integrated into the system of institutions of the all-embracing central distribution. The artificially inflated cooperative sector employed about 25% of total employment during the socialist period. With the approaching change of regime, the rate of cooperative members dropped somewhat, to 12.1% of total employment in 1989 (Statistical Yearbooks, 1987, 1990; HCSO, 1998, 2000).[270] Surviving and restructured cooperatives, however, play an insignificant role in the economy and in employment as well. According to HCSO data, on 31 December 2004 out of the 416,000 active incorporated enterprises there were 5,219 cooperatives in operation in the country but 2,607 of them did not employ anyone and operated purely as an organisation of owners. (A typical solution in consumer cooperatives is that the real economic activities were transferred into a business organisation and thus control by the membership became only a formality.) 36% of existing cooperatives work in services, 30% in agriculture and 19% in trade.[271] Currently employment by the cooperative sector is insignificant: according to data by the HCSO Labour Force Survey, in 2004 only 0.2% of the employed were income earning cooperative members.[272]

84% of all companies give their employees some kind of contingent wage made up of bonuses/premiums, profit share, and turnover bonus in sales jobs.

[270] 69% of cooperative members worked in agriculture, 22% in manufacturing, and 5% in construction.

[271] HCSO (ed.) (2001, 2004), A gazdasági szervezetek száma [Number active undertakings], Budapest.

[272] HCSO (ed.) (2005), Főbb munkaügyi folyamatok [Labour report] January–December 2004, Budapest.

4. Evidence of the Effects of PEPPER Schemes

There is little empirical experience of the use of forms of participation not centrally supported because companies consider it to be their own affair. The use of the new 'Approved Employee Securities Benefit Programme' has had little impact so far. Thus, information is mostly available on the working of ESOP companies. The most interesting aspect of the division of assets between 'inside' buyers is the proportion of ownership between the management and employees. The early buy-outs through limited companies created majority management ownership: in two thirds of companies the share of management ownership was 50% + 1 share and in one third 30 to 40% (Karsai 1993). The high share of management (CEO and managers together) ownership is underlined by data given by Kovách and Csite (1999): in almost half (48.9%) of the companies dominated by employee and management ownership, the share of management ownership is 50% to 99%. After loans were repaid, subordinate employees became 'free' owners and mostly sold their shares to managers. The concentration of shares sooner or later leads to majority management ownership even in companies where this was not the original case.

The ESOP law grants full autonomy for ESOP organisations to create their own rules. In practice, however, the by-laws of ESOP organisations mostly apply the model of a business rather than of a cooperative, consequently decision-making is based upon voting according to individual payments and the ratio of shares, and only rarely on a 'one member - one vote' basis.[273] ESOPs have failed to find an institutional way to cope with the basic contradiction of owners' representation, i.e. employees are subordinated to the CEO but at the same time, as owners, are the employers of the CEO. The business organisation and the owners' organisation are almost never separated. In most companies the Chief Executive Officer or his/her deputy or other confidant is an important member in the ESOP organisation, too. Case studies suggest that top managers are rarely seriously controlled by owners (Boda and Neumann, 1999). There have been scarcely any cases when the owners' organisation fired a bad manager. In most companies owners were unable to prevent the management from pursuing restructuring and redundancy plans even if they wanted to. According to another study (Rozgonyi and Jávor, 1996), even if strategic issues are put on the general assembly agenda, employees seem to be much less interested in those rather than in issues directly affecting them (e.g. work conditions) or in decisions on redundancy or work organisation that potentially have negative consequences.

An analysis of the balance sheet figures suggests that the performance of ESOP companies between 1993 and 1997 was not worse than the average of double-entry book keeping companies (Boda and Neumann 1999). ESOP companies in trade as well as in industrial and retail services were especially competitive. According to data from 2000,

[273] It is a typical mistake of ESOP rules that they do not address the problem of creating transparent and democratic procedures to specify the guidelines of representation for ESOP trusts (Boda, Neumann and Vig, 2005).

the share of profit making ESOP companies dropped to 70% (from 80% in 1997, based on balance sheet figures), 10% of them operated at a loss and about 20% were just about at a break-even level (Boda and Neumann, 2002). Nevertheless, cessation of ESOPs is only rarely related to business performance. Kovách and Csite (1999) found that enterprises in employee ownership (owned by entrepreneurs and by employees and management) in 1996 were more efficient than other ownership forms in terms of per assets sales revenues and realised considerable revenues even with few company assets. At the same time, in terms of labour efficiency these companies were less successful than others: despite large lay-offs, per employee revenues were smaller than the average.

In summary, the employee owned companies operating most successfully were privatised early (in 1992 and 1993). Furthermore, those with minority employee owners do better than ones in majority employee ownership. Based on an analysis of changes in revenue, efficiency and liabilities since 1990, the financial management of the majority of small and medium-sized MEBO and ESOP companies seem to be solid and efficient. Large enterprises were the worst performing ones. Failures were due to large debts, incurred independently of privatisation, and probably to bad market positions and bad management. Employee owned enterprises can be competitive in those segments of the market that meet special demand. The overwhelming majority of efficiently working ESOP companies produce for a stable domestic (or regional) market. In some of them this is a natural consequence of the type of activities they do (for instance, service providers for households). In the sectors where foreign competitors are present, ESOP companies have a chance to stay in the market by offering low prices or meeting special demand (for instance extraordinary consumer taste). Furthermore, they are at an advantage in labour intensive activities.

As for human resources management, no ESOP company was found to have gone bankrupt because of employment or wage decisions made in favour of employees. In fact, redundancy was more frequent in ESOP companies than in other enterprises. The trends in companies with other forms of employee ownership are similar: redundancies were the greatest in employee-management owned companies between 1993 and 1996 (Kovács und Csite, 2002). Wage outflow does not seem to be a problem in ESOP companies either. The projected growth index of average earnings in 1999/1998 was almost identical in the two categories of companies.[274] With regard to asset management, data suggests that the financial situation of surveyed ESOP companies worsened (Boda, Neumann und Vig, 2005). While between 1993 and 1997 their debt (liabilities/own capital) and liquidity (current assets/short-term liabilities) indicators were better than the average of double-entry book keeping companies, in 1998 and 1999 the figures of overdue receivables were worse. In September 2000 one third of companies had completed their loan repayment and only one company was still in a grace period. Apart from losing companies, these companies amortised the loans on

274 The wage growth index was lower than 10% in 47% of ESOP companies, 11% to 15% in 38%, and higher than that in 15%. In 46% of the other group of companies wages did not change or changed by less than 10%; in 42% the growth was 11% to 15%, and in 12% growth was over 16%.

time; moreover paying the instalments seemed to be more important to them than making social security payments or paying taxes. At the same time, some reservations about employee ownership proved to be right: ESOP companies invested less in machines and in real estate development than others: in the second six months of 1999 22% of employee owned companies made some kind of investment as opposed to 38% of other enterprises (Boda und Neumann, 2002).

Annex

Taxation Issues

Personal income tax in Hungary is based upon a progressive scale[275] from 18 to 38%:

Amount of income	Tax and tax rate
0-1,500,000 HUF	18%
From 1,500,001 HUF	270,000 HUF plus 38% of the portion above 1,500,000 HUF

Tax on dividends is 20%, but for example the tax on allowances in kind is even higher, at 44%.[276] Capital gains are taxable at a rate of 20%.[277] The Corporate Tax rate is 16% tax on realised profits.[278]

[275] Section 30. of the Law CXVII of 1995 on Personal Income Tax

[276] Section 66 (8) and 69 (4) of Law CXVII of 1995 on Personal Income Tax.

[277] Section 66 of Law CXVII of 1995 on Personal Income Tax; securities acquired from already taxed personal income of the participant of the programme are not taxable.

[278] Law LXXXI of 1996 on Corporate Tax and Dividend Tax.

VII. Latvia

The main trends in employees' financial participation in Latvia can be described as poorly developed and on the decline. During the transition period privatisation shaped the environment for employees' financial participation and influenced the current state of employee share ownership and profit-sharing. However, the transition process only led to a low level of employees' financial participation. There has been inadequate support by the government and social partners for the last ten years. Their current attitudes are characterised by indifference and no initiatives concerning the development of financial participation were to be found.

1. General Attitude

Financial participation has had a relatively short history in Latvia. In the 1930s, numerous cooperatives were started, mostly in the agricultural sector. In the Soviet period, consumer and housing cooperatives prevailed. However, at no time did cooperatives play an important role in the economic development of the country. The process of privatisation began before independence in all three Baltic countries. The first private enterprises were established during the period of liberalisation that followed Gorbachev's policy of 'perestroika'. In this period, small state enterprises, new cooperatives, leased enterprises and joint ventures were introduced. The Soviet Law on Enterprises of 1987 granted the general meeting of employees' rights concerning future production plans and the right to elect the enterprise's director. Latvia was the first Soviet Republic that implemented this law. The government soon realised that the application of Soviet legislation led to the dissipation of state assets at rather less than fair value. As a result they introduced legislation to stem the flow (OECD, 2000, pp. 121-123). All Latvian cooperatives had to restructure and re-register before March 1992, and the activities open to cooperatives were restricted, forcing the dissolution of many. Latvians could continue to lease state companies, but the legal status remained unclear until February 1993 when new legislation made it possible for groups of employees to enter into a new leasing contract.

Small privatisation started in November 1991 following the Law on the Privatisation of Objects of Trade, Catering and Services. The decision about privatisation method, initial price etc. was made by local Privatisation Commissions. Possible privatisation methods were: sale to employees, auctions to a selected group, open auctions and sale to a selected buyer. Purchasers had to be Latvian citizens or to have been living in

Latvia for at least 16 years. Decrees of August 1992 and February 1993 contained a list, proposed by the sector Ministries, of 579 medium and large enterprises to be privatised. 400 of these enterprises were to be privatised by the public offering of shares, and in addition 147 were to be leased with the option to buy; later this list was expanded to 712 enterprises (Jemeljanovs, 1996, p. 205). However, except for the leasing option the privatisation proceeded very slowly and before the privatisation agency took over, only around 50 large and medium sized enterprises had been privatised. Large privatisation of state-owned property and land was and is being carried out by the Latvian Privatisation Agency (LPA) organised as a joint stock company under the Law on Privatisation of Property Units Owned by the State and Municipalities of 17 February 1994.[279]

For mass privatisation, a voucher scheme was used.[280] Only very few investment funds were formed, 9 licenses were given to investment funds based on vouchers, but only 5 operated. In 1995-98 vouchers for a nominal value of only around 9 million LVL were put into investment funds: less than 1% of distributed vouchers (Mygind, 2000, p. 17). Vouchers could be used until 1 July 2005. 100.63 million vouchers or 90.2% of the total number of issued vouchers had been used in the privatisation of state and local government property units by 1 October 2004 (see Annex Table 1). On average 60% of the price was financed by vouchers while the market value of vouchers was only around 10-20% of their nominal value.

Trade unions are quite weak: the current rate of unionisation in Latvia is 18%. On the one hand, this is due to the discredit of trade unions in connection with their role under Soviet rule. On the other hand, present economic problems such as job uncertainty and high unemployment[281] lead to the inactivity of employees concerning their rights. The Free Trade Union Confederation of Latvia (FTUC**,** Latvijas Brīvo Arodbiedrību Savienība) is the biggest non-governmental organisation in Latvia; it protects the interests of employees who are trade union members at branch and inter-branch level, and represents 25 organisations.[282] Financial participation of employees is currently not on the trade unions agenda. The interests of employers are represented by the Latvian Employer's Confederation (LEC). With regard to the financial participation of employees, the Director General of the LEC, Ms. Elina Egle, declared in an interview that the Confederation's activities are in line with government legislation and

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279 The main privatisation method under this law is sale by tender to the highest bidder, supplemented by restitution and mass privatisation. Many of the largest enterprises have combined the sale of a dominating block of shares to a core investor and the sale of minority share holdings in public offerings.

280 The population obtained one voucher for each year of residence in Latvia after World War II. By 1 October 2004, a total of 103.9 million privatisation vouchers have been issued to 2.45 million people for the time they have lived in Latvia, including 788.3 thousand vouchers granted to 40.8 thousand victims of political repressions. Furthermore, a total of 7.73 million property compensation vouchers have been issued to 112.3 thousand former owners or their heirs.

281 The unemployment rate was 10.6% in 2003.

282 Latvijas Republikas Likums par arodbiedrībām, Ziņotājs, No. 3/4, 31 January 1991 as amended.

that the financial participation of employees is outside the area of competence of the Confederation. Consequently, the issue of financial participation has not been addressed in the Tripartite Agreement on Social and Economic Partnership recently signed by the LEC, FTUC and the government on 1 October 2004 on the initiative of the Prime Minister Mr. Indulis Emsis.

The government is not concerned with the financial participation of employees, as the reduction of employment is considered to be the priority. The Ministry of Social Affairs concentrates its activities on solving problems related to the increase of minimum wages and allowances for the unemployed. Participation of employees has not been on the political agenda of Parliament. Political parties and other policy makers do not give any attention to the issue of employees' financial participation. Financial participation as a component of social model development was not included in the economic sections of parties' programmes. As individual interviews with policy makers have shown, there is no knowledge of the concept and no awareness of the possible positive economic impact of financial participation and no dialogue between those representing the interests of employees and employers about the idea of financial participation.

2. Legal and Fiscal Framework

Employee share ownership as well as profit-sharing are used in Latvian companies and are directly or indirectly regulated by legislation affecting the effectiveness of such forms of financial participation. Whereas no special legal regulation on profit-sharing exists, there are several pieces of legislation that touch upon employee share ownership and which should be interpreted in correlation with each other. Such joint-stock companies can issue special employee stock without voting rights corresponding to up to 10% of the equity capital in the course of capital increase. For employee stock of state and municipal companies, there is an additional provision that employees cannot alienate such stock away from the company when leaving, but the company is also obliged to transfer these shares to other employees and cannot use them for other purposes. However, regulation of employee share ownership has not been developed systematically, so that the legislation partly creates incentives and partly inhibits the development of such schemes.

a) Share Ownership

Privatisation (1991, abolished 1994; 1994, 1996) – Small privatisation started in November 1991 following the Law on the Privatisation of Objects of Trade, Catering and Services. One of the possible privatisation methods was sale to employees and employees who had been working in the enterprise for at least 5 years had a pre-emptive right to buy shares at the initial price. The legislation was changed in February 1992, whereby the pre-emptive right for employees was abolished. The legislation also allowed companies to issue shares worth up to 10% of the authorised capital and to sell them to employees at a discount, or to transfer them free of charge, but the value had to be paid in full when the employees left the company; these shares had full voting rights. In 1992-94, the privatisation process was decentralised whereby sector ministries became key privatisation institutions, so that the existing networks could be used to the advantage of insiders. This was mainly done using the legislation on leasing with an option to buy. Former owners had the first right to enter into a leasing contract, the rights of the insiders of the company were secondary. This gave managers in particular good opportunities to take their enterprises over (Shteinbuka, 1996, p. 187). In 1994, the possibility of entering into new leasing contracts was removed by the new Privatisation Law. Employees could use vouchers distributed amongst all long-time residents of Latvia to pay for the publicly offered shares of their enterprise in the case of privatisation.

Although the privatisation process is advanced, it is not yet complete, so that it is still possible for employees to acquire shares under special procedures as prescribed by law. Today, the Law on the Privatisation of Objects owned by the state or a municipality[283] (hereinafter referred to as PL) is the main regulatory act on the privatisation of enterprises.[284] It should be interpreted in line with the Law on the Reorganisation of State and Municipal Enterprises in Corporations of 8 July 1996[285], hereinafter referred to as RL. Shares of state owned corporations can be sold to employees in the course of privatisation even below the nominal value of such shares. However, the shares to be sold to the employees cannot amount to more than 20% of the share capital of the particular company (Art. 57 RL). If municipal objects are privatised by restructuring, the privatisation plan must contain a clause stating how many shares will be sold to employees as well as the discount, if such is applicable according to law (Art. 40.2.5 RL). Management buy-out can be applied if the company has no tax debts, no salary debts to employees, no other debts or encumbrances amounting to more than 10% of the equity capital, and the company's business activities comply with the Articles of Association (Art. 2.6 PL). By using such a method of privatisation, up to 25% of the shares can be sold to the management (Art. 2.2.6 RL).

An important difference exists between employee ownership and management ownership, the latter being subject to a special privatisation method, which can be used as a reward for successful managers of state or municipal owned corporations. However, the 20 % limit of employees share privatisation appears as a limitation of rights rather than an entitlement, due to the fact that there is no clear obligation in law to offer any shares at all to employees in a particular privatisation case.

283 The PL was adopted on 17 February 1994 (LV, 3 March 1994, No. 27) and, although amended, is still in force.

284 The PL provides for various methods of privatisation: sale, investment in share capital, increase of share capital by attracting private investors, or sale of shares to the management (Art. 2 PL).

285 LV, 19 July 1996, No. 122.

State or municipal owned companies (2001) – According to the Law on State and Municipal Corporations[286], the government of Latvia or the respective municipal authority decides in which state or municipal company employees' shares can be issued (Art. 68 (1), (2)). Employee shares can only belong to employees and board members and cannot be alienated to other persons, even to other employees (Art. 68 (4), (5)). If the employment is terminated, or the member of the board leaves office, the employee's shares are transferred back to the company (Art. 68 (6)). This is one of the exceptions when a company is allowed to acquire its own stock (Art. 70). Where the company has acquired its employee stock, this must be transferred to employees within six months of that date. If the shares are not transferred within the aforementioned time period, the shares will be deleted and the share capital will be decreased respectively (Art. 71 (1), (2)).

Private Companies (2004) – There are three forms of corporations with important differences with regard to the regulation of share ownership of employees: the limited liability company, the private company, the shares of which are not publicly tradable objects, and the joint stock company, a company the stocks of which can be publicly tradable objects (Art. 134 (3), (4) Commercial Law[287], hereinafter referred to as CL). For limited liability company, there are no special legal regulations on employee share ownership so that general rules apply. By contrast, joint stock company can issue employee stock which can be acquired by employees in the broad sense, ie including managers (Art. 255 (1) CL). Employee stock shall be issued only on account of the net profit of the company and the total value of employee stock should not exceed 10% of the registered equity capital of the company (Art. 255 (4) CL). Another limitation concerning employee stock is the requirement that the Company's own capital should not become less than the registered capital (Art. 255 (5) CL). No voting right and right to liquidation quota are attached to employee stock issued according to Art. 255 CL.[288] Such stocks can be freely sold if the Articles of Association do not provide otherwise (Art. 255 (7) CL). It shall, however, be stated that in the event that an employment contract is terminated, or a member of the board of directors leaves office, the company has a pre-emptive right to acquire employee stock (Art. 255 (8) CL). According to the Law on the Financial Instruments Market the requirement to publish prospectus shall not apply to the issuance of transferable securities offered, allotted or to be allotted to existing or former managers or employees by their employer which has its transferable securities already admitted to trading on the regulated market or by an associated undertaking (Art. 16 (1), 5 of the Law on the Financial Instruments Market of 20 November 2003). It is the only provision to be found on employee share ownership in the legislation on securities. Furthermore, in derogation from the general prohibition to

286 From 3 January 2001, LV, 19 Junly 1996, No. 122 as amended.

287 From 13 April 2000, LV, 4 May 2000, No. 158/160 as amended.

288 Employee stock issued by a private joint stock company according to Art. 255 CL should be differentiated from the stock acquired by employees in the course of privatisation. Limitations attached to employee stock according to Art. 255 CL, in particular lack of voting rights, do not apply to privatisation stock.

acquire own stock, according to Art. 240 (1) (3), Art. 237 (1) CL a company may fully pay up own stock, which can belong only to employees provided for that it is transferred within 6 months (Art. 242 CL).

b) Profit-Sharing

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

c) Cooperatives

Cooperatives are outside the scope of the application of the Commercial Law and are regulated by the Law on Cooperatives of 5 February 1998[289] (hereinafter referred to as CoopL). The law defines a cooperative as a voluntary association of persons created with the purpose of providing services to increase the efficiency of the economic activities of its members (Art. 1, 5). Unlike the right to vote in corporations, the right to vote in cooperatives does not depend upon the amount invested, as each member is entitled to one vote only (Art. 22 (2) CoopL). A cooperative is a legal entity and each member of a cooperative is entitled to participate in the management and to dividends of profits, which will be divided according to the investment of the respective member and according to the Articles of Association of the cooperative (Art. 1, 3, 34 CoopL).

All cooperatives can be divided into commercial and non-commercial cooperatives. The purpose of forming commercial cooperatives is to make a profit, whereas non-commercial cooperatives are aimed at improving the management of property belonging to cooperative members. The organs of the cooperative are the Members' Meeting, the Board and the Supervisory Council (Art. 37 CoopL). The Members' Meeting is entitled to elect and vote out of office the members of the Board, the Supervisory Council, the Auditor and the Liquidation Commission, to determine the remuneration of board members and to make decisions on important issues (Art. 39 CoopL). Other decisions are made by the Board. The members of the Board are jointly and severally liable for Board decisions and have the burden of proof for the actions of the Board. The Supervisory Council can be elected to control the Board between meetings. There are no limitations on the distribution of profit of cooperatives. However, the Law on Cooperatives provides for the order of distribution. Profit is distributed, firstly, to

[289] LV, 24 February 1998, No. 48/49 as amended.

provide reserve capital in accordance with the Articles of Association, and, secondly, to pay out dividends. The remaining part of the profit can be distributed in accordance with the decision of the Members' Meeting.

3. PEPPER Schemes in Practice

Employee share ownership emerged in the course of privatisation, but was not sufficiently supported after 1994 and has been steadily decreasing since. It usually changed to former employee, then to management and finally to outsider domestic or foreign ownership after quite a short period of time, as both surveys and case studies show. Leasing of enterprises with the option to buy was used until the mid 1990s, and it was one of the major methods of takeovers by insiders. During the small privatisation, more than 50% of small enterprises were privatised by employees, partly bought at a price below the actual value. Comprehensive information on the overall incidence of PEPPER schemes in Latvia is not available. Today, there is a tendency to use other alternatives to paying salaries to employees, not by offering shareholdings in the company but rather by registering employees as self-employed persons and entering into service contracts with these persons.

a) Privatisation

In 1992, in only 8% of all cases was an auction the chosen method of small privatisation because the municipal authorities were against favouring the richest purchasers, and auctions usually resulted in prices much higher than the initial price. Direct sale to employees or to another selected buyer was by far the most frequent method and more than half of the enterprises in the small privatisation process were sold by instalments. The high price difference between auctions and direct sale indicates that there were favourable conditions for insiders buying at the initial price. These advantages for insiders prevailed in practice for some time, even after the legislation was changed in February 1992. Local Privatisation Commissions continued to give preference to insiders (Frydman et al., 1993, p. 223). We do not have exact data on what percentage of enterprises were taken over by insiders, but we estimate that, especially in the first years, this was the case for the majority of small enterprises. Most small enterprises were privatised by 1994, so although the proportion of payment by certificates was high in the later years, certificates were not important for small privatisation.

In the period between 1992 and 1994 privatisation was rather slow and only 234 firms were privatised by leasing. Of the 234 leased enterprises, 204 were bought out, in most cases by the leaseholder and 16 leasing contracts were annulled (Latvian Privatisation Agency, 1998). The average price for leasing buy-outs was at the same level as for tender privatisation. In 1994, the legislation was changed following the German Treuhand model and the Latvian Privatisation Agency (LPA) was established in May 1994. The tenders usually resulted in a purchase agreement with a single unit or a consortium most often acquiring a majority of shares. Most of these sales were to domestic outsiders, but some of the largest went to foreign owners, and such insider take-overs lost their importance after 1994. However, mainly in the companies with shares sold in public offerings employees had the right to buy up to 20% of the shares. By the end of 1998, shares with the nominal value of 27 million LVL had been sold for vouchers to 25 611 employees and former employees of the companies, amounting to 13.56% of the shares (LPA, 1998). Shares for 4.4 million LVL were sold for vouchers to 250 managers of 24 companies, totalling 13.6% of the shares. (LPA, 1998).

According to the specific ownership survey from 1997 of 167 companies covering the period 1993-1996 (Mygind, 2002), small enterprises with fewer than 100 employees have mainly been taken over from the state or started by insiders and more than 50% of companies with fewer than 100 employees were majority insider owned by January 1995 (see Annex Table 2). More than two thirds of enterprises with 1-4 employees were majority insider owned. For enterprises with more than 500 employees the corresponding figure was only 18%. Most of the enterprises with majority insider ownership in 1995 were 100% owned by insiders. It is striking that for enterprises with 20-199 employees there are slightly more management owned enterprises than employee owned. However, in the small sample of 167 enterprises, for large enterprises with more than 200 employees there are no enterprises with management dominance.

Insider ownership was highest in agriculture and fishing and lowest in transport and services. From the sample it can be seen that the bulk of insider owned enterprises in agriculture and fishing were broadly owned by employees, in manufacturing there was a balance, while managers were dominant in sectors such as construction, trade and transport. Enterprises with an insider majority had around ten times lower capital intensity than other enterprises. The lowest percentage of non-owning employees was found in enterprises with employee majority ownership. Finally, there were more employee owners in privatised enterprises than in start-ups. Looking at the distribution amongst employee owners it is striking that employee owned enterprises are mainly found in the middle category, while this has the lowest frequency for both the categories of ‘rather equal’ and ‘very unequal’ distribution. The explanation might be that in employee owned enterprises there are more owners and more shares owned by employees opening up a wide spectrum and thus higher inequality in the distribution of shares, including a broad group of employees owning quite small shareholdings. Enterprises with broad employee ownership were mostly established in the privatisation process. Newly started companies with high financial participation of employees can be expected to be found in industries with high input of human capital because here the motivation, recruitment and retention of the knowledge of workers are often decisive in the success of the company (Mygind, 2001b, p. 324).

In Jones and Mygind (2005) the dynamics of ownership for Latvia is based upon responses from 915 enterprises specifying their ownership structure for 1997, 1998 and 1999 (see Annex Tables 3 and 4). According to the findings of this study, insider ownership was by far the least stable. The most frequent change was from insider to former employee (38 cases), while many insider enterprises were moving to domestic external ownership. In the period between 1997 and 1999, manager ownership was surprisingly stable, whereas both employee and former employee ownership were changing. The most frequent changes were from employee to manager and from former employee to external domestic. These changes were accompanied by a steep increase in concentration of the largest single owner. The employee owners could see their share-values being eaten up by very high inflation in the early years of transition. No dividends were paid, so the employees had no feeling of the real value and possible capital gains from their shareholdings. In this situation managers could buy the shares at relatively low prices from other employees who were in a very tight economic situation, especially in the early years of transition with falling real wages. In some cases, managers diluted the shares of employees by increasing the nominal share capital, with themselves as the main receivers of the extra capital. Case studies (Kalmi and Mygind, 2005) show that some companies have continued the governance cycle to the next stage of outside, often foreign, takeovers. Thus, the cases confirm the typical ownership cycle from employee to management and then to outside domestic or foreign ownership (Jones and Mygind, 2005, 17:1).

c) Profit-Sharing

The management survey of 167 companies from 1997 gives some information about the spread of profit-sharing in Latvia. Profit-sharing is only reported in 7% of responding enterprises, but 5 out of 28 of the enterprises with majority employee ownership. Monetary incentive schemes are used in 20% of the enterprises but with the percentage falling from 28% in 1993 to 20% in 1996.

Profit-sharing is likely to be used in new, human capital intensive sectors, eg IT, consulting and real estate companies. IT is one of the most competitive and profitable sectors. Despite the fact that employees' participation is presently low, there are factors that may influence the development of the financial participation of employees in this sector in the near future. Most employees are young and highly qualified, have knowledge of economic issues and are not necessarily bound to one company, so that employers have to create incentives to keep them, eg by introducing profit-sharing, and taking into account their high profits, employers are in a position to do so. The real estate sector is also generating high profits; it is typical for real estate companies to enable realtors to participate in the profit made from the price of objects sold by them. In Latvia, realtors receive 3-5% of the profit. However, such participation should be considered as a means of motivation, not as typical profit-sharing, since it usually means that the basic salary of realtors is very low.

c) Cooperatives

The traditional cooperative principle regarding the even distribution of profits is not followed as profit is distributed to members according to their contribution to the capital (see also above under 2.c) Art. 34 (1) CoopL). Mr Ivars Strautins, President of the Central Cooperative Union Turiba declared that the cooperative movement in Latvia is not strong and presently involves about 8,000 people and that there were about 140 cooperatives in 2002-2004, most of them operating in agriculture. On the whole workers' cooperatives are very few and the vast majority of cooperatives are to be found in agriculture. Nevertheless, there exist also small and medium-sized cooperatives producing different products or providing services.

4. Evidence of the Effects of PEPPER Schemes

The available – limited – evidence indicates that Employee majority enterprises have factor productivity equal to companies with other ownership forms, but lower capitalisation. Surprisingly, employee ownership does not present an obstacle for lay-offs as an element of reactive restructuring. A production function analysis based on cross sections from 1994 and 1995 does not show any significant differences in factor productivity between ownership groups (Jones and Mygind, 2000). A multi-variate analysis of the capital structure for the 1995 data shows that the debt ratio for insider-owned enterprises is significantly higher than for state owned enterprises. Bank loans are, however, significantly lower the more insiders own, and bank loans per employee are relatively low for insider owned enterprises (Mygind, 2000, p. 36). With regard to the source of financing for different owner groups traditional finding is confirmed for employee owned companies in relation to their dependence upon internally generated capital. In the survey of 167 enterprises (Mygind, 2002) managers were asked about the implementation of different forms of restructuring. It turned out that the differences between ownership groups were modest regarding organisational changes in the number of departments and changes in hierarchical levels. The in-depth case studies of 9 enterprises show the connection with initial conditions. In contrast to most theories, the performance of most employee owned companies does not point in the direction of employee ownership as a barrier to the adjustment of the labour force - reactive restructuring. The barriers to strategic restructuring seem to be more important for the employee owned enterprises. However, it is worth noting that later shifts away from employee ownership did not improve the situation.

Annex

Taxation Issues

The most important legislation on taxation are the Law on Personal Income Tax of 11 May 1993 as amended (hereinafter referred to as LPT) and the Law on Corporate Income Tax of 9 February 1995 as amended (hereinafter referred to as LCT). Since there are no taxes on dividends distributed when establishing a new company there is a strong incentive to take the profit out of the company not by way of salary to an employee, but rather by paying out dividends and finding other ways to access the profit, which is primarily connected with the differences in taxation: general personal income tax 25 % flat rate (Art. 15, 2 LPT); corporate income tax 15 % flat rate (Art. 3 (1) LCT); exception from general personal income tax: there is no tax on dividends for companies or for physical persons who receive the dividends (Art. 9, 2 LPT).

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

Table 1: Use of privatisation vouchers (as of October 1, 2004)

Type of Property	Number	# of privatisation vouchers (million)	Incl. property compensation vouchers (thousand)
Purchase of housing	412,000 of privatised housing units	34.57	582.1
Purchase of enterprise/ other properties	accurate data not available	7.07	109.6
For purchase of shares	accurate data not available	44.42	954.0
Total:		**100.63**	**6250.0**
% of total vouchers		90.2%	80.8%

Source: Economic Development of Latvia Report 2004, p. 130.

Table 2: Distribution of ownership to employees

\ Ownership Average per enterprise		State majority	Foreign majority	Domestic majority	Manager majority	Employee majority	No Majority	Total	Privatised	New
% non-owning employees										
	1993	82	70	52	85	41	62	58	45	70
	N	(7)	(4)	(23)	(15)	(27)	(6)	(82)	(42)	(33)
	1994	80	78	46	89	43	64	60	48	71
	N	(7)	(5)	(27)	(17)	(25)	(8)	(89)	(48)	(34)
	1995	76	79	47	84	41	67	59	46	72
	N	(8)	(5)	(27)	(18)	(26)	(9)	(93)	(50)	(35)
	1996	87	79	51	80	46	63	61	50	75
	N	(6)	(4)	(26)	(24)	(26)	(10)	(96)	(54)	(36)
Response rate	pct	30	31	74	48	81	71	59	74	51
Distribution of shares to employee owners 1996										
Almost equal		1	4	13	25	11	6	60	23	36
	(Pct)	(100)	(57)	(46)	(59)	(36)	(46)	(50)	(37)	(62)
Unequal (> 1:2)		0	0	8	5	14	4	31	23	8
(Pct)		(0)	(0)	(29)	(12)	(47)	(31)	(25)	(37)	(14)
Very unequal (> 1:10)		0	3	7	12	5	3	30	16	14
(Pct)		(0)	(43)	(25)	(29)	(17)	(23)	(25)	(26)	(24)
N		1	7	28	42	30	13	121	62	58
	(Pct)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)	(100)

Source: Mygind (2002).

Table 3: Ownership transition matrix for private firms 1995-1999

\ last Year first year	Foreign	Domestic	Manager	Employee	Former employee	Total	Change
Foreign	105	7	6	0	0	118	11,0%
Domestic	11	139	20	4	1	175	20,6%
Manager	1	9	308	2	1	321	4,0%
Employee	1	4	13	118	6	142	16,9%
Former employee	0	10	1	13	39	63	38,1%
Insider	6	32	12	8	38	96	79,2%
Total	124	201	360	145	85	915	

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

Table 4: Latvia 1997-1999: Ownership transition matrix for private firms

\1999 1997	Foreign	Domestic	Manager	Employee	Former employee	Total	Change
Foreign	110	8	5	0	0	123	10,6%
Domestic	8	161	13	4	2	188	14,4%
Manager	2	12	326	2	0	342	4,7%
Employee	2	6	15	135	9	167	19,2%
Former employee	0	16	0	6	73	95	23,2%
Total	122	203	359	147	84	915	

Source: Jones and Mygind, 2005.

VIII. Lithuania

After Lithuania regained independence, employee ownership was used to facilitate privatisation. At the initial stage of privatisation 1991-1995, employee-buy-outs at a discount combined with the extensive use of vouchers by employees and leasing with the option to buy led to a high percentage of employee majority ownership. After most of the preferential rights of employees were abolished in 1995, employee ownership is on the decline changing partly to management and to outsider ownership. Participation of employees in decision making in Lithuanian companies has its roots in the trade union movement as well as in the practice of managing companies under Soviet rule. At present, in Lithuania, financial participation is rather viewed as an incentive for managerial employee motivation, initiated by managers and current owners of companies.

1. General Attitude

Financial participation of employees has a short history in Lithuania related first to the cooperative movement and later to the privatisation process, especially in the first half of the 1990s. The start of cooperative activities dates back to 1869, and the first law on cooperatives was adopted in 1919. Numerous credit, agricultural, crafts and consumer cooperatives and cooperative unions existed before 1940, but under Soviet rule only consumer cooperatives remained. Economic reforms were planned well ahead of the full independence Lithuania gained in August 1991. By the spring of 1990 Lithuania was acting as an independent economic unit, and the period of early privatisation was very short. The concept of privatisation in Lithuania was agreed upon and implemented as early as 1991 when strong egalitarian norms were still dominating the consciousness of leading politicians (Čičinskas, 1994, p. 173). The first stage of privatisation (1991-1995) in Lithuania was much faster and more comprehensive than in most Eastern European countries. Vouchers and employee-ownership had a more important role, and direct sale and foreign investment had only a negligible role at this stage. The power of workers at the first stage of transition was based upon workers' councils and trade unions making demands about the distribution of enterprise property and employee ownership. Unlike the other two Baltic countries, Lithuania did not have a large Russian-speaking minority, therefore the national question was not an important issue. Instead, economic policy played an important role from the start, including the possibilities to have real power over decisions within enterprises, to remove old managers connected with the Communist party, and to put into effect the idea of social equality.

During the second and third stage of privatisation all privileges of employees were abolished. Employees could acquire the shares of enterprises in which they were employed only if the enterprise was sold at auction or by public subscription of shares. Enterprises sold at auction were often taken over by insiders, mostly by managers.

Collective farms were privatised according to the Law on Land Reform of 25 July 1991 and the Law on the Privatisation of Property of Agricultural Enterprises of 20 July 1991, which provided employees with pre-emptive rights. Where agricultural cooperatives were started, employees could become co-owners and obtain participation rights. Since the declaration of independence in 1991, trade unions rapidly ceased to exist in enterprises where trade union leaders were weak, serving the interests of management under Soviet rule. On the other hand, trade unions were retained in enterprises where their leaders (old or newly elected) strongly supported the ideas of the Sajudis movement and Lithuanian independence. In such companies trade union leaders took over management of the enterprises and/or participated actively in their privatisation.

Trade unions are organised through the Lithuanian Trade Union Confederation (Lietuvos profesinių sąjungų konfederacija), the Lithuanian Trade Union 'Solidarumas' (Lietuvos profesinė sąjunga 'Solidarumas') and the Lithuanian Labour Federation (Lietuvos darbo federacija). The Lithuanian Trade Union Confederation (headed by A.Sysas), is the largest and strongest union with over 120000 members. In the early stage of transition unions promoted employee ownership and actively contributed to place EO on the privatisation agenda in Lithuania. The General Secretary of the Lithuanian Trade Union Confederation, Ms Janina Matuiziene stated in an interview that trade unions have the general aim of higher wages for employees and are relating it to an increase in company profitability. No particular actions concerning the financial participation of employees are on the agenda of the Confederation, but this issue could be supported if any industrial trade union makes a proposition.

Employers are organised within the Lithuanian Confederation of Industrialists (Lietuvos pramonininkų asociacija), which is actively promoting the interests of Lithiuanian large businesses in the Lithuanian Parliament (Seimas), as well as in the Lithuanian Government, and Lithuanian Employers' Confederation (Lietuvos darbdavių asociacija). The question of the financial participation of employees was not discussed by the Lithuanian Confederation of Industrialists nor by the Lithuanian Employers' Confederation. M. Busila, currently acting as Director of the Department of Economics and Finance of the Lithuanian Confederation of Industrialists, declared in an interview[290] that the confederation had taken no official position on this issue, but supports initiatives of individual enterprises. He mentioned that different methods of motivation of employees related to participation are used in some of the enterprises, but usually these are applied to managers. In his opinion, such practices are distributed by the academic community and by branches of foreign firms. Recently, employers have been paying

[290] Interviews with Mr. M. Busila and Ms J. Matuiziene were conducted by Ms. Jone Sakalyte in March 2005.

more attention to the motivation of employees, i.e. by financial incentives, because of the problem of increasing emigration of skilled workers.

The programmes of the coalition parties which came into power in 2004 including the Social Democrats (Lietuvos socialdemokratų partija LSDP), the New Union (Social Liberals) (Naujoji sajunga (Social liberalų partija)) and the newly established Labour party (Darbo partija DP) do not mention financial participation, they are aimed at increasing social guarantees, and reducing poverty and unemployment.[291] Employee financial participation as well as participation in decision-making has not been on the political agenda of Parliament and the Government, so far there has been no discussion within the parties and in the Government.[292]

2. Legal and Fiscal Framework

Financial participation of employees is barely regulated. Current legal regulations neither contain special provisions concerning PEPPER schemes nor provide companies with incentives to introduce them.

a) Share Ownership

Privatisation (1991, abolished 1995) – The first stage of privatisation started when the Law on the Initial Privatisation of State-owned Property (LIPSP) was passed in February 1991. The cornerstone of the fast privatisation in Lithuania was the voucher scheme.[293] Under LIPSP, employees had the opportunity to buy a certain percentage of shares in the first round of auctions at lower rates before most of the remaining shares were sold in public offerings in later rounds. The percentage of shares available for employees was increased from 10% in 1991 to 30% in 1992 and to 50% after the former Communist Party came into power in early 1993. The 20% extra shares re-

291 According to Vilija Blinkevičiūtė, the Minister of Social Security and Labour and a member of the New Union (Social Liberals), the policy of the Lithuanian government is to reduce unemployment, provide legal and financial state guarantees to employees of bankrupt companies, increase current wages and pension payments and to reform the pension system. This must be seen against a background of increasing migration of the work force to other EU states, including not only highly qualified professionals but also skilled workers in the transportation, construction and retail sectors.

292 All three, trade union organisations, the employers' organisations and government representatives participate in a tripartite Council. There was no public debate on the financial participation of employees in the Council. European Companies can be established after the respective law was adopted by the Lithuanian Parliament on 29 April 2004, but no discussions on employee participation accompanied the adoption of the law.

293 Vouchers and cash quotas were only given to residents and had limited transferability (to relatives, later they could be used in exchange for outstanding housing loans).

served for employees after 1993 did not initially have voting rights, but later it was made possible for the general meeting to convert these shares into regular voting shares. The second stage of privatisation was based upon a new Law on Privatisation of State-owned and Municipal Property of 4 July 1995. Residual shares and some of the very large companies including public utilities and infrastructure enterprises were to be sold. The use of vouchers was abolished at this stage, and only cash privatisation was possible.

The third Law on Privatisation which is still effective was adopted on 11 April 1997.[294] Currently, privatisation of the majority of enterprises in Lithuania is complete. However, privatisation is still possible and the respective legal regulations are still in force. The most important regulations are the Law on Privatisation of State Property and Property of Municipalities of 11 April 1997 as amended (hereinafter referred to as PL), the Law on Securities Market of 16 January 1996 as amended and the Law on the State Property Fund of 11 April 1997 as amended. The current PL does not contain any significant preferential rights for employees in the privatisation process.[295] However, if shares are privatised by public tender employees can be offered up to 5% of the shares owned by the state at par value. This provision is not applicable to enterprises under state control or to enterprises in which employees have already acquired shares of their enterprises under other laws (Art. 16 (3) PL). If shares are offered at a public tender or by direct negotiation, the final payment can be postponed for 5 years for employees (Art. 20 (3) PL).

Private Companies (1995, 2003) – In the course of capital increase, corporations (joint-stock companies as well as limited liability companies) can issue employee shares after all shares subscribed at the time of incorporation have been paid for (Art. 43 Law on Companies[296], hereinafter referred to as CL). The CL does not provide for a maximum percentage of the capital employee shares may constitute. Employee shares are to be distributed amongst employees wishing to purchase them, with the exception of the management (Art. 43 (2) CL). A restriction period of not longer than three

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294 Law on Privatisation of State Property and Property of the Self-government Bodies from 11 April 1997, No. VIII-480 (Valstybės žinios 1997, No. 107-2688) as amended. The State Property Fund, controlled by the Privatisation Committee, was established. The third stage of privatisation started in 2000, involving the remaining minor state shareholdings, real estate and property, and state-owned companies which had been excluded from privatisation according to the Laws before 2000. These were shares of infrastructure companies and companies with a dominant position in the market.

295 The PL allows for: public share subscription (for large and medium-sized enterprises), auctions (for small enterprises or spin-offs), tenders, direct negotiations and leasing with the option to buy.

296 Law on Companies from 11 December 2003, No. IX-1889 (Valstybės žinios 2003, No. 123–5574) as amended; according to CL, shareholders have the pre-emptive right to acquire shares or convertible debentures issued by the company, unless the general meeting decides to withdraw the pre-emptive right for all shareholders. The decision to withdraw the pre-emption right in acquiring the company's newly issued shares or convertible debentures of a specific issue require a qualified majority vote of not less than 3/4 of all votes conferred by the shares of the shareholders present at the general meeting and entitled to decide on the issue (Art. 28 (2) CL).

years must be determined within which employee shares can be sold only to other employees (Art. 43 (3) CL). Within this period employee shares are not only shares of limited tradability, but also non-voting shares before the restriction period expires (Art. 43 (3.3) CL), although employee shares are ordinary shares (Art. 43 (1.1) CL). Art. 43 (5) CL stipulates that an employee must pay for subscribed employee shares before the expiry of the restriction period for the transfer of shares. The first payment should be made in cash within a short period; further instalments can be deducted from the employee's salary upon application of the employee. The corporation is not allowed to put pressure on employees to force them to purchase shares or to pay for shares by deductions from salaries (Art. 43 (4) CL). After the expiry of the restriction period for the transfer of shares employee shares become ordinary shares and can be sold to third parties who are not employees of the company (Art. 43 (3) CL).

Since most employees are minority shareholders, provisions on the protection of minority shareholders are relevant. The right to convene the general meeting and to propose the agenda shall be vested in the supervisory board, the management board or the manager of the company, and shareholders who have at least 1/10 of all votes, unless the Articles of Association provide for a smaller number of votes (Art. 23 (1) CL). The shareholder of an issuer whose shares have been admitted to the official or current list of a stock exchange registered in Lithuania, acting independently or in concert with other persons and having acquired shares representing not less than 95% of the total votes at the general meeting (referred to as majority shareholder) shall have the right to demand that all the remaining shareholders of the issuer sell the voting shares owned by them, and the shareholders shall be obliged to sell these shares ('squeeze-out') (Art. 19^1 (1) Law on Securities Market[297], hereinafter referred to as LSM). Minority shareholders have a corresponding sell-out right: any shareholder of the issuer whose shares are admitted to the official or current trading list of a stock exchange registered in Lithuania shall have the right to demand that the majority shareholder purchases the voting shares owned by him and the majority shareholder is obliged to buy up these shares (Art. 19^1 (15) LSM).

b) Profit-Sharing

There are no specific regulations concerning profit-sharing with employees. Since companies have to pay income tax on dividends, this is viewed as an expensive method of profit distribution; therefore priority is given to share buyback schemes. Employee monetary incentive schemes used in companies include payments of premiums and bonuses, in some cases related to company turnover and profits. Bonuses have tax advantages, since they are not double taxed as dividends are (firstly at corporate profit tax rate, secondly at income tax rate), but taxed only by income tax for individuals (33%).

[297] Law on Securities Market from 17 December 2001, No. IX-655 (Valstybės žinios 1996, No. 16-412, 1996; 2001, No. 112-4074) as amended.

c) Cooperatives

The legal status of cooperative societies is regulated by the Law on Cooperative Societies[298] (hereinafter referred to as LCS) and the Civil Code[299] (hereinafter referred to as CC). A cooperative society is defined as an enterprise established by at least five legal entities and/or physical persons for the purpose of meeting the economic, social or cultural needs of its members. The members make contributions to the capital, share risks and profits according to the turnover of members' goods or services within the cooperative and take an active part in the management of the cooperative (Art. 2 (2) LCS). A cooperative society is a legal entity with limited liability. Its members shall be liable for the obligations of the cooperative society to the extent of their contribution subject to payment for member's share (Art. 3 (2) LCS). Each member of a cooperative society has one vote in the general meeting regardless of the amount of the member's share (Art. 11 LCS). Up to 10% of the profit should be paid out as dividends (Art. 14 (4) LCS).

d) Participation in Decision-Making

According to the Labour Code[300] (hereinafter referred to as LC), employees may be represented and protected by trade unions or by work councils (Art. 19 (1) LC).[301] The work council should be an institution made up of representatives of all employees. A trade union, however, can be established by a small number of all employees in an enterprise. Nevertheless, the power to negotiate with the employer has been vested in trade unions (see Art. 19 (1); 21 (2); 60 (4) LC). Trade unions are active in only a small number of private enterprises, but the special law on work councils (Art. 21 (1) LC) has not been adopted yet, so that no work councils can be established in practice. As a result, conditions favour the creation of trade unions and an expansion of their activities. As far as employees' representation in European Companies is concerned, on 12 May 2005 the Seimas implemented Council Directive 2001/86/EC of 8 October 2001, supplementing the Statute for a European Company with regard to the involvement of employees by adopting the Law on the Involvement of Employees in Decision-making in European Companies of 28 May 2005.[302] EU Directive 94/45/EC on the establishment of a European Works Council (EWC) or a procedure in Community-scale undertakings and Community-scale groups of undertakings for the purposes of in-

298 Law on Cooperative Societies (Cooperatives) from 28 May 2002, No. IX-903 (Valstybės žinios 2002, No. 57-2296) as amended.

299 Civil Code from 18 July 2000, No. VIII-1864 (Valstybės žinios No. 2000, 77-2262) as amended

300 Labour Code from 4 June 2002 in force since January 2003, No. IX-926 (Valstybės žinios 2002, No. 64-2569) as amended.

301 Where an enterprise, agency or organisation has no functioning trade union and if the staff meeting has not transferred the function of employee representation and protection to the trade union of the appropriate sector of economic activity, the employees shall be represented by the work council elected by secret ballot at the general meeting of the staff (Art. 19 (1); 21 (2) LC).

302 Law on the Involvement of Employees in Decision-making in European Companies of 28 May 2005 No. X-200 (Valstybės žinios 2005, No. 67-2407).

forming and consulting employees was implemented by the Law on European Works Councils of 19 February 2004[303].

3. PEPPER Schemes in Practice

Employee share ownership was promoted during the first stage of privatisation, with employees rather than managers being the most concerned. After most of the preferential rights of employees were abolished in 1995, employee ownership changed partly to management and then to outsider ownership and has decreased over time whereby the concentration of ownership increased. However, new measures supporting the development of employee share ownership have been introduced recently in individual enterprises. Lithuanian enterprises use different financial participation schemes (employee shares, stock options and profit-sharing) in spite of the lack of legal regulation in this field. There are only a few individual cases of profit-sharing but practices of financial motivation of employees used by branches of Western European firms in Lithuania have also been adopted by some domestic companies.

a) Share Ownership

Early privatisation was conducted by the transfer of shares of leased enterprises to employees according to the Resolution of October 1990. The amount transferred was the sum of the leasing fees paid, plus delayed wage payments invested in production plus part of social funds. Almost 60 enterprises were included in this programme. According to the law of December 1990, enterprises with capital exceeding a certain amount could sell up to 10% of their shares to employees. Employees could pay part of the price in vouchers. 50-60% of state enterprises used this method at the start of privatisation until July 1991 when the LIPSP programme started (Frydman, Rapazynski and Earle, 1993, p. 263). The LIPSP programme did not formally include special preferences for employees in small privatisation, because small enterprises were mostly sold at public auctions, where vouchers and cash quotas could be used, usually at a price well below the market value. Moreover, because of only partial indexation of the price of the assets and the value of the vouchers, the advantage to employees increased over time (Martinavicius, 1996, p. 280). Although small privatisation included around half of the 6000 enterprises to be privatised in the LIPSP programme, small enterprises only covered a small percentage of the total assets and the total number of employees. According to the statistics of the Ministry of Economics by August 1992, 1300 small enterprises had been privatised; by October 1994 the number was 2498, and in July 1995 it was 2727. At the end of 1992, employees received a relatively small part of the

[303] Law on European Works Councils of 19 February 2004, No. IX-2031 (Valstybės žinios 2004, No. 39-1271).

total privatised equity and 67% of enterprises had no employee ownership. This figure does not include the earliest insider-takeovers of shares, which were formally outside the LIPSP programme.

In just two years there was an astonishing change. By 1994, fewer than 5% of the privatised firms in the LIPSP programme had no employee ownership and the percentage of enterprises where the majority of privatised assets were taken over by employees increased from 3% in 1991-1992, to 65% in 1993, and to 92% in 1994-1995 according to the statistics of the Privatisation Department at the Ministry of Economics. This development reflects the massive increase in support for employee take-overs. However, in most of the enterprises the state still kept some assets (48% of the statutory capital of all privatised entities). Groups of managers usually had to make alliances with broader groups of employees if they wanted to take over the enterprise. By the end of the first stage, privatisation had not brought any cash inflows to the state budget. The Government also felt a shortage of funds due to the restitution of land and real estate, the banking crisis of 1995, and the urgent need for real investments, which together forced the Government to change its privatisation policy. In the next stage of privatisation, state-owned and municipal property could be sold for cash at market price. Both local and foreign investors as well as legal entities and physical persons obtained equal rights. Though the preferential rights of employees were abolished, managers and their family members gained even more influence.

Until 1997 the ownership structure significantly differed from that prevailing in other Central and East European companies, due to extremely low foreign ownership, very high ownership by insiders (management and employees), high state ownership and very low ownership by investors (banks, investment funds, etc.). Since many of the shareholders were not satisfied with the volume of shareholdings, a secondary market in company shares and assets emerged. The value of employees' shares was very low due to the underdeveloped stock exchange, the lack of a mechanism to protect minority shareholders, and because legal regulations favoured large shareholders. Therefore, the majority of employees sold their shares, usually at a loss and used the proceeds of sale for consumption. Data on privatisation for the second and third stages shows an increase in the number of privatised entities up to 2000, and a further reduction in employee ownership. During the period shares of only two companies were sold to employees. All other methods favoured foreign investors, strong local investment groups and the management.

The development of ownership structure can be analysed on the basis of different surveys on ownership structures conducted by Mygind in cooperation with the Lithuanian Statistical department (see also Annex Tables 2 and 3) (Jones and Mygind, 1998; Mygind, 1996; Mygind, 1997; Mygind, 2000; Mygind, 2002). The first ownership survey, undertaken in July 1994, elicited responses from 356 quite large industrial enterprises. It confirms, to some extent, the rapid extension of the ownership of insiders (mangers and other employees). By July 1994 only 8% of these enterprises had no insider ownership and most of these 25 enterprises were still state owned. 25% of the enterprises had 31-50% insider ownership, and 18% of the enterprises had majority insider ownership. Most of these enterprises had more shares owned by employees than managers. In July 1994 in only 13% of cases with some insider ownership did managers own more equity than the remaining employees. In July 1994 15% of industrial firms had an insider majority with employee dominance and only 3% had an insider majority with manager dominance. The Lithuanian industry sample consists of rather large enterprises with an average of 600 employees. Manager dominated insider majority has the largest average, but the data does not reveal striking differences in the size structure.

More updated ownership information for Lithuania is based on a manager-survey conducted in the spring of 2000. It provides information on ownership at the time of privatisation or start as a new firm for 1993, 1996, 1999 and spring 2000 for 405 respondents.[304] This data gives information both on the ownership in the early period of privatisation/start up and the following dynamics in ownership. In 1993 around 50% of employees were owners in the whole sample of 405 responding enterprises. However, the proportion of owners fell to around 1/3 in 1999. Not surprisingly, the proportion of employee owners was highest in employee owned enterprises, but here also the proportion of owners fell from 76% in 1993 to 66% in 1999. The high percentage of owners amongst employees suggests that the Lithuanian voucher system helped employees as a group to overcome the problem of lack of capital. There was also a tendency for the percentage of non-owners to be higher in large enterprises than in smaller. From all of these cases, there was more than one shift in ownership in only 15 cases. The results show employee and former employee owned enterprises as being the least stable (see also Annex Table 4). The average concentration rate of the largest single owner increases in Lithuania from 41.6% to 47.5% during the period of observation. The most frequent change is clearly from employee to managerial ownership, followed by the change from employee and former employee ownership directly to external domestic ownership. All these changes are accompanied by steep changes in concentration. Except for one case, there are no shifts from outside ownership to employee ownership.

Although the tendency since privatisation has been a sharp fall in the incidence of employee participation in ownership there are also some new trends going in the opposite

[304] The sample is a stratified random sample and is derived from a database covering 7546 enterprises that provided financial data for 1997. In constructing our sample we applied the following criteria: eliminate firms that were fully state owned enterprises or were very small (in fact, employed fewer than 20 employees); include all (large) enterprises with more than 100 employees and one third of the smaller firms (employing 20-100). Applying these criteria resulted in 1372 enterprises being identified. Attempts were made to contact all these enterprises, though many were found to have closed and others refused to respond. The 405 responses make up around 30% of the initial group. Some of the enterprises still had a state majority in 2000, therefore only a smaller number is reported in some of the tables below. Furthermore, we have a large data set of 6-7000 enterprises for 1996 and 1997 with some ownership information. We have financial information for all these enterprises collected by the Statistical Department of Lithuania. The data does not distinguish between private new-started and privatised enterprises. However, the data covers mainly enterprises with 20 or more employees and we can assume that most of the large private enterprises are privatised.

direction. We have found several recent cases where employees have obtained shares in companies as part of employee incentive schemes. In the case of the limited liability company Bitė GSM, the second largest mobile service provider in Lithuania, every company employee was granted the possibility of becoming a stockholder of the joint stock company TDC, the sole owner of Bitė GSM. Employees were offered TDC stock options to purchase company shares at a price of 10,49 euro (36,2 Lt) in 5 years. The offered price was three times lower than the traded price at the moment of the offer. Each employee received an option to purchase up to 90 shares (Dubauskas, 2005). Another case is of the Baltic Beverage Holding which included possibilities for employees to acquire shares of the company in the employee loyalty programme (Aleknienė, 2003). In several cases employees (especially management) of branches of foreign companies were offered the chance to buy shares of the company at a discount.[305] The offers are made at the end of the year as a form of remuneration of employees. Such opportunities are attractive when company shares are traded at stock exchanges and an appreciation of share prices is expected.

b) Profit-Sharing

Since the emigration rates of skilled employees are increasing, competition between domestic companies, including branches of foreign companies, for human resources is developing, and different motivation schemes are being introduced. Genuine profit-sharing is quite rare; share repurchases and monetary incentive schemes prevail. Several types of monetary incentive schemes have been developed for managers and other employees, which can be attributed to direct profit-sharing. For company CEOs, premiums and bonuses depend upon annual turnover, and, in some cases, on profit.[306] Such schemes are popular in branches of foreign companies as well as in large and medium-sized domestic companies. For employees, premiums and bonuses are related to annual or quarterly profit only if their input into the profit can be measured. Thus in fact, forms of gain-sharing are used. Fringe benefits paid from earned profit or included directly into costs, such as free of charge mobile calls, leasing of automobiles, low interest/free loans, free visits to sport centres, payment for continuing education have been expanding rapidly (Meškauskaitė, 2005). Investment in private pension funds and accumulated life insurance as a means of motivation for employees have been extensively used first by branches of foreign companies and then also by domestic IT, advertising, telephone, construction, furniture and textile companies since 2004 (Dževeckytė, 2005).

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305 Source: Interviews with company branch management conducted in April 2005.

306 Combination of wages and salaries with profitability was not very popular (especially before the company income tax reduction to 15% in 2003), since financial management in the majority of companies is oriented towards minimisation of taxes paid.

c) Cooperatives

In the late 1980s many new cooperatives were formed in small service and production units. In 1990, new cooperatives made up around 4500 enterprises with about 5% of the total workforce. The Law on Enterprises of 1990 did not include cooperatives as a permissible business form, thus they were transformed into partnerships or closed joint stock companies (Mygind, 1995, p. 264). In 1993, Parliament passed the Law on Co-operation (later Cooperative Societies), and legalised cooperative activities and ownership. Various types of cooperatives, including consumer, agricultural, production, workers, and credit cooperatives currently exist. The number of operating cooperatives (262) is two times lower than the number of registered (541) ones (see Annex Table 5). The majority of cooperative societies are small, employing up to 9 persons. The number of workers' co-operatives is very small.

4. Evidence of the Effects of PEPPER Schemes

Employee majority enterprises had, at least in the early years, relatively high productivity, but lower levels of salaries and lower capitalisation. Data for the analysis of the effect of employee ownership on performance can be taken from the earlier mentioned ownership surveys combined with financial data from the enterprises. We have data for the 1990s, especially the first half, when employee ownership was widespread. The high frequency of employee ownership in this period makes it possible to undertake reliable statistical analysis on their relative performance. The drawbacks are that the financial data is quite uncertain in this volatile period, and that the data is not updated. The data for the early years does not indicate a bias in the direction of low capital-intensity for insider owned enterprises as was the case in Estonia and Latvia (Jones and Mygind, 1999). In Lithuania, high captial intensity has not blocked takeovers by employees, because vouchers combined with a preferential price favoured employees. There does not seem to be a selection bias according to profitability (Mygind, 1997, reprinted 1999).

Early data from 1993-94 shows that for growth in sales employee owned enterprises followed the average, while domestic outside owned enterprises were below average. Insider owned enterprises had quite high labour-productivity, and employee owned enterprises had a wage level above average in 1994. Employee owned enterprises were doing well compared to other groups both in relation to profit margin and return on assets. Management-owned enterprises were around the average. Insider owned enterprises had relatively low bank loans and low investment levels (Mygind, 1997, reprinted 1999, pp. 49-79). A cross section analysis on factor productivity levels for the early data shows no clear tendencies of variation between employee-owned firms and other owner groups (Jones and Mygind, 2000). The 405 enterprise survey (spring of 2000) shows that manager- and employee-owned enterprises have relatively low salaries for managers, which can partly be explained by their lower average size (Mygind, 2002). The average wage for all employees is also lower in these firms. The survey investigates five indicators of restructuring: change in products, production process, markets, suppliers and organisational structure. There was an increase in changes over the period for all enterprises, with organisational change as the most frequent type of restructuring. Employee-owned firms were relatively low in products, production and markets, but quite high in finding new suppliers. Insider-owned enterprises have, on average, a slow development in exports, but much of this can be explained by different weights in the distribution on industries. Insider- owned enterprises have relatively low investment levels. Combined with the analysis on sources of finance it confirms earlier findings (Mygind, 2001) that lack of capital is a barrier for insider-owned enterprises.

The recent case study on the IT company Information technologies shows that one of the positive results of employee financial participation in IT industry is employee stability, only two of eight members of the team, which founded the company, have left. Other positive results are the increase in company share value, turnover and profitability growth. Earned profit is also used for annual dividend payments. Value added per employee has reached 161.000 Lt in 2002. The company has also evaluated another labor productivity measure - value added per employee per hour as equal to 24,9 euro. This ratio exceeded average ratio for the EU service sector (24 euro).[307]

The results of the survey of 405 Lithuanian companies (spring 2000) show that membership of unions was in general very low and had slightly fallen over time (Mygind, 2002). The membership level was significantly higher for enterprises which had remained in state ownership, but even there the role of trade unions diminished. Employee owned enterprises had quite low union membership and there were no unions in new enterprises. In a more recent development, negative attitudes have been diminishing and trade union membership has increased tremendously. Trade unions have started gaining power and as of 2004 their total number has increased to 311.

[307] Source: Interview with company management (<http://www.informacinestechnologijos.lt>) conducted in April, 2005.

Annex

Table 1: Companies by business forms

Company	2003			2004		
	Registered	Operating	% of registered	Registered	Operating	% of registered
State company	271	144	53	201	134	67
Municipal company	139	81	58	111	74	67
General partnership	883	372	42	756	315	42
Limited partnership	470	265	56	431	197	46
Private limited liability company (Ltd)	46888	21146	45	47902	24833	52
Joint stock company (JSC)	1152	670	58	931	578	62
Sole proprietor	83017	31860	38	76090	27898	37
Special purpose JSC	21	16	76	1	-	-
Special purpose Ltd	167	158	95	20	19	95
Branch of foreign comp. (since 2000)	39	-	-	61	25	41
Credit union	54	42	78	59	54	92
Public enterprise	2486	1190	48	2894	1451	50
Agricultural company	2134	523	25	1916	478	25
Association	574	256	45	663	252	38
Non-profit company	103	10	50	95	9	42

Source: Lithuanian Department of Statistics. Note: The table excludes budget organizations, political, religious, mutual, public organizations and associations, trade unions. Data on cooperatives and cooperative unions are given in a separate table.

Table 2: Distribution of ownership on employees

\ Ownership Average per enterprise		State	Foreign	Domestic	Manager	Employee	No majority	Total	Privatized	New
% non-owning employees	1993 N	61 (89)	76 (14)	54 (47)	65 (44)	24 (45)	37 (55)	51 (294)	38 (96)	71 (44)
% non-owning employees	1996 N	69 (69)	94 (27)	63 (97)	64 (89)	43 (42)	39 (74)	61 (398)	46 (238)	94 (87)
% non-owning employees	1999 N	74 (63)	93 (34)	67 (98)	66 (96)	34 (33)	58 (80)	66 (404)	54 (254)	93 (87)
Rather equal	(Pct)	6 (23)	7 (54)	20 (27)	14 (16)	9 (28)	5 (7)	61 (20)	34 (14)	21 (42)
Unequal (> 1:2) (Pct)		8 (31)	2 (15)	21 (28)	16 (19)	12 (36)	33 (43)	92 (30)	72 (30)	14 (28)
Very unequal (> 1:10) (Pct)		12 (46)	4 (31)	35 (45)	55 (65)	12 (36)	38 (50)	156 (50)	132 (56)	15 (30)
N		26	13	74	85	33	76	309	238	50

Source: Mygind (2002).

Table 3: Owner groups and minority ownership by other groups 1993-1999

1993 \Majority ownership Average % owned by	State	Foreign	Domestic	Manager	Employee	No majority	Total	Privatized	New
State/municipal	94	0.7	6	3	6	21	44	42	1
Foreign	0.0	78	3	2	0	5	5	1	27
Domestic external owner	0.8	5.3	73	4	6	23	17	21	10
Managers	0.5	16	8	75	16	23	15	12	52
Other employees	4.7	0.1	10	16	72	28	19	24	10
Total	100	100	100	100	100	100	100	100	100
1996 \Majority ownership Average % owned by	state	foreign	domestic	manager	employee	no majority	total	privatized	new
State/municipal	91	0.7	5	4	4	17	22	13	1
Foreign	0.3	78	4	1	0	3	7	2	25
Domestic external owner	2.3	11	73	6	4	23	26	34	20
Managers	1.2	9	8	74	21	28	25	24	45
Other employees	5.2	1	10	15	71	29	20	27	9
Total	100	100	100	100	100	100	100	100	100

1999\ Majority ownership Average % owned by	State	Foreign	Domestic	Manager	Employee	No majority	Total	Privatized	New
State/municipal	93	1	4	3	2	15	19	9	1
Foreign	1	81	3	2	0	6	9	5	26
Domestic external owner	1	11	78	7	5	28	28	38	20
Managers	1	6	7	75	20	26	27	26	43
Other employees	4	1	8	13	73	25	17	22	10
Total	100	100	100	100	100	100	100	100	100

Source: Mygind (2002). All companies have the same weight when measuring the average.

Table 4: Lithuania ownership transition matrix: privatisation/start to 2000

\2000 Priv/start	Foreign	Domestic	Manager	Employee	Former employee	Total	Change
Foreign	31	3	2	0	0	36	13.9%
Domestic	2	70	6	1	3	82	14.6%
Manager	3	5	69	6	0	83	16.9%
Employee	6	10	33	41	3	93	55.9%
Former employee	1	11	4	2	18	36	50.0%
Total	43	99	114	50	24	330	

Source: Jones and Mygind, 2005.

Table 5: Cooperatives at the beginning of year

Cooperatives	2003			2004		
	Registered	Operating	% of registered	Registered	Operating	% of registered
Cooperative limited liability company (Ltd)	10	3	30	4	2	50
Cooperative Ltd founded by Ltd	5	4	80	2	2	100
Cooperative enterprise	9	1	11	4	-	-
Cooperative company	509	236	46	531	258	49

Source: Lithuanian Department of Statistics.

Taxation Issues

As far as the taxation of salaries is concerned, the company pays social security tax amounting to 31%, and employees pay personal income tax amounting to 33% (Art. 2 (14), (16.1); Art. 6 (3) Law on Personal Income Tax (LPIT)) plus social security tax amounting to 3% as a withholding tax. Sole proprietors can choose if they wish to pay 33% income tax, where they are allowed to make deductions or 15% income tax without the possibility of deductions (Art. 6 (2.8) LPIT). On dividends, the company pays profit tax amounting to 15% (Art. 2 (15), 5 (1.3) Law on Profit Tax, small enterprises 13%), and employees generally pay personal income tax amounting to 15% (Art. 2 (14), 12, 16 (1), 6 (2.1) LPIT). Income from the sale of securities is taxed only in exceptional cases: Profit from sale of shares is not taxed if the owner has acquired them before 1 January 1999 or if he has acquired them thereafter and has owned less than 10% of the shares for more than 3 years preceding the sale (Art. 17 (1.22), (1.23) LPIT).

After the start of pension reform (Law on Pension Reform of 1999 and Law on Pension Accumulation of 2003) the possibility of accumulation of company funds for employee pension plans emerged. Since 2005 private pension funds, the majority of which were established by commercial banks, started operations and the active marketing of the accumulation of company funds in favour of employees. Companies are provided with tax incentives on payments to private pension funds for the benefit of employees. Similar tax incentives are provided for companies' life insurance payments for the benefit of employees to private insurance companies (when the life insurance period exceeds 10 years). The two latter schemes are marketed as being aimed at increasing employee motivation.

IX. Malta

In spite of the strong historical link to the United Kingdom which has been the source of much of Malta's law on Companies and Employment, in practice the financial participation of employees is not well developed, being neither well diffused nor enjoying much political support. The ramifications of the nationalisation programme in the 1970s and the privatisation drive of the 1990s – although diametrically opposed to each other – had the unintended consequences of introducing financial participation practices for employees in some larger enterprises. However, privatisation cannot be said to have been auspicious to workers' participation. The largest schemes in operation at two previous state owned enterprises are share ownership schemes, profit-sharing is rare. In most of the enterprises which have an operating financial participation scheme, the workers are unionised and the trade unions supported these schemes. In 1996 the government introduced a cooperative framework in the public sector which enabled workers to tender for work projects and share in the profits accruing from them.

1. General Attitude

The policy of financial participation started at the Malta Drydocks Corporation (now the Malta Shipyard Ltd) in the context of introducing a codetermination system which ultimately culminated in workers' self-management in 1975. Other financial participation schemes were introduced in industries where the government had a major shareholding but, these firms did not prove to be economically viable (Kester, 1980).[308] However, financial participation schemes were never featured as part of government policy or programmes. In 1988, following a change in government, an attempt was made by the Minister of Finance to introduce financial participation in two state-owned banks through a profit-sharing scheme. The Minister of Finance and the Malta Union of Bank Employees signed an agreement whereby 5% of the banks' profits were to be distributed to employees. This agreement was never implemented as it was not endorsed by the Cabinet of Ministers and much to the chagrin of the employees and their union, the scheme was shelved.[309]

308 Malta Drydocks managed to register a profit for a brief period (1975-1981) during which workers were given a bonus as part of the distribution of profit.

309 By virtue of their nationalisation these two banks had become independent statutory bodies within the realm of the public sector. The government was afraid that this profit-sharing scheme was go-

The government polices that have actually triggered the largest PEPPER schemes in practice in Malta were not focused upon the financial participation of employees but produced it rather as a side effect. Indeed, the schemes in existence in the banking sector are the result of the unintended consequences of two diametrically opposed government policies. Between 1971 and 1987 the newly elected government of the Malta Labour Party (MLP) embarked upon a programme of nationalisation as part of the de-colonialisation process, seven years after the attainment of political independence. The banking sector, at the time dominated by two major banks, was one of the targets of this nationalisation plan. The winding up of a 'widow and orphans' fund in operation in these banks prior to nationalisation resulted in the creation of a number of shares for the employees of one of these banks. The privatisation programme of 1990 adopted by the Nationalist Party (NP), in power since 1987, also had the unintended consequences of introducing financial participation schemes for employees in the banking sector. Reversing the process of nationalisation begun by the previous administration, the government divested itself of several entities in which it was a majority shareholder.[310] A side effect of this privatisation process was the creation of a trust fund for the benefit of employees in one of the banks.

In 1988, following a change in government, national level bargaining was institutionalised by the setting up of a national tripartite body – the Malta Council for Economic Development – in which the major trade union organisations[311], together with the major employers associations, were represented. By Act of Parliament in 2001 this tripartite institution was given legal status and a new name – the Malta Council for Economic and Social Development (MCESD).[312] Financial participation has never featured as an issue in the debates of this social dialogue institution. In spite of this apparent lack of enthusiasm amongst the social partners, trade unions have supported all the schemes that were proposed and put into practice and have participated actively in their administration. The lack of collective bargaining at sectoral level makes it easier for the Maltese trade unions to be supportive of such schemes in practice. The trade union which has been most active in this respect is the Malta Union of Bank Employees. This is due to the fact that the two major banks, where the union is heavily represented, were the target of both the aforementioned nationalisation and privatisation programmes. The general trade unions, General Workers Union, the largest union in the island, and the Union of United Workers, were also involved in prolonged discussions with the Government about the introduction and implementation of a scheme in

ing to have an adverse effect upon the other similar enterprises which were not as commercially oriented as the banks.

310 Restructuring became more urgent in view of the Maltese Government's formal application, submitted in July 1990, to become a full Member of the European Union (Rizzo, 2003, p. 31).

311 The majority of employees are represented by the General Workers Union, the largest union in the island, and the Union of United Workers. The latter, emerging as a general union, is affiliated with the Confederation of Malta Trade Unions, an umbrella organisation embracing within its fold a number of unions representing professional, executive, clerical and related grades.

312 The act provides for the establishment of a Civil Society Committee appointed by the Tripartite Council.

the public sector whereby employees were given the opportunity to set up cooperatives and submit tenders for contracts of work.

PEPPER schemes have never featured prominently on the agendas of the two major political parties. The present NP government is rather passive but not adverse to financial participation. The Chief Executive Officer of Malta Shipyard Ltd. – a state owned corporation in which the Government agreed to offer a profit-sharing scheme – recently stated in an interview that the improvement in the results of the firm has been achieved against the background of the scheme in operation, as established in the collective agreement between management and the trade union.[313] Apropos this accord, the current Minister for Investments was quoted as saying that the profit-sharing scheme was proof that rewarding workers for increased productivity, as against traditional wage increases, worked; the General Secretary of the union that signed the collective agreement stated that performance bonuses show that the shipyards are facing a brighter future thanks to recent reforms in which the union was a major player.[314] In 1992 the Government appointed a committee to make proposals for the development of worker participation in the workplace. Amongst other things, the Committee recommended the setting up of a 'support unit' to promote worker financial participation in sectors of government departments and statutory independent bodies within the public sector (para-statal enterprises). The government's belief was that the initiative in workers' financial participation emanating from government sources should take the form of workers cooperatives. This scheme put into practice 1996 in the public sector stands out amongst others as it was designed with a clear objective and implemented after prolonged discussions between the Government and officials of the trade unions representing workers in the public sector (Zammit, 1996, p. 124).

2. Legal and Fiscal Framework

Maltese law tends to refer to employee participation schemes indirectly; it tacitly recognises that Maltese firms may put such schemes in place (by means of private or collective agreements), rather than establishing a formal framework for their establishment or creating any noteworthy fiscal or other incentives. However, Maltese law does provide for the legal instrument for ESOPs, namely the trust vehicle. Tax incentives for financial participation schemes are few.

[313] The Times (Malta) Business, 15 September 2005, p. 7.

[314] The Times (Malta), 29 August 2005, p. 5.

a) Share Ownership

Privatisation (1990) – The aforementioned privatisation drive which the Nationalist Party embarked upon in the early 1990s resulted in a share ownership scheme being put into place for the employees of two formerly para-statal entities[315] which were partially privatised.[316] However, these schemes did not have any statutory basis; they were set up and regulated by means of private agreements (both individual contracts and collective agreements) between the newly privatised companies and their employees. Interestingly, the statutes of two as yet un-privatised utility providers, the Enemalta Corporation[317] and the Water Services Corporation,[318] explicitly permit the '*establishment, by the Corporation […] of schemes or incentives related to productivity or performance.*'

Private Companies (2004) – There is no statutory framework for share ownership or share option schemes. Maltese law does not regulate the exact conditions under which share option schemes may take place. It is up to individual companies to create their own schemes utilising general company and civil law principles as the legal basis.[319] Provided that a company is empowered by its Memorandum and Articles of Association to implement employee financial participation schemes,[320] employers wishing to adopt one of the two types of schemes can enter into private or collective agreements with their employees, setting out the scope, terms and conditions. Where the company establishing the scheme is itself the issuer of the shares to be offered to its employees, it is not considered to be providing an investment service in terms of the Investment Services Act 1994 (hereinafter referred to as the IS Act) and, consequently, will not require a licence under the IS Act.[321]

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315 By virtue of their nationalisation these two banks had become para-statal entities (independent statutory bodies within the realm of the public sector).

316 This was a trust fund, set up on behalf of employees, in the Bank of Valletta, a formerly state owned bank, and in Maltacom, a state owned telecommunication enterprise.

317 Enemalta Corporation Act, 1977 (Chapter 272 of the Laws of Malta).

318 Water Services Corporation, 1991 (Chapter 355 of the Laws of Malta).

319 Indeed Maltese law does not contain any explicit provisions on share options. In this regard, there is currently a legal debate as to whether the civil law notion of 'promise to sell' or 'promise to buy' coupled with the institute of Kappara or Earnest (a form of deposit that is forfeited by the buyer should he withdraw from the contract or to be paid by the seller if he withdraws) is a sufficient base. Although it is commonly believed that the 'share option' could be 'shoehorned' into this legal institute, there are some early judgements where it was held otherwise.

320 There is no formal requirement for the inclusion of such empowerment; it is instead up to the shareholders of the company to decide upon its inclusion. A typical clause granting this power reads: 'The Company has the power […] to remunerate employees of the Company out of or in proportion to the profits of the Company or otherwise as the Company may deem fit and to promote and give effect to any scheme or arrangement (whether involving the issue of shares or not) for sharing profits with employees of the Company or of any other company forming part of the same group of companies of the Company.'

321 In a case where the company would be offering shares in its parent or other group company to its employees, the company would fall squarely within the definition of providing an investment service (and consequently would require a licence under the IS Act) were it not for the specific exemption provided in regulation 3 (1) (g) of the IS Act (Exemption) Regulations. This exemption

The allotment of shares to employees must be made in accordance with the general rules on the offering and allotment of shares as contained in the Companies Act 1995[322] (hereinafter referred to as the CA). As a general rule, the CA prohibits companies from acquiring its own shares (Art. 105 para. 1 CA) or the shares of its parent company (Art. 110 para. 1 a) CA) or providing financial assistance for the purchase of its own shares or the shares of its parent company (Art. 110 para. 1 lit. b) CA). However, Art. 106 para. 4 CA and Art. 110 para. 2 CA[323] derogate from the aforesaid general rule by providing that a company may both acquire its own shares or those of its parent and provide financial assistance where this is intended to facilitate the acquisition of shares by or for its employees or the employees of a group company.[324] The only limit to this derogation is that the financial assistance being provided must not have the effect of reducing the net assets of the company below the amount required by law. Furthermore, Art. 106 (4) CA[325] stipulates that companies are exempt from requiring the sanction of the shareholders at an extraordinary general meeting when acquiring their own shares for distribution to their own employees or to employees of a group company. In this regard, this sub-article provides that such shares are to be distributed within one year of their acquisition by the company. Finally Art. 89 (e) CA[326] exempts public limited companies from having to issue a prospectus when issuing shares to directors or employees.[327]

It should also be noted that the CA generally allows companies to offer their shares at a discount or pay a commission to any person in consideration for his subscribing or agreeing to subscribe to any shares in the company.[328] This may also apply where shares are to be offered to employees at a discounted rate as part of a corporate share ownership scheme. In this context the CA does not differentiate between discounted shares being offered to employees and where they are offered to third parties.[329] Tax law on the other hand does not offer any tax incentives of note for these schemes. With regard to stock options, Maltese tax law offers certain minor incentives. Under

applies to all companies provided that prior consent is obtained from the Malta Financial Services Authority (MFSA).

322 Chapter 386 of the Laws of Malta.

323 Based upon Art. 23 (2) of EC Directive 1977/91/EC.

324 This sub-article thus permits companies to contribute to employee share schemes.

325 Based upon Art. 19 (3) of EC Directive 1977/91/EC.

326 Based upon Art. 4 (2) lit. f) of EC Directive 2003/71/EC.

327 More specifically, Art. 89 (3) CA exempts share offers where shares are allotted to existing or former directors or employees by their employer which has shares already admitted to trading on a recognised investment exchange or by an affiliated undertaking.

328 Art. 113 (1) CA 1995.

329 Consequently, the following conditions apply across the board: (i) authority for the making of discounts must be given by the company's Memorandum and Articles of Association, (ii) the discount must not exceed 10% of the issue price or as prescribed by the Memorandum and Articles, whichever is less, (iii) the amount or rate of discount must be made public, and (iv) in no event may the value of the shares be reduced to below their nominal value as a result of such a discount.

the Fringe Benefit Rules issued under the Income Tax Act,[330] share options are only taxable upon the exercise of the option.[331] Thus when an employee decides to exercise the share option, the employing company must withhold tax at the source from the income of the employee according to the rates applicable to each individual employee.[332] The taxable amount is to be the difference, if any, between the option price and the market price of the shares at the time the option is exercised.[333] Thus, the income derived from the exercise of the option is in fact considered to be part of the normal income derived by the employee during the course of his employment. Furthermore, when a share option is assigned or renounced in favour of any person, any gain thereby realised (the difference between the option price and the market price of the share) shall constitute a capital gain that is subject to Maltese tax.[334] In this regard, the share acquisition price of the shares is again deemed to be the market price of the share at the time the option was exercised. The employee (not the employing company) must declare such income as part of his normal assessable income for the year in which the income arose. The granting of share options does not attract any duty on documents or transfers (stamp duty).[335]

Employee Share Ownership Plans (ESOPs) – Maltese law does not contain any specific legislation concerning ESOPs. Recent Trust legislation,[336] inspired by Jersey legislation, successfully achieved a seamless integration of the UK common law concept of trusts into Maltese law. A Trust can take many forms,[337] and although the concept originated in the UK, trusts are not exclusive to countries that follow the common law tradition. One of these civil law countries[338] is Malta which, through the Trusts and Trustees Act 1988, as amended in 2004 (hereinafter referred to as the Trusts Act), allows Maltese individuals and companies to set up and be a beneficiary in trusts regulated by Maltese law.[339] The Trusts Act does in fact contain an explicit reference to

[330] Legal Notice 125 of 2001.

[331] Rule 36 of the Fringe Benefit Rules (LN. 125 of 2001).

[332] Such withholding of tax is carried out by the employing company and reported in the tax forms of the employee which the employing company is bound to submit, on a monthly basis, to the Maltese tax authorities according to the Final Settlement System.

[333] Ibid, Rule 37.

[334] Ibid, Rule 38.

[335] Chapter 364 of the Laws of Malta.

[336] The Trusts and Trustees Act, 1988 (Chapter 331 of the Laws of Malta)

[337] Its essential characteristic being that a person (the Settler) transfers property to another person (the Trustee) or declares that he holds property (unilateral declaration of Trust) for the benefit of someone else (the Beneficiary) and such property will form a ring fenced patrimony separate from that of the trustee.

[338] Trusts are generally recognised as one of the most flexible and versatile vehicles for holding, managing and administering assets. It is therefore not surprising to note that many countries, particularly those with a civil law tradition, such as France, Italy and Liechtenstein have, by specific legislation, introduced the concept of a Trust.

[339] It is to be noted that prior to the 2004 amendments, Maltese resident individuals and companies could not be the Settlor or Beneficiary of a Maltese Trust and immovable property situated in Malta could not be included in the property held on Trust. In 2004 these restrictions were lifted.

'employee benefit or retirement schemes or arrangements' as forming the basis of a Trust. This explicit reference is contained in the Trusts Act's definition of 'commercial transactions', for which the said Act permits certain significant derogations, granting a higher level of flexibility when planning the manner in which an ESOP (in Trust form) is to operate. One such derogation is that contained in Art. 6 and Art. 21 (7) Trusts Act: although as a general rule Maltese trusts are subject to the rules of the Trusts Act concerning *inter alia* the effects of the trust and the duties and liabilities of the trustees, trusts set up in connection with commercial transactions (Commercial Trusts) operate exclusively according to the express terms of the deed establishing the said commercial trust. Similarly, Art. 21 (6) Trusts Act allows, as a derogation to the general prohibition, the trustees of Commercial Trusts to benefit under the trust.

Although traditionally used for hedge funds, the 'Collective Investment Scheme' (hereinafter referred to as CIS) may also be used as the basis for an ESOP.[340] A CIS may take a number of legal forms, namely the SICAV (Société d' Invessement à Capital Variable), the INVCO (Investment Company with Fixed Share Capital), the Unit Trust, the Mutual Fund or the limited partnership. In addition, Art. 4 IS Act imposes certain strict regulatory requirements on all CISs operating from or in Malta.[341] Certain types of ESOPs operated by a company may in fact be caught by the definition of a CIS. In this regard, the legislator, recognising that such schemes do not require the same level of protection as other funds and as an incentive towards their establishment, provided an explicit exemption for such schemes.[342] Thus ESOPs may be subjected to fewer formalities than funds intended to be marketed to the general public. ESOPs which fall within the above exemption are not automatically exempt from any form of regulation; the prior approval of the MFSA is required at all times in order to benefit from the exemption. As a consequence only those schemes which, in the opinion of the MFSA, offer an acceptable level of professionalism and protection will be able to benefit from the exemption. Furthermore, CIS ESOPs established under a

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340 'Collective Investment Scheme' defined in Art. 2 IS Act is any scheme which aims at 'collective investment of capital acquired by means of an offer of units for subscription, sale or exchange'. It must operate according to the principle of risk spreading and either (i) the contributions of the participants and the profits or income out of which payments are to be made to them are pooled; or (ii) at the request of the holders, units are or are to be re-purchased or redeemed out of the assets of the scheme or arrangement, continuously or in blocks at short intervals; or (iii) units are, or have been, or will be issued continuously or in blocks at short intervals.

341 Although these stiff requirements are necessary for the purposes of investor protection especially since, as stated above, CISs are usually synonymous with consumer funds or hedge funds, the definition is wide enough to encompass certain types of funds that do not require such a costly level of regulation.

342 Regulation 4(1)(c) of the Investment Services Act (Exemption) Regulations, 1994 – Legal Notice 6 of 1995 as subsequently amended exempts schemes: '…operated by a company for its own employees, former employees and their dependents, or for employees, former employees, or their dependents, of companies in the same group, in instruments issued by a company or companies within that group and any other instruments as may be approved by the [Malta Financial Services Authority]'.

Unit Trust[343] will, according to Art. 43 (7)(e) Trusts Act, also benefit from an exemption from the requirement for obtaining a licence under the said Trusts Act. Since in the case of ESOPs, a Unit Trust structure is far more straightforward and cost effective, this double exemption is a strong incentive.

With regard to the taxation of ESOPs which fall within the definition of CISs, unfortunately the Income Tax Act 1948 does not distinguish between exempted and non-exempted CISs, so the income arising from CIS ESOPs will be taxable at the normal rate. For taxation purposes, a CIS may be treated either as a prescribed fund or as a non-prescribed fund, depending upon the geographical location of 85% of its assets (whether in Malta or not). Since this report concerns ESOPs in Malta, we can assume that the assets of the fund will in fact be situated in Malta and hence it will be treated as a prescribed fund.[344] Investment income, as defined in the Income Tax Act 1948, which is received by a prescribed fund, is subject to a withholding tax of 15% on bank interest and 10% on investment income other than bank interest. Other income and capital gains remain exempt in the hands of prescribed funds. If the CIS ESOP holds foreign securities (such as those of its foreign parent company), capital gains, dividends, interest and any other income from the foreign securities may be subject to tax imposed by the relevant country of origin. Thus, when Maltese resident participants of the CIS (the employees) redeem, liquidate, or cancel their units in the CIS they will not be subject to a second withholding tax.

b) Profit-Sharing

Maltese employment law classifies profit-sharing arrangements between employers and employees as forming part of the wage of the employee. Maltese labour legislation also appears to envisage contracts of service that solely contemplate remuneration by way of commission or a share of the employer's profits,[345] although these are rarely used in practice. This treatment as a 'wage' implies that any share of the profits will be computed together with the employee's salary for the purposes of the imposition of income tax.

[343] Unlike an ordinary trust, unit trusts are divided into portions or units where the unit holders have no proprietary or equitable interest in the underlying assets until termination of the trust. During the duration of the trust the unit holders instead have a personal interest in the value of the unit which is calculated according to the terms of the trust deed (normally with reference to the NAV of the trust fund). The Trusts Act defines a unit trust as meaning any trust '…being a collective investment scheme as defined in the Investment Services Act.'

[344] By way of contrast, non-prescribed funds are not subject to withholding tax in Malta. However, the unit holders will be required to pay a withholding tax of 15% on all dividends and on capital gains from the redemption, liquidation or cancellation of units.

[345] Art. 22 (3) and Art. 36 (13) Employment and Industrial Relations Act, 2002.

c) Cooperatives

Maltese law has a rather detailed legislative instrument entitled the Cooperative Societies Act 2001 (hereinafter referred to as the Coop Act). Cooperatives may be set up by a minimum of five members by applying for registration to the Cooperatives Board, which was established under the Act. According to Art. 31 Coop Act, once registered, cooperatives are corporate bodies having limited liability and a separate and distinct legal personality from that of its members. Unless the cooperative's statute provides otherwise, all members have one vote. At the end of each accounting period, profit is to be distributed amongst the members after the transfer of at least 20% to a reserve fund, to be used exclusively to cover any losses incurred by the society (Art. 90 Coop Act). Furthermore, every cooperative is bound to contribute 5% of its profits to a Central Cooperative Fund which is used for the furtherance of cooperative education, training and research, and for the general development of the cooperative movement (Art. 91 Coop Act). The net surplus of a society after these two aforementioned transfers have been made may be divided amongst its members through a dividend (Art. 92 Coop Act). With regard to the taxation of cooperatives, Art. 12 (q) Income Tax Act exempts the income of cooperatives from the payment of income tax. Nevertheless, distributions of dividends to members of the cooperative, bonus shares or certificates,[346] and patronage refunds[347] are all subject to the members' full personal income tax rate.

In its drive to increase efficiency and productivity in the public sector, in 1996 the Government, after prolonged discussions with the trade unions, introduced a scheme whereby public sector employees were given the opportunity to form cooperatives.[348] This scheme, envisaged as an alternative to privatisation, enables employees to set up a cooperative within their department. The head of the department can allocate work to a cooperative within his/her department. The Director of a Government Department can also compete for tenders on behalf of the cooperative. If, after the call for tenders, the work contract is awarded to the cooperative and/or the Department, an agreement has to be reached between the Department and the cooperative about the allocation of income from the work contract. The workers will continue to receive their salary, which is assured by the contract. However, as members of a cooperative, they also receive a share of the profits which may accrue from a work contract in which they actively take part in accordance with the provisions laid down in the Coop Act.

[346] Fully or partly paid shares allotted to the members.

[347] In terms of Art. 93 Coop Act, Cooperatives may grant patronage refunds. These are where the society distributes all or any part of the net surplus of the society, paid amongst its members in proportion to the volume of business or other transactions done by them with the society.

[348] These cooperatives were set up following a circular issued by the Office of the Prime Minister, MPO Circular No. 35/1996; Chapter 442 Coop Act refers to them in Section 29 (3).

3. PEPPER Schemes in Practice

The existing PEPPER schemes in Malta are not mandated by law, but are the result of agreements reached between employers' and employees' representatives. They are mainly share ownership schemes found either in enterprises where the state is a major shareholder or in formerly state owned enterprises, and not part of an official government policy to introduce workers' participation. However, in other areas of the public sector financial participation happened more by design, as part of a government strategy to improve the efficiency and productivity of employees in this sector.

a) Share Ownership

Privatisation – When in 1994 the Government offered part of the shares of the Bank of Valletta (BOV) to the public, a number of shares were issued solely for the purpose of setting up of a trust fund for BOV employees. This trust fund was part of the agreement reached between the Government, the Maltese Union of Bank Employees (MUBE) and the General Workers Union (GWU) during negotiations leading up to this privatisation process. The initial funding of this trust, launched in 1995, consisted of 1,385 million shares which were later increased by another 1.5 million through a government loan. This loan had a moratorium of ten years during which no interest was charged. Repayment was to start after ten years, with every annual repayment to be not less than half the amount of dividends declared. The fund was administered by a committee of five members directly elected by the employees. In order to ensure continuity, the election was held by rotation; every year two or three members had to resign and seek re-election. One of these five committee members was appointed to be a member on the Board of Directors to represent the interests of the beneficiaries of the trust. Benefits were given in the form of lump sums in the year when an employee reached the legally stipulated retirement age; the amount of the sum being based upon the number of units accumulated by the employee. At the launching of the fund in 1995 each employee was allocated twenty units to which an extra unit was added for every ten years of service with the bank. These units are not pledgeable. Employees who leave their jobs will have the value of their units frozen as per the date of termination of employment. However, an employee who leaves before the lapse of ten years will not be entitled to any benefits. In the case of death before retirement, the sum is given to the heirs.

A similar trust fund is also in operation in Maltacom plc (formerly Telemalta), a telecommunications enterprise and the main provider of the land telephone system in Malta. In 1998 the Government sold 60% of shares in the state-owned Telemalta Corporation to the public. An agreement between the Government and the trade union representing the workers was reached to allocate 3% of the shares in the form of a loan to a foundation set up to administer a trust fund on behalf of the employees. Broadly speaking, the fund operates on the same principles and lines as that of the BOV, with a committee elected by the workers administering the fund.

Private Companies – Today employee share ownership is found in two major private banks, which had been nationalised in 1974/75: the National Bank of Malta[349] (renamed the Bank of Valletta) and Barclays Bank[350] (renamed the Mid Med Bank plc). The employees of both banks had been contributing to a widows and orphans fund which was appropriated by the Government during the nationalisation process. The trade union representing these employees maintained that since this fund was made up of contributions by employees, appropriation was *ultra vires*. In 1988, following a change in government, it was decided to repay the contributions made by the employees to this fund. The employees of the Mid Med Bank received their repayment in cash while the employees of the BOV[351] were given shares. At the Mid Med Bank (once it had been sold to HSBC Holdings plc (UK) in 2002, becoming HSBC Bank Malta plc.), three types of financial participation schemes were introduced, one of them a share ownership scheme. This 'Save-As-You-Earn' (SAYE) scheme is a savings plan that allows the bank employees to save for HSBC UK shares.[352]

In 2001 and 2002 share options were granted to all employees of Vodafone.[353] Finally, after the Mid Med Bank was sold to HSBC Holdings plc (UK) in 2002, a discretionary share option allotment linked to an employee's performance was introduced. Known as Group Share Options, they become exercisable subject to the fulfilment of certain conditions linked to corporate performance and usually run for a term of three years. When the options become exercisable, employees must fund the cost themselves; HSBC provides a service, however, whereby a loan is arranged to assist in financing the option cost. The loan is repaid from the sale of shares. A second option is a scheme similar to the Group Share Option, with the options held on behalf of the employee and exercised at the end of a three-year period.

Employee Share Ownership Plans (ESOPs) – The trust funds operating in both the BOV and Maltacom have legal characteristics that appear to indicate a unit trust arrangement.[354] Apparently these trust funds were part of an agreement made between

349 Following a run on the bank by depositors, shareholders were forced by the Government to surrender their shares.

350 The Government became the major shareholder owning 60% of the shares; later on Barclays renounced its 40% shareholding so that Mid Med became an entity fully owned by the state.

351 Many of these employees are still on the pay roll of the bank.

352 SAYE schemes have no formal legislative structure or statutory basis in Malta; since HSBC is a UK bank we assume that this is a UK based SAYE scheme. Employees are invited to subscribe to the scheme, choosing a term of 3 or 5 years. The number of shares they obtain upon maturity depends upon their monthly savings and the offer price, normally at a discount. Upon maturity they can choose either (i) to receive the sum saved plus interest earned – i.e., not exercise the option, or (ii) to exercise the option and buy the stated number of shares at the offering price.

353 However, the general policy tends to limit share options to key people in the company. Several other large companies such as First International Bank plc also operate share option schemes for employees, although these schemes are only offered to key personnel.

354 Malta has had some form of trust legislation since 1988 however the legislation (namely the 1994 Trusts Act) excluded Maltese resident individuals or property from acting as Settlor or Beneficiary or forming part of the trust fund respectively. Perhaps the BOV Trust Fund was originally set up

two unions representing the workers and government officials on the procedures to be followed. As a collective agreement – conforming to the minimum provisions laid down in the law – it became legally binding on both sides. Anecdotal evidence also indicates that other companies have taken advantage of the recently revamped trust laws to set up employee trusts; this practice, however, is not widespread. In each case the trust is the vehicle for employee benefit or retirement schemes or other arrangements.

c) Profit-Sharing

Following the merger of the two state-owned entities, Malta Drydocks Corporation[355] and Malta Shipbuilding Company into Malta Shipyards Limited, the Government agreed to offer a profit-sharing scheme in the form of a bonus to the 1,761 employees of this newly formed company (October 2004). Prior to the merger the two companies had been operating at a loss and were heavily subsidised by the Government. According to the performance-related pay (PRP) scheme agreed upon by the Government and the General Workers Union (GWU) in the last collective agreement (signed in November 2003), workers of the Malta Shipyard Ltd. are to receive a quarter of the additional profits achieved through a cut in labour costs. The PRP is given if financial results are better than the forecast. In other words, if quarterly turnover exceeds budget targets, employees are given one fourth of the difference, using a weighting system that divides the work force into management, supervisory, administrative and industrial functions. In August, 2005, the shipyard workers received their first performance bonus after the company's financial results for the first three months of the year exceeded targets.

c) Cooperatives

The last Cooperative Directory, issued in 2000, lists 45 cooperatives.[356] According to the secretary of the Cooperative Board, the present number of registered cooperatives is 58 with approximately 4,569 members. One of these is a secondary cooperative which gathers within its fold seven primary agricultural cooperatives. This cooperative, which employs about 30 persons, is responsible for about 26% of the agricultural sales in the main agricultural market. Although the cooperative movement has managed to branch out in areas lying outside the agricultural sector, cooperatives are still marginal

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as an ad hoc or sui generis arrangement which exhibited similarities to a trust. We assume that a Fund initially set up that way, later with Trust legislation being amended, adapted its statutes.

355 Malta Drydocks, formerly a naval dockyard, is a commercial shipyard. It was nationalised in 1968 after the company, which in 1959 was given a ninety-nine year lease of the Dockyard by the colonial government, discontinued its operations.

356 Up until 1992, the Ministry responsible for cooperatives was the Ministry of Agriculture and Fisheries. In 1992 this responsibility was transferred to a parliamentary secretary within the Ministry of Education and Resources. The change was not simply cosmetic, as following this move a number of cooperatives lying outside the agricultural sector were registered.

to the main economy. Most of them serve as an umbrella organisation for the vested interest of their members. Their contribution to the economy has never been quantified or identified separately in the official statistics issued by the National Statistics Office. The number of workers who have taken the opportunity to participate in the public sector cooperative scheme during the nine years since its inception (1996) is not impressive. However they have managed to set up a working model in a sector rarely praised for its productivity or efficiency. Four cooperatives have been registered under this scheme in the public sector and two more in independent statutory bodies, with a total of 100 members (see annex table 1). The cooperatives have adopted an accrual accounting system, in contrast to the cash accounting system used in Government departments, thus enhancing transparency in their business practices.

4. Evidence of Effects of PEPPER Schemes

Empirical studies have not been conducted in Malta to assess the effects of schemes relating to the financial participation of employees. Financial participation has not been a topical issue in either the field or the literature of industrial relations.[357] The organisation of cooperatives in the public sector seems to have had positive effects. Zammit (2004, p. 27) reports 'that compared to the period before cooperatives were set up, the rate of sick leave has declined. There are also examples of employees working voluntarily beyond normal hours, without being compensated or being placed under a flexible schedule. Additionally, cooperative employees are demonstrating initiative in diversifying their services in order to increase their income. Cooperative funds can be used for capital investment for the benefit of their enterprise. Hence this experience has resulted in a culture change among public employees, increasing their performance, efficiency and productivity, instilling pride in their work and improving their work ethic.'

[357] This may be due to the fact that such schemes are mainly offered to workers who enjoy relatively good conditions of work and good pay. Moreover schemes that tend to benefit employees in the short term, such as share options, are usually restricted to a small number of employees who occupy high grade positions in the enterprise. Nevertheless excerpts from newspapers and extracts from literature pertaining to management studies and workers' participation provide some anecdotal evidence of the effects of PEPPER schemes.

Annex

Table 1: Cooperatives set up within the public sector under Scheme 'B' 2005

Cooperative	Section within Public Sector	Activity	Membership
Linen Service Cooperative Society	Department of Health	Laundry service and work related to cleaning and provision of clothes	60
Cooperative for Traffic Signs and Notices	Department of Work	Maintenance of notices of highway code, road signs, bus shelters	15
Aluminium Cooperative	Department of Work	Aluminium work	5
Cooperative of Carpenters	Department of Work	Carpentry work	6
Crossroad Cooperative	Water Services Corporation*	Laying of pipelines and other work related to road work	5
Malta Maritime Pilots Authority	Malta Maritime Authority*	Pilot Service in the Harbour	10

* Independent Statutory Bodies, established by law as Government Agencies but given status of a distinct corporate body.

Taxation Issues

Taxation on income in Malta is governed by the Income Tax Act, 1948,[358] and the Income Tax Management Act, 1994.[359] To these one might add the Duty on Documents and Transfers Act, 1993,[360] that establishes a stamp duty payable upon the execution of certain types of contracts[361] in Malta and upon the transfer of certain assets.[362] There is a tax on income and on certain capital gains[363]. Maltese resident individuals are subject to income tax chargeable at progressive rates ranging from 0% to 35% depending on the individual's income bracket, whereas Maltese companies are taxed at a flat rate of 35%. Distributions by Companies registered in Malta (dividends) to shareholders are taxable at source at the corporate rate of 35%, however, individual shareholders may elect to claim the tax deducted at source as a tax credit, in which case their dividends will be subject to their personal income tax rate. Local investment income is subject to

[358] Chapter 123 of the Laws of Malta.

[359] Chapter 372 of the Laws of Malta.

[360] Chapter 364 of the Laws of Malta.

[361] Such as insurance policies.

[362] Immovable property, marketable securities, etc.

[363] Such as gains arising from the transfer of the ownership of immovable property, or any rights thereon, or from the transfer of the ownership or usufruct of or from the assignment of rights over any securities, business, goodwill, copyright, patents, trademarks and trade-names or gains or profits arising from the transfer of the beneficial interest in a trust.

a final tax liability of 15%. Interest received from investments situated outside Malta is taxed at the normal rates; however, non-residents are exempt from tax on local interest. The transfer of shares and other securities gives rise to a liability for payment of stamp duty in terms of the Duty on Documents and Transfers Act, 1993.[364]

[364] Ibid.

X. Poland

The most significant form of employee financial participation in Poland today is employee ownership. Poland's privatisation programme was characterised by significant incentives for employee participation, especially in firms privatised by leasing and transformed into so-called employee-companies (*spółki pracownicze*). Ownership structures in these companies have, on the whole, been relatively stable, with non-managerial employees retaining, on average, a significant portion of enterprise shares. Less significant forms of minority employee share ownership emerged during privatisation using methods other than leasing. Finally, workers' cooperatives, which existed under socialism, are still present in the Polish economy. However, it must be borne in mind that financial participation hardly extends beyond these companies and the small worker cooperative sector, and the significance of these groups of firms in the Polish economy is shrinking. Although, presently all forms of financial participation are also available for use in employee compensation schemes outside of privatisation, there are no tax incentives to do so, and no interest in the development of such schemes can be observed either in political or trade union circles.

1. General Attitude

Workers' cooperatives have been part of the Polish industrial landscape since the late 19th century. Prior to the Second World War, they constituted a small part of a very broad and important cooperative movement which was strongly associated with the Polish Socialist Party and whose most important elements were housing, credit, and agricultural cooperatives. In 1948, when the Stalinist era in the economic history of Poland began, national cooperative associations were established in order to integrate the cooperatives into the planning apparatus of the Communist state. These associations became the link in the planning chain between the central Ministries and individual cooperatives, distributing planning directives and passing them on to cooperatives, whose members were thus deprived of the bulk of the democratic decision-making rights that constitute the essence of cooperativism.[365] Thus the growth in the number of workers' cooperatives which occurred in the Communist era was no indication of the strength of genuine cooperativism in the Polish economy. An indication of the largely formal character of Polish workers' cooperatives under socialism is the fact that

[365] A further limit on the rights of members was inherited from the pre-war era: since the passage of the 1920 Law on Cooperatives, Polish cooperatives have been characterised by group ownership; that is, the cooperative's basic capital fund, called the 'resource fund' (fundusz zasobowy) was indivisible, and individual members had no claim to any part of the collective property.

in the 2,049 cooperatives registered by the Central Association of Workers' Cooperatives in December 1988, there were 501,400 employees but only 398,100 members.

The strong position of its state enterprises and self-administration of the enterprises which was introduced in 1981 together with the resultant relative independence became a fundamental problem when transformation or liquidation was necessary. The central point of prime importance is that enterprises had to be integrated into the privatisation process and the necessary initiative that this entailed was difficult to achieve as the enterprises often warded off and in some instances even blocked privatisation. The organs of the enterprises had a strong position, relatively independent from the state. This, together with the failure to establish direct state control, led to a position where the priority aims were not autonomy and introduction into the market economy but the attainment of control and conditional exertion of influence on the behaviour of the enterprises. Thus the paradoxical situation arose in which the State first needed to regain control over the 'state owned enterprises' before it could, as the owner, dispose of them within the framework of privatisation. In so doing, the resistance of the workforce and partly also the management, who would de facto disband themselves through the transformation, had to be counteracted.

In this situation Poland (like Hungary) decided to tread a balanced path and chose a comprehensive concept. The demand for 'social privatisation' and the described strong position of state enterprises combined with the lack of private domestic capital gave rise to the government's 1990 decision to allow, amongst other privatisation techniques, the introduction of a special lease-buy-out (LLBO) model leveraging 'employee-companies'. The drive to make employee buyouts a major form of privatisation came from the same movement which had supported employee self-management in state-owned enterprises during the 1980s. Furthermore, besides preferential employee shares that existed from the very beginning, in 1995 Poland's version of voucher privatisation, the National Investment Fund programme was launched as a third type of privatisation.

No interest in the further development of PEPPER schemes can be observed either in political or trade union circles. The positions of trade unions like Solidarność with regard to PEPPER schemes and other forms of workers' participation were – and still are – not consistent and often ambiguous. On the one hand they were profiting when the loss of power of the organs of self-administration of the state enterprises undergoing privatisation was compensated, e.g. by the participation of an employee representative on the executive boards of privatised enterprises employing more than 500 employees or the granting of protection against lay-offs to members of the Workers Council for the time of their term and the following year. On the other hand there was political pressure from the trade unions to avoid bankruptcy and liquidation of the companies and, consequently, often also resistance against radical restructuring.[366]

[366] There were whole branches of the economy where privatization had barely started (e.g., the mining industry, the sugar industry, and the spirit industry), with the delays being due to strong pressures exerted by trade unions, farmers' organizations and other lobbies.

Furthermore, especially in small and medium sized 'employee owned companies' their position seems not to correspond with that of the employees: Trade unions are at their weakest in the manager-owned companies and strongest in strategic outsider-controlled firms and in companies with dominance of non-managerial employee ownership; at the same time the role of non-managerial employees is perceived as relatively strongest (but still at the lower end of hierarchy) in companies controlled by non-managerial employees and weakest in firms with strategic outsider investors (Kozarzewski and Woodward, 2001, p. 39).

Traditionally amongst Polish managers attitudes reflecting a conviction that decision-making powers should be concentrated in the hands of a small elite and that the role of the remainder of the work force consists solely of executing the decisions made by that elite have been prevalent.[367] However there is also evidence of a great deal of consultation with employee representatives on certain issues (generally connected with wages, benefits, and working conditions) and it is worth noting that amongst workers the managerial option was also fairly popular.[368] Survey results provide us with indications that the development of employee ownership resulting from the privatisation process in Poland was highly pragmatically motivated and not due to any commitment to employee involvement, and that this was the case not only for managers but also for the employees themselves.

Institutions created to support employee-owned firms in Poland include the Union for Employee Ownership (*Unia Własności Pracowniczej*), the All-Poland Chamber of Employee-Owned Companies (*Ogólnopolska Izba Gospodarcza Spółek Pracowniczych*) in Poznań, and the Gdańsk Employee Ownership Bank (*Bank Własności Pracowniczej SA w Gdańsku*); however, their significance to the process of employee-led privatisation in Poland was very limited. Thus, as of early 1996, the Union for Employee Ownership, founded in the autumn of 1990, had only 76 member firms, some of which were still state-owned. In addition to lobbying activities and the organisation of annual conferences on the subject of employee ownership in Poland, the Union's activities included the provision of assistance to enterprises in the process of employee leasing privatisation and of legal aid and various types of training programmes to member firms. From early 1996, the All-Poland Chamber of Employee-Owned Companies had 105 member firms (all of them privatised) and was also primarily focused on lobbying activities. The Employee Ownership Bank, in operation since September 1990, had, by late 1995, assisted in 30 employee leasing privatisations (concentrated mostly in southern Poland) by means of so-called 'privatisation bonds' (these bonds were sold to the state enter-

367 Thus, for example, the authors of a study analysing the results of a survey of 465 Polish managers carried out in the 1990s characterise the attitudes of Polish managers as individualistic (i.e., relatively unwilling to engage in teamwork) and relatively uninterested in communication and negotiation with the firm's employees (Karpowicz et al., 1996; Chełmiński and Czynczyk, 1991; Kloc, 1997, pp. 130-131).

368 Indicated by 20.2% of the respondents from this group (Gładys-Jakóbik, 1995, p. 144).

prise being liquidated; the money was then lent by the bank at preferential rates to the employees for the purpose of financing share purchases).[369]

It is clear that since the mid-1990s the principal openly declared aim of the privatisation policy was the maximisation of budget revenues, and that therefore all but the smallest state enterprises were to be privatised by commercial methods (in spite of the fact that it was actually the larger employee-owned companies which tended to attain the best financial results). In addition, privatisation policy-makers have sought to encourage enterprises using this method of privatisation to find outside investors, and for this purpose, a clause was included in the 1996 Privatisation Law which would make pure management-employee buyouts difficult or even impossible by requiring at least 20% of the shares of a leasing firm to be purchased by persons not employed in the firm (although it also states that the Minister of Ownership Transformation – now the Minister of the State Treasury – may permit exceptions). No incentives have been provided by policy makers for the extension of employee financial participation other than privatisation schemes.

2. Legal and Fiscal Framework

In Poland the legal framework, in principle, provides various forms of PEPPER schemes, embracing on the one hand share ownership and profit-sharing and on the other cooperatives and the private sector as well as enterprises undergoing privatisation. However, no incentives have been provided by policy makers for the extension of PEPPER schemes. All forms of participation are available for use in employee compensation schemes, although there are no tax incentives to do so.

a) Share Ownership

'Employee Companies' (1990, 1996) – The so called employee companies emerged though Leverage-Lease-Buy-Out (LLBO) privatisation (Woodward, 1998), which is one form of so-called liquidation privatisation, thus it is applied not to incorporated companies, but to state enterprises. A newly established private company concludes an agreement with the State Treasury to lease the assets of the state enterprise for a maximum period of 15 years.[370] According to Art. 39 PrivL, since the beginning of 1997 liquidation privatisation (leasing, fast-track-sale and contribution-in-kind) re-

[369] On the Employee Ownership Bank, see Dryll (1995), pp. 42-43.

[370] Until 2002 Art. 52 para. 1 PrivL foresaw a maximum of 10 years; the legal regulations for LLBOs are to be found in Art. 39 para. 1 No. 3 and 50 to 54 PrivL; it is reserved exclusively for Polish nationals and as an exception also legal persons (Art. 51, para. 1 No. 2 PrivL).

quires:[371] relatively good financial and market conditions; no requirement for substantial investment to modernise, replace, develop equipment etc; a yearly turnover of max. 6 million€; not more than 2 million € equity consisting of two enterprise funds; having management and employees willing to undertake the financial risk involved in embarking upon a common investment (including third parties).

Prerequisites for concluding the leasing contract are that the contract must be concluded in favour of the company and over half of the companies´ employees are from the liquidated enterprise. Due to this last condition pure management companies (MBO) can never occur as LLBO-Companies. It is the Management-Led Employee-Buy-Out that is a buy out by both groups under the direction of the management, which is the rule.[372] Furthermore Art. 51 para. 1 No. 4 PrivL from the end of 1996 onwards requires 20% of shares to be purchased by outsiders in a LLBO transaction. However, it is common for persons not employed in the enterprise to take part in an LLBO privatisation; by the end of 1994 more than 20% of the companies set up for this purpose involved a strategic investor. As an additional organisational and financial hurdle Art. 51 para. 1 No. 3 PrivL requires that the members of an Employees Company pay 20% of the net value of the object of the lease before the company can start doing business. In the case that the enterprise is not leased but constitutes a contribution-in-kind, Art. 50 para. 1 PrivL requires that the shareholders, but excluding the Treasury, pay 25% of the net value of the equity before the company can start doing business.

The interest payment (referred to in Polish regulations as the 'additional payment' [*oplata dodatkowa*]) was set at 30% (75% of 40%) if the central bank refinance rate were to exceed 40%[373] and later in 1993 this was lowered to 50% of the refinance rate.[374] Moreover, a leased company can apply to its founding organ for a reduction in the interest payments owed by the company as a result of postponements during the first two years of the leasing period if its investment expenditures out of profits amount to at least 50% of its net profit. Finally, the corporate income tax law allowed the firms to include the interest portion of the lease payments as costs in their accounts, thus reducing their tax liability.[375] The new privatisation law in 1996 additionally leveraged the financial lease contracts in order to enhance the creditworthiness of employee-

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[371] These criteria were altered with the new Privatisation Law in 1996 which set up additional financial hurdles, giving room to the suspicion that the government intended to reduce liquidation privatisation.

[372] Here one can see that this form of participation should act as a safety valve with regard to the political expectations surrounding 'Social Privatisation'. Although in practice MBO occurs much more frequently and although experience has shown this to be more successful, a specific mention of it in the Privatisation Law was rejected. Instead the much less frequent EBO was emphasised which shows again that it is not economic but political considerations that dominate the development of the concept.

[373] Ordinance of the Minister of Finance of May 7 1991, Monitor Polski 1991 Nr 18, Pos. 123.

[374] Ordinance of the Minister of Finance of May 13 1993, Monitor Polski 1993 nr 26, poz. 274.

[375] Law on Corporate Income Tax of February 15 1992, Art. 15.

leased firms when applying for bank loans. Art. 52 PrivL gives the possibility that full ownership may be acquired before the end of the contract if one third of the total amount of the leasing rates have been paid, provided approval of the balance sheet for the second business year of the company. A payment of more than half of the total leasing rates cuts down the blocking period by half. Because of the difficult conditions on the Polish credit-market, this regulation has in practice become very important.[376] In the above mentioned situation of an in-kind-contribution of the enterprise members of an Employees Company constituted exclusively of employees of the enterprise and the Treasury have to pay only 10%[377] of the net value of the equity before the company can start doing business, while at the same time Art. 49 PrivL requires 25% for non-employee or mixed companies.

Employee shares in Capital Privatisation (1990, 1997) – The new PrivL came into force in early 1997; according to Art. 36 employees can acquire 15% of shares for free, with the restriction that these shares are exempt from free trade[378] for two years, and for three years in the case of employees elected to the management board (Art. 38 para. 3 PrivL). They are required to state their claim within 6 months before the registration of the company, otherwise the right expires, and can execute it for 6 months after the sale of the first share. Shares are allocated in groups made up according to the time spent in the enterprise.[379] The total value of allocated shares according to these claims may not exceed the sum of the average salary in the public sector in 18 months multiplied by the number of employees acquiring shares. This rule applies not only to commercialised companies undergoing capital privatisation and those included in the Mass Privatisation Programme[380] but was extended to 15% employee participation in a 'direct privatisation' transaction embracing sales of an enterprise as a going concern as well as in kind contributions of an enterprise (Art. 48 para. 3, Art. 49 para. 4 PrivL). The only remaining exception is commercialisation via debt-to-equity-swaps.

Private Companies (2003) – In deviation from the general prohibition to acquire own stock, Art. 362 para. 1 of the Commercial Companies Code (CCC) permits a company to acquire its own shares in order to offer them to current employees or retired employees of the company or employees of an affiliated company provided there

[376] Furthermore Art. 54 PrivL foresees the possibility to regulate the specific conditions of such leverage by Ordinance of the Council of Ministers including the possibility to reduce the threshold of paying 20% of the net value of the object of the lease stated in Art. 51 para. 1 No. 3 PrivL to 15%. In this context Art. 64 PrivL granted existing Employees Companies the right to renegotiate their contracts within 3 months of the Ordinance coming into power.

[377] Until the end of 1996 privatisation rules required 20%.

[378] This does not apply to shares allocated in an Employees Pension Fund set up under the Law on Employees Pension Programmes of 20 April 2004, Dz. U. No. 116, Pos. 1207.

[379] The principles of the formation of these groups are set out in detail in an Ordinance of the Minister of Privatisation of 3 April 1997, Dz. U. No. 33, Pos. 200.

[380] Regulated in the Law on National Investment Funds and their Privatisation being passed on April 30th, 1993; Dz. U. No. 44, Pos. 202; 1994 No. 84, Pos. 385; 1997 No. 30, Pos. 164, No. 47, Pos. 298 (with subsequent amendments).

is a minimum of three years of that business relationship.[381] In this case Art. 393 No 6 CCC requires a decision by the general shareholders assembly and Art. 363 para. 3 CCC states that the shares shall be transferred to the employees within twelve months of acquisition. According to Art. 362 para. 2 CCC the possibility of the acquisition of the company's own shares in this case is limited to the extent that the total nominal value of the shares may not exceed the value of 10% of the enterprises' equity capital and that the purchase price together with the transaction cost may not be higher than the reserve made from the company's own profits (Art. 348 para. 1 CCC).[382] Additionally under the current legislation joint stock companies may issue new shares to be transferred to employees in the context of so-called conditional capital increases, with Art. 448 para. 2 No. 2 CCC expressedly referring to the possibility of transferring shares to employees in the case where they have previously acquired claims from profit-sharing. According to Art. 448 para. 1 CCC a prerequisite to this form of capital increase is that the relevant employees are identified in the decision of the general shareholders assembly about the capital increase. The issuing of shares to be acquired by employees in this case shall not be considered as a public offering but as a 'private subscription' (Art. 431 para. 2 No. 1 CCC). The matching regulation is Art. 442 para. 1 CCC which stipulates the possibility of capital increases financed by the company's own capital, again referring to Art. 348 para. 1 CCC concerning reserves made from the company's own profits.

In order to facilitate the acquisition of shares by employees, by Art. 345 para. 2 the CCC the legislator has deviated from the general prohibition to leverage the acquisition of its own stock. Conditional upon the creation of a reserve (Art. 348 para. 1 CCC), the company may advance funds, make loans, and provide security, with a view to acquisition by employees of the company or employees of an affiliated company. Furthermore, in principle, employees may received stock options, including options to acquire shares on a privileged basis (at below-par prices or even free of charge) although no specific regulations exist (Ciupa, 2001, p. 203). An issue to be mentioned in the context of employee share ownership is a new regulation introduced at the end of 2003[383] which, in the case of joint stock companies permits the major share owners (not more than five owning together at least 95 % of all shares and each single one not less than 5%), to make a final share buyout offer to the remaining minority shareholders (squeeze out). In such a case the minority share holders, who on some occasions may be employees of the company, would have an obligation to sell their shares to the major shareholder.

Pre-emptive Right of Purchase of an Enterprise under Insolvency Law (2003) – With the Insolvency and Reorganisation Law (IRL) a completely new version of Polish

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381 This regulation had its origin in the harmonisation with the *acquis communautaire*, i.e. the implementation of the second Council Directive of 1976 (77/91/EEC; OJ L 26, 31.1.1977, p. 1).

382 Art. 347 para. 3 and 348 para. 1 CCC provide the possibility to allocate enterprise profits to special funds while not paying them out as dividends to shareholders, thus allow share based profit-sharing.

383 Art. 418 CCC modified with the last amendment of 12 Dec. 2003, Dz. U. No. 229, Pos. 2276.

insolvency law[384] became effective on 1 October 2003.[385] Embracing regulations on both bankruptcy and arrangement proceedings, interestingly, the IRL contains a hidden leverage for setting up employee companies in the context of liquidation procedures. If the sale of the debtor's business as one or several functioning units is not possible, then each asset should be publicly auctioned by the administrator under supervision of the judge-commissioner. If assets are not sold at a public auction or the judge-commissioner does not accept the offer, the judge-commissioner can order a second auction or determine the minimum price and conditions of sale and allow the administrator to find a purchaser or allow the administrator to sell assets free of procedural restrictions. The sale of real estate and ships free of procedural restrictions must be approved by the creditors' committee. In this case a company consisting of at least half of the debtor's enterprise's employees and being a commercial company with the participation of the Treasury has a pre-emptive right of purchase of the enterprise or functioning enterprise units (Art. 324 IRL). The sale of movable property free of procedural restrictions must be approved by the judge-commissioner (Art. 326 et seq. IRL).[386]

b) Profit-Sharing

The possibility of implementing profit-sharing, i.e. a form of remuneration, in addition to pay systems, directly linked to enterprise profits is stipulated in Art. 347 para. 3 and 348 para. 1 CCC for joint stock companies (*tantiema)*.[387] Furthermore, as already mentioned, share-based profit-sharing is regulated in the context of conditional capital increases according to Art. 448 CCC, stressing the possibility of transferring shares to employees especially for the situation where they have previously acquired claims from profit-sharing. The general type of scheme linked to enterprise results is referred to in Polish as a '*bonus*' but has no legal foundations. Other practices presently sanctioned by law are compensation forms linked to an employee's individual results (gain-sharing) which are not usually linked to enterprise results and thus do not constitute PEPPER schemes.[388]

384 Dz. U. 2003 No. 60, Pos. 535.

385 For a detailed analysis of the new law see Zedler (2003).

386 Ordinance of the Ministry of Justice of 16 April 1998, Dz. U. No. 55, Pos. 360, entered into force on 14 May 1998.

387 See decision of the Supreme Court of 5 May 1992, I PZP 23/92, Bibl. Prac. No 25, p. 96.

388 Such as other forms of remuneration, e.g., gratifications (gratyfikacja, nagrody, nagrody jubileuszowy), thirteenth salary, commissions (prowizja; used frequently, if not universally, in the case of sales force employees) and various types of bonus schemes. For details see Ciupa (2001); 'Premie I nagrody dla pracowników', Rzeczpospolita of 3 Oct. 2005.

c) Cooperatives

In January 1990 the central cooperative associations were liquidated. In August 1991 Parliament passed a law allowing for the conversion of the 'resource funds' into share funds in all types of cooperatives (except housing cooperatives), which resulted in the creation of genuine individual shares for members. Cooperatives are legally defined in the Law on Cooperatives of September 1982 (hereinafter referred to as LoC).[389] A cooperative is a voluntary association of natural (minimum 10 founders) and/or legal (minimum 3 founders) persons created with the purpose of providing an economic activity or to safeguard the economic, social or other need of its members. According to Art. 36 para. 3 LoC a cooperative is a legal person and every member may participate in the management, each member having one vote in decisions (in cooperatives having exclusively legal persons as members the Articles of Association may stipulate something else. The cooperative is liable for its obligations with all its assets; its members are not liable (Art. 68 LoC). In principle each member is entitled to a share of the profit of the cooperative according to the contribution of the respective member; the volume of distributed profit is set by the general meeting, the rules of the distribution of the profit between the members are stipulated in the statutes (Art. 75 ff. LoC). Furthermore, in the case of liquidation of a cooperative Art. 135 para. 3 LoC stipulates that each member receives a liquidation quota according to his share. The profit shares of cooperatives are taxed like any capital gain.

d) Participation in Decision-Making

Codetermination on the strategic level exists in the form of an obligatory representation of employees on the supervisory boards of commercialised companies of, initially, two fifths of the members and - from the moment the state ceases to hold 100% of the shares - one third (Art. 14 Law on Commercialisation and Privatisation, hereinafter referred to as PrivL[390]). Furthermore Art. 11, 12, 60 PrivL provides a detailed procedure for the election and qualification of representatives while Art. 15 PrivL grants protection of their labour contract for the time of their term and the following year (Boc, Guziński and Kocowski, 1997). New in the context of 'social compensation' is the participation of an employee representative on the executive boards of privatised enterprises employing more than 500 employees (Art. 16 PrivL). Outside privatisation the development of participation in decision-making has been very limited, even in companies where employees hold significant share packages. Poland remains domi-

[389] Dz. U. No 30, Pos. 210, newly published on 10 May 1995 Dz. U. No 54, Pos. 288, (with subsequent amendments).

[390] The possibility to abandon this representation from the moment the state ceases to hold more than 50% of the shares foreseen by the old Law on Privatisation of State Owned Enterprises of 13 June 1990 (Dz. U. No. 51, Pos. 298) was eliminated in the new Law on the Commercialisation and Privatisation of State Owned Enterprises of 30 August 1996 (Dz. U. No. 118, Pos. 561, republished in Dz. U. 2002 No. 171, Pos. 1397, No. 240, Pos. 2055 altering the title by abolishing the 'of State Owned Enterprises', with subsequent amendments).

nated by an elitist and managerialist corporate culture which minimises the opportunities for participation. Almost all progress which has been made in the area of decision-making participation in Poland can, however, be ascribed to the European Union.

Although it seems that the development of both direct and indirect (representational) employee participation in decision-making processes in employee-owned companies is rather low, there are signs that some potential for the development of genuine employee involvement could be resting latent in these firms. In many Polish employee-owned companies, for example, no dividends have been paid out - even after two to three years of functioning as a private firm - due to decisions to plough back profits in the form of investment or not to pay dividends until the lease is paid off. The fact that employee shareholders can be convinced to vote in favour of such 'austerity' plans provides some evidence that the entrepreneurial attitudes characteristic of genuine ownership and participation may be present amongst the work forces of certain employee-owned companies.

3. PEPPER Schemes in Practice

In spite of the relatively broad legal foundations of PEPPER schemes in practice financial participation hardly extends beyond privatised companies and the small workers cooperative sector. Furthermore the significance of these groups of firms in the Polish economy is shrinking. The economic performance of employee-owned companies in Poland is certainly satisfactory in comparison with most other ownership groups in the country's economy. However, econometric evidence provides little or no support for the hypothesis that employee ownership is related – either positively or negatively – to performance. This is due to the organisational culture which is dominant in Polish companies regardless of their ownership form. The sort of identification with a firm which is the cornerstone of genuine ownership and the associated entrepreneurial spirit does not automatically result from mere shareholding. Ownership must imply not only a claim on a portion of the firm's revenues, but also participation in decision-making and responsibility for the firm's development.

a) Share Ownership

'Employee Companies' – This form of privatisation was dominant in the early transition period in Poland. Of the state property which had been privatised in Poland to mid-1995, a very high percentage was privatised by the 'leasing liquidation' method: At this point, Art. 37 liquidations represented 66.9% of all completed privatisations, and since leasing represented about 73% of all Art. 37 liquidations, 48.8% of Polish privatised companies in mid-1995 were employee-leased companies[391] Later the situation

[391] This calculation is based upon information contained in CSO (1995), p. 22, and CSO (1996), p. 64.

changed, due - amongst other things - to the implementation of the NIF programme and the increasing popularity of other methods of direct privatisation.[392] In terms of the numbers of enterprises privatised, however, leasing still represented the single most frequently used method. Most of the firms in this category are small to medium-sized firms, usually with less than 500 employees. Of the enterprises which had initiated or completed privatisation by employee leasing by 31 December, 2001, only 13.8% employed over 250 persons (CSO, 2002, p. 43).

Studies of Polish employee-owned companies have found that on average they tended to have, initially, a fairly egalitarian distribution of shares, that the management began to accumulate shares in a process of concentration that was usually rather slow, and that management shares seemed to have stabilised by the end of the 1990s. Research conducted in the late 1990s on a sample of 110 employee-leased companies privatised between 1990 and 1996 showed that on average, the share of non-managerial employees in ownership decreased from 58.7% immediately after privatisation to 31.5% in 1999. Approximately 32% of leasing-privatised firms were still majority owned by non-managerial employees by mid-1999. Over time, more and more shares were also found in the hands of outsiders (probably due largely to retention of shares by people whose employment relationship with the firm ceased for whatever reason), and the presence of strategic outside investors (including foreign investors) had begun to be felt in a minority of firms by the end of the last decade (see Annex Table 3).

The importance of new share issues is indicated by the results of a 1996 Unia Własności Pracowniczej survey, as 20.9% of the respondents said that they had had new share issues and 19.8% said that they were preparing such issues. For the latter two categories combined (issue planned or already carried out), 8.1% reported that the issue had been public, and 31.4% reported that it had been closed (Unia Własności Pracowniczej, 1996). A number of well-known employee-owned companies, including the Bydgoszcz-based cookie and candy manufacturer Jutrzenka, the Krakow-based candy producer Wawel, and the Toruń-based mining equipment manufacturer Apator, have issued shares on the Warsaw Stock Exchange, and the number of such cases can be expected to grow fairly rapidly in the near future. On the other hand, a number of employee-owned companies with equally well-known brand names have chosen the option of selling out their holdings to outside strategic investors.

Survey research carried out in the 1990s repeatedly demonstrated that transition to employee ownership was the most preferred method of privatisation for employees of state enterprises.[393] However, it appears that this preference for employee ownership reflected not so much the aspirations of state enterprise employees to some form of

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[392] At this point, therefore, lease-leveraged employee buyouts represented a little over one third of completed privatisations (CSO, 2002, p. 22).

[393] For example, when workers and managers were asked in a 1993 survey what form of ownership they would like to see in their enterprise (they could choose more than one type), 66% said they would like to see it remain state-owned and 63% said they would like it to become employee-owned; by way of comparison, foreign ownership was viewed favourably by 15% and private ownership by a Polish investor by 30% (Badora, 1994, p. 55).

employee participation as the conviction that this type of privatisation offered them the greatest possibilities for financial gain or was simply the least of all possible evils.[394] Interestingly, there was a tendency for trade unions to vanish after a state enterprise had been privatised by leasing. Two studies of fairly large samples (Szóstkiewicz, 1995=1996, 1998) showed that unions are present in only about half of the leasing companies, with these results being confirmed in later research. In fact, analysis shows that the situation in almost all employee-leased companies is largely free of conflicts, with trade unions passive and even – in almost half of the companies – ceasing to exist over time (Kozarzewski and Woodward, 2001, pp. 9, 17; see also Annex Tables 1 and 2).

Employee attendance at shareholder meetings was found to be high on the average in the firms surveyed by Unia Własności Pracowniczej: 75% to 100% of the employees attend in between 45% and 50% of the firms and 51% to 75% attend in about 20% of the cases. Attendance seems to be much higher in companies privatised in 1991, 1992 and 1993: the majority of employee shareholders attends meetings in over 84% of companies privatised in 1991, in over 77% of companies privatised in 1992, and in about 60% of those privatised in 1993, but only in 37.5% of companies privatised in 1994 and 50% of companies privatised in 1995.[395] Nevertheless, given the facts that these meetings occur only once a year and are often dominated by a core group of shareholders, usually from middle and top management, holding the largest blocks of shares, and that management is usually uninterested in facilitating information flows to the work force, it is not surprising that several researchers have concluded that the dominant management style in Polish employee-owned companies is more autocratic than democratic (Dąbrowski et al., 1992, p. 50; Dąbrowski et al., 1993, p. 49; Gardawski, 1995b, pp. 60-63).

Employee shares – No systematic data is regularly collected on employee shareholdings in private companies or companies privatised in Poland by commercial methods. However, a study of ownership and governance patterns in over 80 of Poland's 500 largest companies which were privatised between 1990 and 2001 found that employee shareholdings were marginal in this group of firms. Insiders possessed only 12.7% of shares at the beginning of 1998, and this fell to 11.4% two years later. In two thirds of

[394] Amongst the same respondents to the aforementioned survey, e.g., the desire to actually become an owner seems to be much rarer than the preference for employee ownership as a privatisation method. When respondents were asked whether they would buy shares in the enterprise in which they worked if they had such an opportunity, 43% said they would, 38% said they would not, and 19% said they did not know (Kawalec, 1994, p. 166). The low figures for 1993 may reflect the limited financial resources of the workers. A similar survey carried out a year later, after significant improvement in the Polish economy, indicates that the percentage of people willing to buy shares in the enterprises for which they worked had grown impressively, as 60.9% of respondents expressed such willingness, 30.4% said they would not buy shares, and 8.7% said they did not know (Gardawski, 1995a, pp. 184, 186).

[395] It is possible that the results for 1994 and 1995 are not representative, as the sample includes only about 9 of the former (9.3% of the sample) and 3 of the latter (3.5% of the sample). See Unia Własności Pracowniczej (1996).

the companies, managers held no shares at all, and non-managerial employees held no shares in almost half of the companies in the sample. Managers and other employees had majority stakes in only 5% of the firms (Kozarzewski, 2002). Broad-based stock options are not used.[396]

b) Profit-Sharing

While no empirical research has been conducted in Poland to determine the extent of the use of profit-sharing schemes in practice, the opinion of experts is that they remain largely unused except for managerial employees. In fact, the so called *Tantiema* as a form of profit-sharing in practice seems to be used exclusively for managerial employees and the one bonus scheme linked to results, referred to in Polish as a '*bonus*' is not a widespread practice. The only relatively frequently used scheme is not a profit-sharing, but a gain-sharing scheme referred to in Polish as the *premia*[397], constituting a predetermined proportion of pay conditional upon fulfilling certain criteria usually stipulated in a regulation at enterprise level.

c) Workers' Cooperatives

As of 31 December 2001, 411,700 persons were employed in the cooperative sector, which represented 2.9% of employment; this was down from 642,000 at the end of 1995 (CSO, 2003, p. 147)[398]. However, employment in workers' cooperatives is now certainly much lower: as of 31 December 2002, while a total of 18,682 cooperatives were registered in Poland, only 2,208, or 11.8%, of them were industrial workers' cooperatives (CSO, 2003, p. 613). Although numerically their role in the Polish economy is comparable to that of the employee-owned companies which were created as a result of the process of privatisation of state enterprises (these companies are discussed in the next section), a great deal less research has been devoted to workers' cooperatives.[399]

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[396] Interviews with representatives of Poland's private equity and venture capital industry about the extent of such schemes in Poland were conducted for this report. The common reply was that options were used in Poland only for top management.

[397] See decision of the Supreme Court of 21 Sept. 1990, I PR 203/90, OSP No. 7-8/1991, Pos. 146 and of 15 Jan. 1991, I PR 382/90 – not published.

[398] This figure includes not only worker cooperatives but also, e.g., agricultural, housing, consumer, and credit cooperatives.

[399] This neglect is probably due in large measure to the fact that privatisation has occupied a great deal ainmore of the attention of researchers studying the Polish economic transformation than has the evolution of the cooperative sector, and, additionally, to the relatively small significance of workers' cooperatives in comparison with other forms of cooperatives such as agricultural, housing, consumer and credit cooperatives.

4. Evidence of the Effects of PEPPER Schemes

Empirical research on the effects of PEPPER schemes in Poland has been limited to 'Employee-Owned Companies' emerging from Leveraged Lease-Buy-Outs (LLBO).[400] The sample used in the first Jarosz research project (1993-1994) was a group of 110 companies selected from the population of companies privatised by the leasing method to the end of 1991 (constituting 56% of the entire population of firms privatised by this method by that date). The second project utilised a sample which included 110 firms privatised by the leasing method between 1990 and 1996. This constituted 12.9% of the total number of companies privatised by that method to the end of 1996. Other empirical research can only be described as anecdotal. In the first half of the 1990s, employee-leased companies were, on the whole, financially sound in spite of the burden of lease payments and the effects of the general recession which affected the country in the first three years of economic transformation. Profitability indices for the average Polish employee-owned company have been close to or better than the average indices for firms privatised by other methods, including commercial methods (see Annex Table 4). In the second half of the 1990s, the Jarosz group found gross profitability to be declining amongst employee-leased companies in their sample of privatised companies (see Annex Table 5).

In spite of the regular - and rather burdensome - lease payments to which a large portion of profits must be dedicated, thus limiting the possibilities of using retained earnings to finance investment, by the late 1990s the situation in employee-owned companies had improved noticeably. A 2000 State Treasury report lists these companies along with foreign-owned companies, publicly listed companies, and companies with domestic strategic investors in the group of companies with relatively high and stable rates of investment, contrasting them with state-owned enterprises, state-owned companies and companies privatised under the National Investment Fund programme, which had poor investment performance (Ministerstwo Skarbu Państwa, 2000, p. 52).[401] However, the authors did note that investment per employee and the ratio of investment to sales revenues was much lower in employee-owned and other domestically owned companies than in foreign-owned companies. The relatively high investment propensity of these companies is illustrated by statistics concerning investment of profits in the Jarosz sample of employee-owned companies in the years 1996-1998. 30-40% of the companies in the sample did not pay dividends in spite of having made

[400] Two research projects on LLBOs were conducted by an interdisciplinary team headed by Maria Jarosz of the Institute of Political Studies of the Polish Academy of Sciences – the first in carried out between June 1993 and June 1994 and the second from 1997 to 2000 – and were followed by an econometric analysis by Woodward using the data obtained by the Jarosz team in its studies. For detailed discussions of the results of these studies, see Jarosz (ed., 1994, 1995, 1996, 1999, 2000).

[401] However, the authors did note that investment per employee and the ratio of investment to sales revenues was much lower in employee-owned and other domestically owned companies than in foreign-owned companies.

profits, and among those companies which did pay dividends, the percentage which paid out less than 60% of profits in dividends was consistently over 70% in the years 1996-1998 (see Annex Table 6).

It is true, however, that in the early to mid-1990s restructuring and adjustment activity in firms privatised by the employee leasing method tended to be concentrated on increased promotional activity and adjustments of a simple, cost-reducing nature (e.g. employment reductions), involving little in the way of the introduction of new products or significant improvement in the level of technology (Pietrewicz, 1995, p. 51-52). Employee-owned companies showed a great deal of elasticity in their employment policies, often engaging in significant layoffs (in firms that were on average relatively small to begin with).[402] Employment restructuring was no longer needed in the second half of the 1990s, and greater economic prosperity brought increased employment.[403] Wage growth was found to be fairly high in the period immediately following privatisation but slowed down considerably thereafter, even failing at times to keep pace with productivity growth.[404]

Woodward has carried out two econometric studies of the effects of employee participation on productivity, using data from the two Jarosz samples. Measures of employee ownership included the percentage of the company's shares held by non-managerial employees, the percentage of the work force holding shares in the company, and the degree of equality of share distribution. There was also one measure of the participation of employees (or rather their representatives) in corporate governance; namely, the percentage of supervisory board members who had been non-managerial employees prior to privatisation. In both cases it would be justified to conclude that in Poland the failure to observe a strong relationship between employee participation and productivity is due to the managerialist culture of Polish enterprises and the resulting extremely limited scope for employee participation in decision-making, especially on the shop-floor level.

402 Average employment in the first Jarosz sample fell from 285 at the end of 1991 to 242 at the end of 1992 (i.e., a 15.1% decrease) and to 213 at the end of 1993 (a 12.0% decrease), stabilising somewhat in 1994 (average employment in mid-1994 was 209); Pietrewicz (1995), p. 29.

403 In the second Jarosz sample, average employment fell from 211 at the end of 1993 to 182 at the end of 1995, but then grew to 190 at the end of 1996 and 204 at the end of 1997 before dropping slightly again (to 198) at the end of 1998; Krajewski (2000), p. 127.

404 Thus, for example, in 1993, average productivity growth in the first Jarosz sample was about 2.9%, but real earnings decreased by about 1.9%, and by mid-1994 average earnings in the sample were below the national average (Pietrewicz, 1995, pp. 30, 34). In the second half of the 1990s the situation changed again. In the second Jarosz sample, average monthly earnings in employee-owned companies were well above the national average for the period 1995-1998.

Annex

Table 1: Presence of trade unions in Polish leverage-lease-buy-out firms

Trade union present in enterprise	Number of companies	
	at establishment	in 1994
Solidarność	33	19
OPZZ (post communist)	17	4
Other union	4	3

Source: Bukowski (1995).

Table 2: Polish leverage-lease-buy-out without trade unions, by year

	Number	Percent	N
At time of privatisation	24	30.8	78
1997	21	26.9	78
1998	47	43.5	108
1999	24	38.7	62

Source: Kozarzewski and Woodward (2001).

Table 3: Transformation matrix

	Had over 20% in 1997									
Had over 20% at time of privatization	No data	SI	***M***	***W***	**SMW**	SM	MW	SW	None	Total at time of priv.
No data	**5**	0	0	1	0	0	2	0	0	8
Strategic investor (S)	0	**3**	0	0	0	0	0	1	0	4
Exec. Bd. memb. (M)	0	0	**4**	0	0	0	1	0	0	5
Non-mg. workers (W)	3	4	2	**48**	0	0	5	3	4	69
All three	0	0	0	0	**1**	0	0	0	0	1
S & M	0	0	0	0	0	**0**	0	0	0	0
M & W	0	0	4	1	0	0	**12**	0	0	17
S & W	0	0	0	0	0	0	0	**1**	0	1
None	***1***	***1***	***0***	***0***	***0***	***0***	***0***	***0***	***3***	***5***
Total	9	8	10	50	1	0	20	5	7	110

Source: Kozarzewski and Woodward (2003).

The transformation matrix presented in Table 3 shows the transformation trajectory of firms grouped with respect to dominant shareholders (defined as shareholders or coalitions of shareholders – for example, top management together with a strategic outside investor – with at least 20% of the firm's shares) at the time of privatisation: in the rightmost column, we see the number of firms in each group at the time of privatisation, and looking leftward, we see where the firms in these groups ended up in 1997. The diagonal, in which the numbers are printed in boldface, shows firms that remained in the same group in which they started.

Table 4: Gross profitability (ratio of gross profit or loss to total revenues)

	1994	2001
Employee-owned companies	6.4	1.7
State enterprises currently undergoing Art. 37 liquidation	3.2	1.7
Capital-privatised companies	4.9	1.4
Commercialised companies participating in the NIF programme	4.2*	-4.0

Source: CSO (1995), p. 66; CSO (2002), p. 47. * Companies designated for participation in the programme.

Table 5: Gross and net profitability and losses in Jarosz sample of leasing companies, 1993-1998

	Gross profitability	Net profitability	Percentage of companies with losses
1993	7.7%	4.2%	5.5%
1994	7.5%	3.8%	6.0%
1995	6.5%	3.1%	6.5%
1996	6.9%	3.8%	8.5%
1997	6.1%	3.7%	20.4%
1998	3.2%	1.6%	37.9%

Source: Krajewski (2000), p. 132.

Table 6: Dividends in the Jarosz sample of leasing companies, 1996-1998

	1996	1997	1998
Percentage of companies paying dividends	50.0%	48.7%	32.0%
Of which: Percentage which paid out 60% or less of profits in dividends	78.0%	72.7%	75.8%

Source: Krajewski (2000), pp. 113-115.

Taxation Issues

With the rare - and very limited - exception of LLBOs[405] employee tax incentives for PEPPER schemes do not exist. Tax rates[406] are:

- a uniform 15% dividend tax rate,
- a uniform corporate income tax rate of 22% (decreasing from 28% in 2002),
- a progressive personal income tax ranging from 19%, and 30% to 40%.

[405] Allowing firms to include the interest portion of the lease payments as costs in their accounts, thus reducing their tax liability; see above 2.

[406] Law on Corporate Income Tax of 15 February 1992 (with subsequent amendments); Law on Personal Income Tax of 26 July 1991 (with subsequent amendments).

XI. Romania

The idea of employee financial participation in Romania is relatively new, apart from some pseudo schemes attempted under the communist regime. PEPPER schemes emerged during the early privatisation process when mass privatisation and insider privatisation via an ESOP-like scheme were the major privatisation methods. The prevailing form is employee share ownership, mainly by the ESOP method. Nevertheless, after more than ten years of transition, only 40% of the total number of large enterprises and around two-thirds of its medium-size enterprises are privatised. The number of state owned or state controlled firms in Romania is larger than the total number in the remainder of Central and Eastern European countries combined.[407] Since 2001 cash-based profit-sharing, referred to as 'The Fund of Employee Profit Participation", are compulsory in companies and in autonomous bodies with the state as single or majority owner. Although presently, the number of cases of profit-sharing is still limited, their number is increasing gradually.

1. General Attitude

Employee participation was initially introduced during the last decade of communist rule for propaganda reasons in the form of so-called social parts (shares) held by workers from the total amount of 'national capital'. The communist government decided that 30% of the development fund of each socialist enterprise had to be made up from the contributions of employees.[408] At least theoretically, the social part owner had the right to participate in the general meeting of employees and to vote on the strategic and daily business issues of the enterprise. In practice, employees were forced to contribute to the compulsory growth of the national capital stock by paying for the share from their own monthly wages. At the end of the communist regime, each employee, depending upon his or her contribution period, held a small part of the registered stock of the national capital. After December 1989, one of the first measures of the new

[407] According to the most recent available data (World Bank, 2004), at the end of 2003 there were about 1,300 state-owned enterprises and another 600 enterprises de facto under state control.

[408] The return of each social part was put at 6% per year if the socialist enterprise fulfilled the benefit target (similar to the net profit target), 8% per year if the benefit was larger than the target, and a minimum return of 5% per year if the socialist enterprise did not achieve its benefit target. The above rates of return remained in force until they were changed by the Communist state decision in 1987 from 6% to 4%, from 8% to 6% and from 5% to 3.5% per year respectively.

government (already criticised by some authors) was to return these accumulated assets ('social parts') to each employee as an amount of money; the remaining part of the capital, held by state enterprises, was to be privatised during the transition period. As a result, employee ownership was created on a new basis, mainly during the privatisation process where citizens obtained shares in the course of mass privatisation, insiders in firms privatised via an ESOP-like scheme and some employees in the course of minority interest sales. Compared to other Central and East European countries, Romania experimented with various alternatives of privatisation that took a long time to develop and a large privatisation agenda still remains today. After more than ten years of transition, only 40% of the total number of large enterprises and around two-thirds of its medium-size enterprises are privatised. According to the most recent available data, at the end of 2003 there were about 1,300 state-owned enterprises and another 600 enterprises de facto under state control. This number is larger than the total number in the remainder of Central and Eastern European countries combined (World Bank, 2004).

In many cases of privatisation of utilities and the oil and gas industry, employees purchase shares through trade unions since the unions are very strong and have substantial influence in these sectors and they have the right to appoint at least one member to the board of administration in these industries. In some cases (e.g. the sale of 8% of the social capital of the PETROM Company, representing a total value of about 200 million €) the trade unions tried to achieve an amendment of the relevant law, so that employees' associations controlled by the trade unions rather than individual employees become the purchasers of the offered shares. Such cases illustrate that the interests of trade unions and of their legal representatives are not necessarily in line with the interests of individual employees and that sometimes trade unions also tend to achieve their goals at the expense of employees' rights. Furthermore, the consultations and negotiations with trade unions[409] are important for employers because they still hold a very strong position within the tripartite council (National Social and Economic Council), which also includes the government and the employers' associations. Employers' associations[410] have not yet addressed the issue of financial participation of employees.

At present, the problem of the financial participation of employees is not given priority by the government or political parties. The last significant commitment by policy makers was in 2001 the introduction of the mentioned compulsory cash-based profit-sharing scheme, 'The Fund of Employee Profit Participation'. The only aspect of financial participation of employees currently addressed by the government is the sale of minority shares to employees in public enterprises where privatisation is underway in

[409] At present, employees are represented by a number of large trade union confederations, such as 'The Confederation of the Democratic Trade Unions from Romania', The National Trade Union Confederation 'Meridian', The National Trade Union Confederation 'Cartel ALFA', The National Trade Union Block, and The National Confederation of the Free Trade Unions from Romania 'Fratia'.

[410] The employers' associations are even more dispersed than the trade union movement, with eleven employers' associations registered.

such sectors as the utilities (or the so-called *Régies autonomes*), oil and gas and banking, but also such state companies as the National Lottery and the National Printing House. Due to the recent change of orientation in economic privatisation policy towards sale to strategic outside investors, including foreign investors government support is expected to be rather declining. Since, in some of these privatisation cases, trade unionists and representatives of political parties are suspected of insider deals and corruptive practices at the expense of employees, the credibility of governmental support for the financial participation of employees is considered by the general public to be relatively low.

2. Legal and Fiscal Framework

Currently, Romanian law does not contain a systematic legal framework regulating employee financial participation. However, several laws linked with the privatisation process were passed which had an impact upon the extent to which the concept of employee financial participation has been spread, with mass privatisation and an ESOP scheme being the major methods. The only legal regulations on profit-sharing are concerning a compulsory scheme in (majority) state owned companies to which National Labour Collective Agreements are applicable.

a) Share Ownership

Privatisation (1991, 1995, 1999) – The Romanian Privatisation Law 58/1991 set up a number of 30% of shares to be transferred for free applying different privatisation methods, with voucher privatisation being the main focus. Although Law 58/1991 did not provide incentives for insider privatisation in voucher privatisation, it contained regulations on preferential treatment for employees and management with regard to the sale of shares through the national Privatisation Agency (*Fondul Proprietății de Stat*). According to Art. 48 of Law 58/1991 on Privatisation, employees (including the management) of the respective enterprise had a pre-emptive right to purchase the offered shares on advantageous conditions. In the case of a fixed price sale the 'insider share price' had to be 10% lower than the public price; in the case of a sale by means of competitive bidding the insider offer had to be accepted by the Privatisation Agency as long as the offered price is not lower than 90% of the highest public bid. This preferential treatment was also extended to the direct sale procedure where the insider offer had to be accepted by the Privatisation Agency in the case of an equal negotiation result with other interested parties. In 1999 the law was amended and in privatisations transactions a share of 8% from the social capital is compulsory sold to employees, pensioners having their last job in the company, members in the General Association of Employees[411] or in the Board of Directors.

By means of Law 55/1995 on the Acceleration of the Privatisation Process, the aim of the 30%-quota was re-emphasised, the privatisation agency established a list of suitable enterprises and issued the so called 'nominal value vouchers for privatisation' (*cupoane nominative de privatisare*) to be spread amongst the resident population.[412] For the first time, this new law contained a real incentive for employee financial participation in voucher privatisation. While the general public owning the aforementioned nominal value vouchers for privatisation could trade their vouchers only for shares of companies to be chosen from a list of suitable enterprises issued by the privatisation agency, Art. 5 of Law 55/1995 on the Acceleration of the Privatisation Process offered the opportunity for certain persons to acquire shares of non-listed companies in exchange for their vouchers. This was possible for employees and the management of state companies who were interested in exchanging their vouchers for shares of the company they were employed by.[413] The same privilege was granted to former employees (pensioners or the unemployed) who had their last employment contract with the respective firm. In addition this opportunity was open to farmers with continuous economic relationships with companies of the agricultural sector (dairies, slaughter houses and other agricultural processing enterprises) without being actually employed by these companies.[414]

Employee Stock Ownership Plans (1992, 1994, 1997) – ESOP associations root in Rule 1/1992 on the Standard Procedure for the Privatisation of Small Enterprises by the Sale of Shares which came into force in January 1993. Although focused on the privatisation of so-called 'small enterprises'[415], this regulation defines insider privatisation via an ESOP-like scheme as the standard privatisation procedure. This ESOP-like privatisation had to be implemented by means of direct negotiations with interested employees and management staff, having priority over the second method which is defined as a more or less public tender procedure. The procedure is aimed at selling either all or at least a majority part of the shares to employees. However, the shares

411 In Romanian: AGA – Asociatia Generala a Angajatilor.

412 Only persons who had not made full use of their property vouchers received according to Law 58/1991 were granted the new vouchers for privatisation. The main difference to the old system was that the new vouchers were not tradable. Furthermore, the new vouchers could only be exchanged for the shares of just one company while the old property vouchers could still be used for the purchase of shares of one or more different companies.

413 Art. 5 lit. a) and b) of Law 55/1995 on the Acceleration of the Privatisation Process.

414 Art. 5 lit. e) of Law 55/1995 on the Acceleration of the Privatisation Process. This last provision accounts for the economic situation of farmers which is in some respects similar to that of employees (e.g., strong dependency on certain regional processing enterprises with regard to their respective production focus).

415 The maximum size of these enterprises is determined by the number of persons employed on average within the reporting year which is set at 50 employees; see annex 2 of Government Decision 10/1992 on the Approbation of the Statute of the Privatisation Agency, published in M. Of. 208/1992.

were not acquired directly by participating employees but by an incorporated association of share owners.[416] Law 77/1994 on Associations of Employees and Members of the Management in Companies in the Privatisation Process provided the specific regulations required for widespread use of this ESOP privatisation model. It allowed employees and the management of partly or fully state owned enterprises which were to be (fully or partially) privatised to establish ESOP associations.[417] The number of ESOP associations was limited to one for each enterprise to be privatised, so any competition between associations over the purchase of one specific enterprise was excluded by law. Membership of the ESOP association was voluntary, but it was also a precondition for making use of the advantages and exclusive rights with the result that every employee seriously considering the purchase of shares had to become a member of the respective association. While the voucher privatisation came to an end (no more new vouchers being issued while the tradability of the old vouchers was restricted by several legal deadlines), the legislation on ESOP associations remained in force for the most part. In this context, Emergency Ordinance 88/1997 only defines a rough legal framework for the employee shareholder associations and refers for the details to the general legal provisions governing associations and foundations.[418]

The law states that a minimum of 30% of the total number of employees and management staff have to participate in establishing the ESOP association. ESOP associations can only perform activities listed by law 77/1994; as already mentioned above, the associations were granted specific rights in the privatisation process which offer advantages to insiders. The enterprise has to disclose all relevant commercial and financial information to the founding committee of the association; also the costs for a feasibility study in the preliminary stages of the buy-out have to be borne by the enterprise. The ESOP association buys and administers the shares for its members. The membership is open to employees with unlimited labour contracts with at least half-time employment and to members of the management of the respective enterprise. Furthermore, former employees, both unemployed and pensioners, belong to this privileged group.[419] The main decision-making body of the association is the general meeting in which each member of has one vote. The general meeting decides upon the ESOP associations Articles of Association which must contain strict rules with regard

[416] This association is called 'Programul acţiunlor salariaţilor' [Employee's Share Programme]. When the law came into force there was no special legislation governing this specific kind of association, therefore the old Law 21/1924 on Legal Entities was applied special regulations came into force.

[417] So-called management and employee associations; the Romanian term is 'asociaţiă salariatilor şi membrilor conducerii'.

[418] Laws 58/1991, 77/1994 and 55/1995 have been merged into a single privatisation law by Emergency Ordinance 88/1997 which came into force on the 1 January 1998 which itself has been modified several times (the last significant modifications brought by Ordinance 36/2004, M. Of. No. 90/2004).

[419] For details see also Art. 3 of Law 77/1994. Besides the above mentioned category of farmers and agricultural workers persons with continuous economic relationships with companies of the agricultural sector - dairies, slaughter houses and other agricultural processing enterprises - without being actually employed by these companies may become members of the employee's association.

to the distribution of shares purchased by the association. This privatisation procedure, initially for small enterprises, was aimed at selling all or at least a majority part of the shares by means of the ESOP method, thus the result of a successful privatisation under this regulation was also the acquisition of the majority voting rights for the benefit of the participating employees. However, as the shares obtained via instalment options are not acquired directly by employees and management staff but by the interposition of an association with an autonomous legal personality, the voting rights are also exercised by the ESOP association. The extent of participation in decision-making therefore depends upon the decision-making procedure inside the association and the way the members' decisions are transferred to the shareholders' meeting.

The ESOP association may purchase the shares as a representative of individual members. In this case the shares are distributed directly to members and administered by the members themselves once they fully pay up for the shares with cash or offer privatisation vouchers in exchange for them. Yet the main advantage of the ESOP association scheme in comparison to the individual purchase of shares is the use of the credit facilities offered either by the Privatisation Agency itself or by external banks. In this case the shares are not bought in representation of individual members but in the name of the entire association; the shares are not vested directly to individual members, but kept by the association until they are not entirely paid for, serving as credit securities during this period. The ESOP associations' members have pre-emptive rights concerning the unvested shares taking in consideration criteria like employment duration, position in the firm and salary. In case the right of pre-emption is not exercised by members, the respective shares may be distributed to new employees of the enterprise. As soon as all shares are distributed to the members, the association has to be dissolved. Law 77/1994 additionally offers preferential instalment options[420] for shares purchased by ESOP associations. This starts with a low advance payment and is complemented by a minimum repayment period of five years and a maximum interest rate of 10% per year. Against the background of a high inflation rate during the 1990s, the interest rate limit especially turned out to be remarkably advantageous.

Private Companies – The legal framework with regard to Romanian company law is defined by law 31/1990[421] on companies, republished in November 2004 and recently modified (October 2005).[422] Romania has only partially made use of the tools/exceptions offered by the Second Council Directive 77/91/EEC of 13 December 1976 to promote employee financial participation by means of corporate legislation. Regarding the permission to acquire the companies' own shares for its employees (Art. 19 III Council Directive 77/91/EEC) Art. 104 lit. b) the Law on Companies offers an exception with respect to the acquisition of shares for the workforce of the

420 Regarding Art. 52 of Law 77/1994 the Privatisation Agency is bound by these conditions. Furthermore, the Agency has to accept a certain amount of privatisation vouchers (property vouchers) in exchange for the shares to be transferred.

421 M. Of. No. 33/1990.

422 The most recent amendment/modification incorporated here was by Law 302/2005, published in M. Of. No. 953/2005.

company; this regulation is in contrast to the restrictive general regulation for this kind of transfer in Art. 103 Law on Companies, which requires an extraordinary shareholder's meeting in the case where the company intends to acquire its own shares. The second exception the Romanian legislator made use of is Art. 105 III Law on Companies based on Art. 23 Council Directive 77/91/EEC (the encouragement of share acquisitions by employees by permission to advance funds, make loans or provide security, with a view to acquisitions). While Art. 105 Law on Companies specifically prohibits any advancement of funds, the issuing of loan schemes or the providing of securities with the purpose of encouraging the acquisition of shares by any third party, para. III of this article provides an exception to this rule when the shares are purchased by employees of the company. Additionally, there are some provisions protecting the rights of minority shareholders.[423]

b) Profit-Sharing

In 2001 the government passed Ordinance 64/2001 on the Repartition of Profits Obtained by State and Municipal Companies with the State as Single or Majority Owner.[424] The regulations covers state or municipal enterprises which are either constituted in the legal forms provided for by Law 31/1990 on Trading Companies, with the state as single or majority owner, or in a specific legal structure which is still widely in use in relation to public utilities.[425] The ordinance regulates the details of profit distribution, such as reserve funds, payouts to owners and the coverage of losses from previous years. In Art. 1 lit. e), the ordinance also contains a provision which sets the maximum payout rate for employee profit-sharing at 10% of the overall profit of the enterprise (10% in the case of companies, or 5% in the case of autonomous bodies, depending upon employees performance and contribution to the financial results).[426] There is currently no provision regarding a minimum rate and it should also be noted that the number of state firms actually making a profit is still low. Nevertheless, Ordinance 64/2001 is one of the few laws expressly dealing with the issue of employee profit-sharing. Against the background of the pronounced encouragement of ESOP

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423 I.e., preference shares without voting rights are limited to 25% of the total share capital; the number of votes attached to one share may be limited only for the holders of more than one share; a shareholders' meeting has to be called on the request of shareholders representing a minimum of 10% of the total share capital; various information rights with regard to accounting issues; and the right to apply to court for a detailed financial audit by shareholders representing a minimum of 10% of the total share capital. Currently, there is no squeeze-out or sell-out regulation in Romanian company law.

424 Ordinance 64/2001 on the Repartition of Profits Obtained by State and Municipal Companies with the State as Single or Majority Owner, published in M. Of. No. 536/2001; the regulation abrogated earlier regulations, e.g., Ordinance 23/1996 on the same issue.

425 This form is called regiă autonoma and is governed by specific regulations.

426 Supplemented by Governmental Disposition No. 298/25 February 2002 for the approval of the explanatory note regarding the establishing of the amounts making the object of the profit repartition conforming to the Governmental Ordinance No. 64/2001 and their reflection in bookkeeping – published in the M. Of. No. 157/2002.

privatisation schemes, profit-sharing in companies privatised this way[427] should be widespread as a side effect of share ownership. As the ESOP privatisation policy particularly favoured the sale of smaller enterprises to employees and management, profit-sharing schemes should be over-represented in the sector of small and medium sized firms.

c) Cooperatives

The recently revised Law on Cooperatives[428] reiterates the important role of cooperatives in the Romanian economy. According to the new Law on Cooperatives, there are now two types of cooperatives. While the so called 'type I'-cooperatives consist exclusively of physical persons, 'type II'-cooperatives provide a legal structure for the merger of 'type I'-cooperatives into larger legal entities. The Law determines that every member has one vote at the general meeting irrespective of the number of cooperative shares actually held by the member. For the newly introduced 'type II'-cooperatives[429] the Law even limits the maximum share held by one cooperative member to 20%. Both measures are aimed at limiting the economic influence of single cooperative members and preserving the democratic decision making structures inside cooperatives. Liability is generally limited to the cooperative capital; this may be exceeded in certain cases of civil or penal liability. Profits are distributed in accordance with the participation structure taking into consideration the labour contribution of the respective member.

d) Participation in Decision-Making

While the old legislation before 1990 emphasised employee participation in decision-making in an almost redundant way[430], the privatisation laws passed since 1990 contain no special regulations concerning this issue. Also the notion of employees' co-determination, ie like in German law, was not introduced. The Company Law does not provide any legal means for the privileged participation of employees in decision making. However, it contains various provisions protecting the interests of minority shareholders. The new Labour Code of 2003[431] as well as the nation-wide collective agreement with trade unions of 2005[432] contain regulations for some compulsory con-

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[427] For details see above Chapter 2 a) ESOP.

[428] Law 1/2005 on Cooperatives, M. Of. No. 172/2005.

[429] This new type is designed as a sort of parent cooperative which has several type-1 cooperatives as members and is aimed at increasing the economic significance of cooperatives in certain trade environments.

[430] The old Labour Code from 1972 alone mentions this concept in more than 20 articles, admittedly with virtually no implications in practice.

[431] Law 541/2003 on the Labour Code, M. Of. No. 913/2003.

[432] The validity period for the current agreement is the years 2005 and 2006. The content is accessible via the website of the Ministry for Labour, Social Security and Family issues (<http://www.mmssf.ro/>).

sultation procedures to be carried out if changes to labour conditions are planned by the management.

3. PEPPER Schemes in Practice

Share ownership is by far the most popular form of employee financial participation, while the concept of employee profit-sharing is still scarcely used in practice.

a) Share Ownership

Mass privatisation – Mass privatisation is characterised by the distribution of vouchers of ownership to citizens, held in private funds representing 30% of the privatised company's capital stock. Early voucher privatisation did not lead to a significant spread of employee ownership amongst the population. The two main opportunities to use the property vouchers were to swap them for shares in privatised companies within a period of five years or to sell them, as they were freely tradable. This last opportunity was extensively used by the population. As the initial process was not a success and some people accumulated a significant amount of the total number of vouchers issued, a new form of mass privatisation with privileges for insiders was introduced. Nevertheless, only in a limited number of cases, when they were organised within a strong employees' association, did the employees use their vouchers to buy a large amount of shares and become important shareholders.

Employee Stock Ownership Plans – In a classification provided by the EBRD (2002), ESOP is noted as the primary method of privatisation in Romania. This method of privatisation has been used most frequently since the start of transition (World Bank, 2004). Privatisation by ESOP started even before the mass privatisation programme, its heyday was in 1995-1996 and continued into 1997, when the practice largely ceased. It is estimated that, by the end of 1998, over a third of all industrial firms in the State Ownership Fund had undergone ESOP privatisation (with average employee ownership of 65%). In addition, ESOP participants were the largest owner group in one-fourth of Romanian privatised firms, which makes this method the most important tool of state ownership divestiture in the country (see Earle and Telegdy, 2002; also Annex Tables 1-3). However, when the Romanian legislative adopted regulations on ESOPs in 1994, it also introduced legislation encouraging mass privatisation with more favourable taxation regulations. This drastically reduced new opportunities for employee ownership through ESOPs. Two features of the process made it unique in the region (Earle and Telegdy, 2002; World Bank, 2004): 1) the ownership share that went to insiders (ESOP privatisation) was very large – 65% on average, with a median employee ownership of 71%. To the extent that there was any outside ownership, mostly through residual mass-privatisation shares, it could play no role in corporate governance; and 2) usually, the entire stake was transferred to employees, so the method should really be considered as employee buy-outs.

Minority Interest Sale to Employees – After 1999, the method of selling a minority interest to employees was introduced in order to involve the employees in the privatisation process of major companies; often there were some schemes of preferential treatment for employees in individual enterprises. The stake size was between 8% and 10% of the total number of shares issued at the time of privatisation. The Privatisation Law did not offer an instrument for participation in the decision-making process to employees. In addition, the current privatisation legislation favours strategic investors because the State Ownership Fund is aiming at increasing the share capital by the amount of the investment engaged. This resulted in a continued and irreversible reduction in the importance of minority shares held by employees or other small shareholders. In these circumstances, the majority of employees were encouraged to sell their own shares. In the case of privatisation of utilities and the oil and gas industry, employees purchase shares through trade unions because they are very strong and have substantial influence in these sectors. Moreover, trade unions have the right to appoint at least one member to the board of administration in these industries.

b) Profit-Sharing

The most common scheme is cash-based profit-sharing used in the public sector as a 'Fund of Employee Profit Participation' created in state owned companies in order to allocate 5-10% of the net profit for distribution to employees depending upon their performance and contribution to the final financial result of companies. It is mainly used in the banking and insurance industries, mining industry, aluminium industry, etc. This scheme and its derivative versions applies to 'national' public utility companies, the so called *regiă autonoma,* a specific legal structure which is still widely in use in relation to public utilities as well as all companies in which the state holds a majority share and thus is estimated to cover more than one million employees. As an average proportion of labour costs, at a national level, net profit directly paid to employees in 2003 was about 2.2%, while 70.3% was distributed from salary funds, including premiums and benefits.[433]

c) Cooperatives

Workers' cooperatives established before 1989 are still present in the Romanian economy. Cooperatives have been part of the national economy since the second part of the 19th century. Cooperatives first emerged in urban areas in the 1860s, being organised as private associations of savings and loans or as loan cooperatives. After 1903, special cooperative laws were adopted in order to regulate the organisation of various

[433] Although compulsory, interview evidence reported, that in practice it is seldom applied and, if applied, concerns a rather small number of employees.

types of cooperatives. After the First World War, a new cooperative law was introduced which strengthened state control of the cooperative system. In 1935, the government established several central control institutions. In 1948, when the Stalinist government came into power, new national cooperative associations were established in order to integrate cooperatives into the planning apparatus of the communist state. Formally, the old cooperatives remained in place, but many of their fundamental principles were altered. In the first years of transition, there were no important changes in the cooperative system except the liquidation of the National Union of Agricultural Production Cooperatives. Also, the system of credit cooperatives (reinforced by Law 109/1996) was involved in several financial scandals related to the bankruptcies of so-called popular banks.

After 1989 cooperatives (especially handicraft cooperatives) registered an accelerated decline, in the number of their members, their fixed assets, and in the volume of economic activity. For instance, in the period 1991-1997 the share of cooperative ownership in total tangible fixed assets declined from 1.2% to 0.3% (after 1998 published data included cooperatives in the 'private sector'). As official published data shows, between 2000 and 2003 the share of cooperatives in total employment decreased from 0.4% to 0.2%. According to the Household Labour Force Survey 2003, agricultural holdings and cooperatives had approx. 17,000 members in the reporting year.

4. Evidence of the Effects of PEPPER Schemes

In Romania, there are no statistics, surveys or case studies regarding the economic performance of different ownership structures. Only at the level of the whole private sector there are available statistical data.[434]

[434] Due to the extension of privatisation process, the share of private enterprises in national economy increased continuously. In 2003, the share of the private sector in GDP was 70.4% and in the total number of employees of 63.2%. Private enterprises showed a higher productivity than state enterprises.

Annex

Table 1: ESOP associations in privatisation in Romania, 1992-2000:II

	1992	1993	1994	1995	1996	1997	1998	1999	2000:II	Total
Number of firms	19	249	565	479	509	378	267	336	46	2,632
Mean percent privatised	87.5	98.9	97.1	79.8	43.7	37.3	49.0	57.3	57.5	70.8
Median percent privatised	100.0	100.0	100.0	95.0	40.0	40.0	42.0	52.0	66.0	73.0
Number majority privatised	16	247	553	376	113	21	105	183	27	1,652

Source: CEU Labour Project privatisation database, Earle and Telegdy (2001).

Table 2: Post-privatisation ownership structure, by year (average percent of shares weighted by employment)

	1992	1993	1994	1995	1996	1997	1998	1999	2000:II
ESOP participants	0.4	4.0	10.8	21.2	25.3	26.2	27.5	29.8	30.4
MPP participants	0.0	0.0	0.0	0.0	17.6	17.6	17.6	17.6	17.6
Outside investors, of which:	0.3	0.5	0.8	1.9	2.7	5.1	9.2	16.3	20.1
- Domestic individuals	0.1	0.1	0.1	0.1	0.2	0.4	0.8	1.8	3.4
- Domestic institutions	0.2	0.2	0.4	1.1	2.1	3.3	5.0	8.8	11.0
- Foreign investors	0.0	0.2	0.3	0.4	0.4	1.4	3.4	5.7	6.7
Others	0.0	0.4	0.8	1.2	1.6	2.0	2.6	3.2	3.3
Total Private	**0.8**	**4.9**	**12.4**	**24.0**	**47.3**	**50.8**	**56.9**	**66.8**	**72.3**
State	69.5	66.8	61.7	53.5	43.5	40.2	34.5	25.1	19.7
POF/SIF	29.8	28.3	25.9	22.5	9.2	9.0	8.6	8.1	8.0

Source: CEU Labour Project privatisation database, Earle and Telegdy (2001). Notes: Number of firms: 7,307. 'Others' refers to privatisation transactions with non-identified owners. Employment figures from 2000. 'MPP' means Mass Privatisation Programme.

Table 3: Post-privatisation ownership structure, by year (average percent of shares weighted by book value)

	1992	1993	1994	1995	1996	1997	1998	1999	2000:II
ESOP participants	0.0	0.3	1.1	4.7	6.9	7.3	8.1	10.0	10.5
MPP participants	0.0	0.0	0.0	0.0	15.1	15.1	15.1	15.1	15.1
Outside investors, of which:	0.0	0.0	0.1	0.6	1.8	4.4	8.5	18.4	24.2
Domestic individuals	0.0	0.0	0.0	0.0	0.0	0.1	0.3	1.7	3.2
Domestic institutions	0.0	0.0	0.1	0.5	1.7	2.9	5.0	9.7	12.5
Foreign investors	0.0	0.0	0.0	0.1	0.1	1.4	3.2	7.0	8.5
Others	0.0	0.3	0.7	1.0	1.4	2.0	2.6	3.3	3.3
Total Private	**0.0**	**0.7**	**1.9**	**6.4**	**25.2**	**28.9**	**34.4**	**46.8**	**53.2**
State	70.0	69.7	69.1	66.1	61.5	58.2	53.3	41.5	35.2
POF/SIF	30.0	29.6	29.0	27.6	13.3	12.9	12.3	11.7	11.6

Source: CEU Labour Project privatisation database, Earle and Telegdy (2001). Notes: Number of firms: 7,418. 'Others' refers to privatisation transactions with non-identified owners. Book value from 2000. 'MPP' means Mass Privatisation Programme.

Taxation Issues

With the new Tax code of 2003[435] and several amendments introduced by the new centre-right government in 2004[436], taxation has become an area not only of rapid change, but also of some thorough simplification and reduction in applicable tax rates. As part of this policy the number of tax quotas has been reduced, while a general tendency of convergence was developed.[437] As a side effect of this policy the applicable quotas are less different from each other. The actual rate for taxation of income from dividends is 10%[438] while the general income tax rate is 16%. The uniform rate is also applicable to every form of income from profit-sharing schemes. This also implies that there is less space for the promotion of specific investment forms by means of a different design of tax quotas.

435 The Tax Code of 2003 covers about 95% of all taxes in Romania, M. Of. No. 571/2003.

436 Emergency Ordinance of the Government 123/2004 on the Modification of the Tax Code, M. Of. No. 1154/2004, which came into force on 1 January 2005.

437 So a flat income tax rate of 16% has been established, which covers almost all kinds of income with very limited facilities for deduction.

438 The same rate applies to income from investment funds.

XII. Slovakia

In spite of political declarations during the mid 1990s, in reality, PEPPER schemes have not played any notable role and financial participation has remained marginal. In general, the environment for employee participation was more favourable than in the Czech Republic as the major difference driving this claim occurred in the privatisation design in Slovakia that was revised after the split of Czechoslovakia in December 1992. Starting with a focused policy favouring the voucher scheme, the new government changed to traditional privatisation methods - in particular trade sales but also insider privatisation - in its second privatisation wave. The populist government in the mid-1990s used employee shares as an appendix together with managerial types of privatisation to assure the smooth property transfer to closely-related parties. However, the subsequent reformist government abolished this system and from 1998 the *Dzurinda* government focused on the revenue oriented privatisation of the remaining state enterprises which included telecommunications, gas utilities and large banks. The private ownership structure which emerged is totally dominated by external types of ownership or managerial ownership with a relatively small cooperative sector.

1. General Attitude

In 1989 Czechoslovakia had one of the smallest private sectors in the communist world, employing only about 1.2% of the labour force and producing a negligible fraction of the national output (all estimates are well below 3% of GDP). After the fall of communism, the necessary macroeconomic reforms took place; however, they contributed to the split of Czechoslovakia in 1993. During these reforms privatisation was begun, but its outcomes were only realised after the split and therefore the Czech and Slovak Republics followed slightly different paths. After the break-up of Czechoslovakia in 1993, Slovakia underwent difficult times during *Meciar*'s reign followed by political and economic stabilisation since 1998. The resulting corporate governance and structure of enterprises are still driven by the pre-1993 conditions as well as political development during the *Meciar* government. In both countries the design of privatisation was adverse to the creation of significant employee ownership and only a small share of GDP continued to be produced by industrial cooperatives. As in the Czech Republic the roots of this development are mainly to be found in the historic starting point at the beginning of ownership transformation. The attempts at political and economic reform in Czechoslovakia were terminated by the Soviet invasion in 1968. The country faced a strong central presence in state owned enterprises and very weak, obedient official trade unions. In Czechoslovakia workers had little if any power within state enterprises; even under the partial reforms of 1988/89 employee participation remained extremely weak and the state planning authorities were still entitled to impose obligatory requirements on the enterprises.

Slovak large-scale privatisation, similar to the Czech Republic (due to its common origins), was the most important privatisation programme and the driving force of future developments in Slovakia. Large-scale privatisation techniques were similar to those described in the Czech Republic (or Czechoslovakia).[439] The privatisation in the early 1990s created employee shares to a very limited extend which were rarely used. After the break-up of Czechoslovakia, the voucher method was abolished and all steps in the second wave were nullified. Instead, the entire remaining large-scale privatisation has executed via non-transparent direct sales in the mid-1990s, preferably to close supporters of the leading political party. Citizens were given treasury bonds instead of the originally intended shares and each participating citizen received the same amount of governmental bonds.

Current and past general attitudes towards employee participation can be characterised as 'unsuitable for Slovak economics'. External ownership is the most preferable form of ownership and no incentives to encourage different types of ownership or employee participation are provided. A possible explanation might be a pervasive notion of the positive effects of (mainly foreign) external owners on the performance and profitability of firms. Surveying past and recent literature on enterprise sector development and corporate governance in Slovakia reveals that there is no professional or public interest in employee participation. In particular, there is not even a mention about insider ownership shares; at best managerial ownership and buy-outs are dealt with. In general, attitudes toward employee participation are similar to the situation in the Czech Republic. The trade unions as a whole also seem uninterested: the only document on the website of the Confederation of Trade Unions of the Slovak Republic that mentions employee shares is about social dialogue, not about shares as a form of corporate governance; the occurrence is only casual, and does not seem to bear any weight at all.[440]

As described in Kotrba (1995), labour-management played a significant role in the Social Democratic Party's election programme in both the 1990 and 1992 elections. Employee Share Ownership Plans (ESOPs) were an important element of the 1992 programme of the 'Liberal Social Union' and also included in the programme of the Communist Party. And last, but not least, until the summer of 1990, ESOPs were discussed within the government and employee ownership was listed as one of the privatisation methods in some early 1990 government documents. Not until the rise of the system of non-transparent direct sales established under the *Meciar* reign were man-

439 The general pattern was preserved: auctions and tenders were used for small firms; medium-sized firms were usually sold by tender and the largest corporations were transformed into joint stock companies with their shares either distributed during the voucher privatisation, sold (either in various tenders or to a predetermined owner) or transferred for free.

440 See <http://www.kozsr.sk/sk/twinning.html>.

agement employee buy-outs (MEBOs) for a short time to become a topic in the political discussion.

Today, political parties seem to ignore this issue with the exception of the Communist party which explicitly mentions employee shares; however the programme is from 1994 and has not been modified since then. Based upon these, partly anecdotal, pieces of evidence we claim that the possibility that employee shares will become a focal issue of government economic policy in the near future is unlikely, as it is of interest only to the far left of the political spectrum and not of interest to the trade unions, government or general public. Current national policy prefers foreign ownership. Overall, which form of privatisation is to be deployed is not an issue as after the first sale the ownership is endogenous and because of the revenue and market gaining prospects a foreign investor is considered to be the best option. The top priorities of national policy are taxes, the social benefit system and foreign investments. Employee participation is not on the agenda of any significant political force (including the unions). A possible explanation might be the bleak labour market situation. Even after 15 years of economic transition the unemployment rate is still at the level of two digits (in July 2005: 15.2%). Neither *Meciar*'s, nor the reformist's government of *Dzurinda* since 1998 has succeeded in bringing unemployment down below 10%, but lately, the rate has been decreasing.

2. Legal and Fiscal Framework

At present under Slovak law - similar to the Czech Republic - specific employee financial participation programmes or a particular law or regulation created to regulate specific issues concerning PEPPER schemes do not exist. The only form of employee participation in the ownership structures of corporations covered by general laws have been – to a limited extent – regulations on the acquisition of shares by employees and profit-sharing in joint-stock companies.

a) Share Ownership

Privatisation (1990; 1995, abolished 1996) – Under the *Meciar* reign insider privatisation was permitted with its own special programme, which foresaw the participation of employees of established companies as well as the issuing of employee shares.[441] Despite the promise of the programme, [442] and the legal concept the programme launched by the Ministry of Privatisation was never successfully implemented due to political

[441] The so-called 'Principles of Implementation of Workers' Participation in the Privatisation of Enterprises', materials prepared by the Minister of Privatisation *Peter Bisak* to be presented to the government, unpublished, Bratislava, May 1995.

[442] See Baláz (1994) and Prno (1993) reflecting the public discussion.

hurdles (see Mikloš, 1995, p. 22 f.) and a shift in power from the Ministry of Privatisation to the National Property Fund.[443] The Slovak Republic National Council Act No. 192/1995 was the basic legal act, accelerating primarily direct sales, simultaneously subsidising domestic entrepreneurs, and enabling them to participate in the privatisation process under favourable economic conditions. Direct sales were to be used for enforcing employee ownership, obliging the transferee either to issue employee shares that accounted for 10% of the companies' equity capital or to enable employees to acquire at least a one third[444] stake in the transferees' equity (SNAZIR, 1997, p. 10). Instalment payments scheduled for 5-10 years with the first instalment at about 20% of the purchase price were foreseen in order to off-set the domestic financial capital shortage.

Private Companies (1989, 2001, 2004) – In 2001[445] the concept of genuine 'employee shares' as a special type of share was abolished in favour of the possibility for joint-stock companies to include rules in their statutes under which their employees may buy company shares at a discount. According to § 768c para. 17 Commercial Code[446] (hereinafter CC) previously issued 'employee shares' had to be converted into regular shares by a decision of the general shareholders assembly by January 2004 (Moravčík et al., 2004, § 768c para. 17 CC, p. 1287 ff.). In the case where the conversion requirement was not met, § 768c para. 14 CC foresees the possibility of the liquidation of the company by court decision. § 204 para. 4 CC introduced the possibility of the acquisition of shares on preferential conditions to replace 'employee shares'. The general prohibition for a company to acquire its own stock which is regulated in §§ 161a and 161 f CC is in principle an obstacle to the introduction of employee shares (Moravčík et al., 2004, § 209a CC, p. 694). However, the corporation charter can allow that, pursuant to the rules laid down in § 161 a para. 2 lit. a) CC, introduced in 2004, a company can acquire its own stock with the aim of transferring them to its employees; those shares have to be transferred within 12 months of acquisition by the company. Furthermore, under the current legislation joint stock companies may issue new shares granting employees favourable conditions in the context of so-called mixed capital increases according to § 209a para. 1 CC, i.e. the capital increase of a company issuing new stock financed by the companies' own capital. § 209a para. 3 CC stipulates that in such a case the purchase price has to be paid according to the deadlines specified in the general shareholders assembly's decision. However, according to § 204 para. 4, the general shareholders assembly can decide that a certain number of those shares can be offered to employees at a lower price than the emission price; the difference shall be paid from the own resources of the company.

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443 Law No. 190/1995 Z.z.

444 A twist appeared in this year, when all the privatised firms were required to issue 34% of their share capital in employee shares: This requirement was abolished within half a year and the privatisation law then only mentioned an option to issue employee shares, not a requirement to do so.

445 Law 500/2001 Z.z., effective as of 1 January 2002.

446 Of November 5, 1991, Sb. 1991 No. 513; last amended by the Law of April 3, 2005, Sb. 2005, No. 315.

In order to facilitate the acquisition of shares by employees the legislator has provided the possibility that a company may fully pay for the stock which is acquired by the employees of the company. § 204 para. 4 CC states that a prerequisite to the preferential conditions for the purchase of shares by employees is, that the volume of the overall value of the granted discount for the issued shares has to be covered by the company's own resources (Moravčík et al., 2004, § 204 CC, p. 674). The terms will be decided by a general shareholder's decision. In the case of the aforementioned mixed capital increase, applying § 204 para. 2 CC and in analogy to § 209a para. 3 and 5 CC, the total discount may amount to 70% of the share price provided that the remaining 30% is paid by the employees at the moment of the transaction, unless the down payment for the acquisition is financed otherwise (Moravčík et al., 2004, § 204 CC, p. 674 f.). In fact § 161e para 2 CC, introduced in 2004, contains an additional regulation permitting the company, in deviation from the general prohibition to leverage the acquisition of own stock, to do so in order to facilitate the acquisition of shares by employees of the company (Moravčík et al., 2004, § 161e CC, p. 574). The company may give loans to their employees in order to acquire newly issued shares or to buy them from third persons as well as guarantee such loans from third persons provided for that this does not endanger the company's own funds. Thus the acquisition of shares by the employees of a particular company may be accomplished by the company by discounting the purchase price, by providing credit and financing, by acting as guarantor or by a combination of all three preferential conditions.

b) Profit-Sharing

There is no prohibition in the Slovak legal system with regard to profit-sharing by companies with their employees. However, the only explicit regulation is provided for by § 178 para. 4 CC which states that – in accordance with the corporation charter – employees may be entitled to a share in the company's profits (Cash-based profit- sharing). The corporation charter or the general shareholders assembly may also stipulate that the part of profits that is allocated to the employees is used exclusively to purchase shares on preferential conditions or to make up the discount granted to employees in such a purchase (Share-based profit-sharing) (Moravčík et al., 2004, § 178 CC, p. 609 ff.). Furthermore, share-based profit-sharing is mentioned in the context of capital increases. As a rule a capital increase requires the decision of the general shareholders assembly, but § 210 CC – in accordance with the corporation charter – foresees delegation to the management board. § 210 para. 4 CC regulates a capital increase by the issuing of shares to be transferred on preferential conditions to employees. It stresses this possibility especially in the case where the general shareholders assembly has previously decided that the part of the profits that it allocates to employees is used exclusively to purchase these shares. All those benefits will be subject to personal income tax of 19%.

c) Cooperatives

Cooperatives were being treated in a separate programme and were not subject to mass privatisation. At the end of 1991, Czechoslovak Parliament passed Law Number 42, known as the 'Transformation Law'. Although the practical application of the Transformation Law brought foreseeable problems to agricultural cooperatives for several years, the change towards new modern market conditions continued. The old cooperatives were either being wound up, or transformed into new cooperatives having their own goals based upon their own decisions and activities (Šubertová, 1996). According to § 240 para. 1 CC a cooperative is a legal person[447] and every member (natural and/or legal persons) of a cooperative may participate in the management, each member having one vote in decisions, unless the Articles of Association stipulate otherwise. The cooperative is liable for its obligations with all its assets; its members are not liable unless the statutes stipulate that by decision of the general meeting some or all of its members have to cover the losses of the cooperative (§ 222 para. 2 cl. 2 CC). Each member is entitled to a share of the profit of the cooperative – unless the statutes stipulate otherwise – according to the investment of the respective member; the volume of distributed profit is set by the general meeting (§ 236 CC). Furthermore, § 259 para. 3 CC stipulates that in the case of the liquidation of the cooperative, each member receives a liquidation quota according to his share. The profit shares of cooperatives are taxed like any capital gain (i.e. on shares).

d) Participation in Decision-Making

According to § 200 of the Slovak CC, joint-stock companies (similar remnant as in the Czech case due to common initial conditions) with more than 50 employees must have 1/3 representation of employee-delegated members on the supervisory board. There are no special rules for participation of employees in decision-making with regard to PEPPER schemes or privatisation matters. With regard to employee shareholding the general rules of the Commercial Code concerning shareholders rights apply.[448]

3. PEPPER Schemes in Practice

No comprehensive information is available on the overall incidence of PEPPER schemes in the Slovak Republic, and the evidence we found is rather anecdotal. Unlike the Czech Statistical Office, the Slovak Statistical Office only provides information on industry structure by form of ownership since 1999. Also, the Slovak Statistical Office did not recalculate various historical data series to reflect only the Slovak lands of Czechoslovakia. Therefore, one cannot easily infer on overall enterprise sectoral de-

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447 Cooperatives are legally defined in §§ 221 to 260 of the Commercial Code.

448 For limited liability companies see §§ 114, 122, 123, 125 ff., for joint stock companies see §§ 178, 179, 180 ff. CC.

velopment and the effect of the country split. Nevertheless, the overall trends seem to be quite similar in both pre- and post-split times and are similar to Czech development as well. No data is available to assess the extent of the coverage of the existing schemes except for cooperatives but it seems that financial participation of employees is rather marginal.

a) Share Ownership

Privatisation – At the beginning of the transition period the most significant number of companies in Czechoslovakia which were controlled fully or predominantly by employees existed in the newspaper sector but these were later sold to foreign publishing groups (for details see country chapter Czech Republic). During the short period of promotion of insider privatisation in 1995/96, contrary to the initial intention of leveraging Employee-Buy-Outs as a rule, the most frequent form of direct sales, accounting for 83% of the property to be privatised, were Management-Led-Employee-Buy-Outs, mostly at a very low price with the managers holding more than 50% of the shares. Empirical evidence on Management-Led-Employee-Buy-Outs in the Slovak Republic is limited, with only a few cases being reported. Such is the case of the privatisation of the previously commercialised Slovnaft Joint Stock Company[449], in which the Slovak National Property Fund – after a capital increase to 16.5 billion SK – sold 39% of the shares to the Slovintegra Joint Stock Company, remaining the second largest shareholder with 25% of the shares.[450] Slovintegra was founded by 19 ex-managers of the previously state owned Slovnaft with the participation of employees and after the transaction employees held 49% and management 51% of the shares. Of the total sale price of 6.4 billion SK a first down payment of 100 million SK, i.e. 1.6%, was made by Slovintegra when the contract was signed. Another 900 million SK have to be paid in instalments during the following 10 years, while the remaining 5.4 billion SK were reduced in exchange for the obligation to invest 20 billion SK by the end of 2001 into Slovnaft. For Slovintegra the price per share was about 156 SK while at the time they were traded on the capital markets at 830 SK. Another case is a cement producing company in Ladce which was privatised in September 1995 involving more than 95% of the employees of the former state owned enterprise. In the privatisation project PortlandCement Joint Stock Company, acquiring 58% of the shares of the commercialised company, as the main shareholder was obliged to offer its own shares to the employees. The acquisition of the shares by the employees was financed by a communal bank.[451]

As in the Czech Republic (for details see country chapter Czech Republic), although the design of privatisation allowed employee shares to emerge this option was not utilised and, consequently, almost no employee ownership has emerged from mass privati-

449 For details see 'Slovnafts Managers are already co-proprietors' (in Slovak), Trend, 4 October 1995.

450 At the time the biggest direct sale of the Slovak National Property Fund.

451 For a detailed report see 'More than 95% of the employees are taking part in the privatisation of the cement producing company in Ladce' (in Slovak), Trend, 28 February 1995.

sation. However the major hindrance to the implementation of approved privatisation projects anticipating employee shares was unintended: a selling price was frequently set based upon an inadequate book value. It was mainly the resulting overvaluation of the equity capital of the enterprises that caused the transfer of shares to employees to remain insignificant. Since this method for evaluation relating mainly to the book value initially applied also to direct sales and the establishment of the minimal selling price in tenders it was most probably not discriminatory (Kotrba, 1997, reprinted 1999, p. 135).[452] In the framework of voucher privatisation during the first wave the allocated portion to employees was only about 1.5% of the total shares under consideration. However, almost no shares went to employees for the same reason. Some large industrial companies in the Slovak Republic have founded their own Privatisation Investment Funds. These Funds later invested into their founding companies and in related enterprises in the same industry and focused on attracting employees into the funds. Amongst industrial companies founding Investment Funds, the most important example and the largest is VSŽ Košice, East Slovak Steelworks, the major employer of the East Slovak region.[453]

Private Companies – As in the Czech Republic a number of companies (former state owned and privatised, fully private or joint ventures) have chosen to introduce some forms of employee ownership. After 2001, due to a legal change, all employee shares as a specific category ceased to exist and all these shares were converted into ordinary ones or a priority type. As a result, it is almost impossible to trace their development since 2001 as employees who hold shares in their company are no longer restricted in their sale or transfer. However, despite the split of Czechoslovakia and the change in the Slovak attitude to privatisation, the current situation is not that different. For example, SlovGlass made employee shares available after privatisation. In 2003 the trade union representative noted that since 1994 when the shares were distributed no dividends were paid. Therefore, employees are not interested in buying any shares, even at a preferential price. The only benefit mentioned for employee ownership in the union representative's answers is that the wages were paid regularly.[454] The Slovak banks have used 'employee shares' in the same way to improve the motivation of their employees and thereby alter the productivity of the enterprise. For example, Tatrabanka was selling its own shares for a nominal price. By comparing the dividend flows the total stock of employee shares was around 1% in 2000. On the other hand, foreign companies (mainly US-based) tend to implement their global policies and if these contain stock options, the incentives are to implement these as well. Such, B. Hauer, a Director of Dell in Slovakia expects that the Dell programme is open to employees of the Bratislava Call centre.

452 Overvaluation due to inaccurate historical book value is still one of the major problems in the balances of many companies, namely of Privatisation Investment Funds.

453 For the activities of these funds see Hajko (1994).

454 <http://www.sklar.sk/2003/3.php>.

b) Profit-Sharing

Although company law mentions profit-sharing, such schemes seem, in practice, to be rarely implemented.[455] Most probably the reason is that the existing stipulations had their origin in the harmonisation of the Slovak legal system with the *acquis communautaire* of the EU rather than in a policy decision of the legislator. Consequently, although profit-sharing (as discounted employee shares) would be possible under Slovak law, there are no tax incentives for the use of these possibilities, e.g. special tax breaks for employee shares do not exist.

c) Cooperatives

The basic information on the ownership structure of the Slovak economy (See Annex Tables 1, 2 and 3) is rather heterogeneous and provides data from one period on corporate structure and from another period on ownership form. We see the minor importance of cooperatives in the corporate structure of the Slovak economy. They constituted only 9% of the total number of industrial firms in 1993, amounting to 1,922, and their share already decreased by 2% till 1996. Recently we can see a further declining trend from 1999 to 2004 resulting in cooperatives, with their total number having dropped to 1,564, constituting about 2% of all enterprises in 2004.

4. Evidence of the Effects of PEPPER Schemes

There are no studies that deal with the performance of employee co-owned firms or cooperatives in the Slovak Republic. Despite the widely held view that direct sales involving insiders led mostly to asset stripping and 'tunnelling', there is no empirical study on the effect of post 1993 privatisation techniques on enterprise performance. The only account is a case study by Djankov and Pohl (1998). They argue that the majority of large Slovak firms have successfully restructured even with the absence of foreign investors and government-led restructuring programmes. Also, they showed that privatisation to insiders through management buy-outs did not hinder the restructuring of firms since the new management invested in new technologies, looked for foreign partners and were ready to sell shares to outsiders to obtain the necessary financial resources.

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455 Again, to our knowledge the only widely practiced mechanisms are those that allow the trade unions to negotiate a compensation formula that sets additional benefits (e.g., 13th salary or similar benefits) in the case where the firm meets an agreed profit target. This is not a PEPPER Scheme though and constitutes rather an expected part of wages, which may be explained by the past dependency and presence of 'yearly bonuses' even in the command economy.

Annex

Taxation Issues

Although discounted employee shares and profit-sharing are possible under Slovak law, there are no tax incentives for the use of these possibilities, e.g., special tax breaks for employee shares do not exist. The most important regulatory acts connected with employee financial participation in companies is the Law on Income Tax[456] regulating both personal income tax and enterprise income tax at a general rate of 19%.

Table 1: Corporate Structure of Industry: number of firms (in %)

	1993	1994	1995	1996
Cooperative	**9**	**8**	**7**	**7**
Ltd. Company	33	44	50	54
Entrepreneur	3	2	2	2
Joint stock company	29	29	31	32
State-owned company	26	17	10	5
Total (%)	**100**	**100**	**100**	**100**

Source: Studená (2004).

Table 2: Profit organisations by selected forms of ownership

Ownership	1999		2000		2001		2002	
	Number	%	Number	%	Number	%	Number	%
Foreign	5,172	8.9	5,754	9.4	6,155	9.8	5,680	9.5
International	5,460	9.4	5,639	9.3	5,720	9.1	5,031	8.5
Private inland	44,505	76.3	46,474	76.3	48,337	76.9	46,228	77.7
Cooperative	**1,855**	**3.2**	**1,793**	**2.9**	**1,703**	**2.7**	**1,546**	**2.6**
State	690	1.2	619	1.0	306	0.5	261	0.4
Municipal	498	0.9	507	0.8	515	0.8	499	0.8
Associations - Political Parties	141	0.2	133	0.2	130	0.2	241	0.4

Source: Statistical Yearbooks of the Slovak Republic.

456 Law No. 595/2003 Z.z. on Income Tax (Zákon o dani z príjmov).

Table 3: Number of Businesses, by selected legal form or ownership

Year	Enter-prises	Joint stock	Ltd.	**Coops**	State	Foreign	Entre-preneurs	Farmers
1993	28,522	1,691	18,147	**1,922**	1,049	437	264,090	17,632
1994	36,187	2,117	25,024	**1,988**	1,082	633	263,733	20,789
1995	43,636	2,708	31,470	**2,081**	1,030	776	248,204	19,599
1996	47,866	3,425	39,378	**2,233**	846	898	226,665	21,014
1997	53,819	3,297	40,228	**1,923**	203	871	244,419	20,571
1998	60,334	3,916	46,339	**1,917**	149	923	263,733	19,122
1999	58,333	4,060	45,277	**1,802**	97	815	266,903	17,616
2000	60,920	4,208	47,810	**1,747**	75	908	269,323	15,550
2001	62,867	4,229	50,073	**1,682**	67	1 668	279,597	11,722
2002	59,486	3,993	47,865	**1,523**	44	1 361	273,322	11,710
2003	64,420	4,135	52,673	**1,517**	37	1 427	306,356	10,320
2004	74,207	4,341	61,919	**1,564**	35	1 516	336,640	10,055

Source: Statistical Yearbooks of the Slovak Republic.

XIII. Slovenia

Slovenia has a long tradition of employee participation, starting with employee self-management since the 1950s. The strong tradition of employee involvement in corporate affairs is in fact reflected in both the Slovenian model of privatisation and in the development of Slovenian company law. Furthermore, in contrast to other Eastern European countries, Slovenia has retained relatively strong political support for the financial participation of employees to the present time, with respective draft laws being presented in 1997, 2002 and 2005. Although Parliament did not pass either of the draft laws, associations established by supporters of financial participation promote a legal framework and keep up public debates on this issue. In particular, employee share ownership which emerged during privatisation is still high, although it has been on the decrease since the end of privatisation. By contrast, profit-sharing schemes are seldom used. The number of cooperatives is small and decreasing, and there are almost no workers' cooperatives left.

1. General Attitude

With the exception of certain issues in the field of industrial law which the Republic of Slovenia could regulate through its own laws, two Yugoslavian federal laws in particular defined the situation of workers and their participation in the economic entities at that time, namely the Law on Associated Labour of 1976 and the Employment Relationships Law of 1990. Since enterprises were in social ownership, there was no direct participation of workers in enterprise ownership. In practice, workers shared control over their enterprise together with government officials and managers. By the end of the 1980s, economic liberalisation had developed, allowing for private initiatives that made the incorporation of private working organisations possible. These issues were finally regulated by the Company Law in 1988 that did not abolish worker management directly, but allowed for a reorganisation of the existing basic and working organisations into business corporations that could operate with social (also public) capital, mixed capital or private capital.[457] Companies were organised as public companies or

[457] In companies in social ownership, workers' councils elected managers and were authorised to decide upon the privatisation of companies under the privatisation law. Company Law defined corporations as legal entities engaged in economic activities in order to generate income or profit. Corporations were divided according to ownership into socially-owned companies, cooperative societies, and companies with mixed ownership (social and private). Workers were entitled to manage socially-owned companies and to distribute the entire profit. Companies in mixed ownership were managed by owners in proportion to their contribution, and workers participated in the management according to the collective agreement. Profit was distributed according to contribu-

corporations, and also in the form of partnerships, such as unlimited trade partnerships and limited commercial partnerships.[458]

Slovenia adopted a gradual and multi-track approach to privatisation which introduced a model of ownership transformation as a combination of the free distribution of shares to both insiders and citizens. Privatisation methods further differed across three main groups of firms. Enterprises under the direct supervision of the government (public utility companies and steel works) remained in the government domain. Large unprofitable enterprises (98 firms employing 56,000 people, approximately 10% of the total workforce in the production sector and accounting for 40% of total enterprise losses outside the public utilities) were placed under the responsibility of the Slovenian Development Fund. Employees in these firms could obtain (for money or in exchange for ownership certificates) up to 20% of shares, while the remaining capital was allocated to the Development Fund.[459] As part of the process of the adoption of EU rules, the Development Fund was finally liquidated in 2002 and most of its portfolio was transferred to the Privatisation Investment Funds (PIFs) in exchange for unused privatisation vouchers (Simoneti et al., 2004).

Debates concerning the establishment and preservation of employee ownership and other forms of financial participation started in the early 1990s. In 1995 a group of enterprise representatives, union representatives, journalists and academics established the DEZAP (Employee Ownership Association). DEZAP's main task is to stimulate the existence, enlargement and effective use of employee ownership in Slovenia. To achieve this objective, the Association promotes the adoption of suitable legislation on employee ownership, provides professional assistance to, and training and education of, employee owners, develops networks of employee-owned firms and promotes co-operation with other firms and international organisations. At one of the latest

tion. Companies in cooperative ownership were managed by cooperative members, and workers participated in management according to the Articles of Association and the collective agreement. Privately owned companies were managed by owners and workers participated in management according to the collective agreement (Art. 3 Company Law). Workers participated in profit-sharing in privately owned companies only if this was decided by the owner.

458 Public companies were managed by the workers' council as the managing body which also decided upon profit distribution (Art. 49 Company Law). The statute of public companies had to include special provisions on profit distribution methods (Art. 65). The statute of a socially-owned stock company and joint stock company in mixed ownership also had to define the methods and conditions for profit-sharing. A part of the profit of a mixed ownership company – in proportion to the social funds invested – belonged to the workers. In limited commercial partnerships, the whole profit belonged to the founders.

459 As a temporary owner, the latter should have installed a system of corporate governance, reduced overstaffing, negotiated workouts of the enterprise debt and, later on, liquidated or sold the companies through trade sales, debt-for-equity-swaps and joint ventures. However, the Development Fund has developed into a permanent institution for providing various forms of non-transparent and politically motivated aid to enterprises.

conferences (April 2004), DEZAP's members (26) agreed that they will continue working on the legal regulation of financial participation and employee ownership.[460] Similarly, all forms of employee participation are supported by the Association of Works Councils (Studio Participatis, currently consisting of 100 members).[461] Nevertheless, Trade unions have a differentiated standpoint and, e.g., opposed the 1997 profit-sharing law because it was proposing the introduction of profit-sharing along real wage concessions, something which also explained the final rejection of the law. Finally, the promotion of employee financial participation, eg by tax allowances, is stated as one of the objectives of the Slovenian Association of Managers for 2005 (Združenje Manager).[462]

The Slovenian Economic Ministry established an expert group in October 2002 to prepare the regulations on employee share ownership and other forms of financial participation. A similar and more detailed proposal was provided by Simoneti, Bohm, Gregoric, Cankar and Borec (2002). Both propositions are aimed at a more efficient organisation of current employee ownership in Slovenian firms and provide grounds for further employee participation in profit and, most importantly, corporate ownership. The two expert groups agree that the implementation of the profit-sharing and share ownership schemes should be voluntary. However, the adoption and success of such schemes is conditional upon the introduction of corresponding changes in the tax system, which would provide some tax allowances for both employers and employees participating in such schemes. The introduction of tax relief has in fact been the main obstacle to the adoption of the Law on Employee Financial Participation in 1997. A new draft Law on Employee Financial Participation was submitted to Parliament by the Social Democrats in 2005, but rejected. According to some unofficial sources, the Labour Ministry should be starting to work on a new draft Law. However, the Advisory Council to the current Slovenian government also recommended the implementation of employee share ownership and profit-sharing schemes to the Slovenian Government (Delo, 30/4/2005). Furthermore it is included in the Strategy for the Development of the Republic of Slovenia that underlines the main reforms forthcoming in Slovenia.

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460 <http://www.dezap.si>; furthermore the members agreed to promote the transposition of the European cooperative society statute into Slovenian law and the implementation of the European Commission Communication on the promotion of cooperative societies in Europe.

461 <http://www.delavska-participacija.com>.

462 <http://www.zdruzenje-manager.si>.

2. Legal and Fiscal Framework

There is currently no specific legal framework for employee financial participation schemes, although several draft laws have been prepared and submitted to Parliament in recent years. As minority shareholders, employees have only a limited possibility to influence the decisions of the general meeting. However, employees have a relatively strong position in decision making due to the Slovenian co-determination model.

a) Share Ownership

Privatisation (1990, 1993, 1997) – A special form of participation of workers was regulated by Art. 168 Company Law as amended in August 1990[463], that authorised the managing body of socially-owned companies and public companies to offer the employees the possibility to buy the assets[464] of the company under the conditions defined in the Articles of Association. This amendment constituted the basis for early privatisation. Moreover, the possibility to privatise companies was introduced by the of the Law on Ownership Transformation of 1992[465] (hereinafter referred to as LOT), determining that companies and the social capital could be sold to workers or third parties, defining a special form of workers' participation in social capital. Companies in social ownership were transformed[466] into corporations and issued shares in the amount of the value of the social capital. The shares could be distributed by internal distribution of shares, internal sale of shares, sale of shares to outsiders, and sale of assets to outsiders. The LOT provided for the mandatory distribution of 40% of the social capital to different funds (10% to the Pension Fund, 10% to the Restitution fund[467] and 20% to the Development Fund for further sale to Privatisation Investment Funds). The firms were then entitled to distribute (in exchange for employee vouchers) up to 20% of ordinary shares amongst its current and former employees, including retired employees. Registered shares, obtained by workers, were not transferable for a period of 2 years after the issue date, except when transferred as an inheritance. In practice, however, employees found ways to sell the shares before the expiry of the restriction period and many of them sold them immediately.

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463 The adoption of this amendment went into history as the date of the beginning of capitalism in the Socialistic Federal Republic of Yugoslavia.

464 Since at the time no share capital of the company existed, the workers acquired the 'ownership' of the assets which was then transformed into the share ownership of the company.

465 Of 5 December 1992, OG RS 55/1992, as amended

466 The LOT emphasised ownership transformation rather than privatisation, which, nevertheless, was the final goal of the law. Transformation was the interim stage, allowing for the acquisition of ownership by workers and other Slovenian citizens of existing social capital (public funds).

467 The Slovenian Restitution or Compensation Fund has to issue debenture bonds to re-privatisation claimants who did not get their nationalised property returned in kind. The Slovenian Compensation Fund obtained funds from the non-distributed public funds.

Furthermore, companies had discretion over the allocation of the remaining 40% of their capital (after the distribution of 40% to different funds and 20% to inside owners); they could either sell them to insiders (internal buy-outs) or outsiders (outside privatisation). Within the internal buy-out, workers could buy shares with the profit of the companies belonging to the participants of the internal sale programme as well as with their salaries and other funds. The workers could also obtain a part of the shares against overdue salary claims or other due claims against the company. Furthermore, the option of the so-called 1/5 company model was introduced in order to support employee participation in ownership. For privatisation purposes, Slovenian citizens were granted vouchers; the value of vouchers granted to each individual depended upon the duration of employment (Art. 31 LOT). Vouchers could be used to obtain shares in the company of employment within the scope of the internal distribution of shares (the initial 20%), to obtain shares of Privatisation Investment Funds, to purchase shares of other companies privatised by the public sale of shares, and to purchase shares or other property of the Republic of Slovenia and state-owned companies offered to the public against vouchers (in the latter case, vouchers could not be freely traded).

Certain measures were taken in order to preserve employee ownership after privatisation, starting with the 2-year (4-year) restrictions on trading with shares gained from internal distribution (internal buy-out). To prevent the decline in employee ownership, some firms decided to limit trading by internal acts, namely through 'shareholder agreements'; which prohibited the sale of employee shares to outsiders and provided for the representation of employees in the firm's decision-making process. However, shareholder agreements were easy to abandon and difficult to administer (Mrčela, 2002). Upon the proposition of DEZAP, the Slovenian Chamber of Commerce and the Association of Free Trade Unions, an amendment was introduced to the Takeover Law of 1997, which provided for the possibility of an institutional organisation of inside owners in the firms Workers Associations (mentioned earlier as WAs) and which exempted them from public bids (Art. 81). By the amendment to the Take-Over Law, Worker Associations became professional proxy organisations and as such had to act according to the Takeover Law (Art. 298) and the provisions of the Company Law.[468] The aforementioned laws regulating transformation and privatisation have not been abolished, but they are not applied in practice, since privatisation is generally complete.

Private Companies (1993, 2004) – Limited partnerships are based upon the German model (KG) with the important difference that limited partnerships have a legal personality under Slovenian law. Under Slovenian Company Law of 1993[469] (hereinafter referred to as CL), workers can become limited partners in the company they are employed by; in which case the company becomes the general partner, and the workers

[468] A draft framework Law on Employee Financial Participation was submitted to Parliament in October 1997 but was never discussed. As stated above, a new proposition of the Law on Employee Profit-Sharing was sent to Parliament in April 2005 but was again refused following Parliamentary discussions.

[469] Of 10 July 1993, OG RS 30/93, as amended

become limited partners. Furthermore, with the transposition of the Second Council Directive 77/91/EEC of 13 December 1976 into Slovenian CL 2004, companies can buy own shares up to 10% of the subscribed capital for distribution amongst their own employees and employees of associated companies within a one-year period (Art. 240 CL). This can be done both by joint stock company and by limited liability company; there is no restricted tradability for shares acquired in this manner. Furthermore Art. 241 CA allows companies to advance funds, make loans, and provide security, with a view to acquisition of the company's shares by employees of the company or employees of an associate companies. Pursuant to Art. 318 CL, part of the profit can be distributed to employees in the form of new shares if the general meeting makes such a decision.

b) Profit-Sharing (1990, abolished 1993; 1993)

In the early 1990s employees shared enterprise profits if the company was in social ownership (namely owned by the public or society as a whole). Practically, it was often possible to exclude employee profit-sharing in the Articles of Association of joint stock companies, limited liability companies or partnerships. In 1993, the new Company Law was adopted by which socially-owned companies were abolished and the restructuring of companies into corporations, regardless of the ownership of capital, was introduced. The obligation to share profits with employees was abolished, but the employees continued to share the decision-making power. In Art. 228, the new CL of 1993 regulates the use of net profit. Primarily, the profit must be used for covering losses and creating legal and statutory reserves. The rest of the profit, but not more than 50% of the net profit, may be used for other reserves and, if the Articles of Association provide for it, for paying a part to employees and members of the management and supervisory boards.[470] This is to be decided upon by the general meeting as part of the decision on profit distribution. The CL thus makes profit-sharing possible provided that there is enough profit to cover losses, legal and statutory reserves, that the possibility to use part of the profit for employees is contained within the Articles of Association of the company, and that the general meeting makes such a decision.[471] The participation amount is usually determined as a percentage of the annual profit of the company. However, taxation imposed on this kind of income is the same as on salaries.

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[470] Only the Articles of Association can regulate that members of the management board are granted the right to participate in profit-sharing for their work (Art. 252 (1) CL).

[471] It is also possible that participation in profits is defined by the meeting of shareholders (Art. 276 CL), but, by systematic interpretation of special provisions in conjunction with general provisions, it can also be concluded that in this case the general meeting has to amend the Articles of Association.

c) Cooperatives (1992)

A special Law on Cooperatives of 1992[472] regulates the legal status of cooperatives. The cooperative is an association with an unlimited number of members established with the purpose of accelerating the economic welfare of its members, and based upon voluntary accession and withdrawal and equal participation in management. A cooperative can establish a company, another cooperative or other legal entity and become a member of a legal entity. The workers can organise a cooperative as a means of cooperation with the company they are employed by. Cooperatives may be both commercial and non-commercial. Their members can be both legal and physical persons. The members' liability is limited to the amount invested by them. Each member of the cooperative has one vote. The profit is divided into equal shares between the members. There are no provisions that would give special rights to employees of the cooperatives who are also members of the cooperatives, but such provisions can be included in the Articles of Association.

d) Participation in Decision-Making (1993)

Art. 75 of the Constitution provides that workers participate in the management of economic units and institutions in the manner and under the conditions as determined by the law. This constitutional provision was implemented by the special Law on Workers' Participation in Management of 1993[473], regulating the manner and the conditions for workers' participation in the management of economic units regardless of the ownership form, including cooperatives.[474] According to this law, workers participate in management by submitting initiatives, by demanding information, by consultations with their employer, and by participation in decision-making, including the right to reject employers' decisions. In particular, workers are entitled to nominate from 1/3 to ½ of supervisory board members and, in firms with more than 500 employees, one member of the management board. The tradition of social ownership and self-management is further reflected in the chosen model of privatisation or ownership transformation: by exchanging their certificates or buying shares employees could end up holding about 60 % of the privatised capital. Since employees who obtained shares in the course of privatisation, as a rule, are minority shareholders, special provisions of the CL on the protection of minority shareholders apply. These special rights relate to the general meeting, the right to information, the right to examine the books, and the right to lodge a complaint against the decisions of the general meeting. On the other hand, these rights do not include the right to replace the management.

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472 Of 28 March 1992, OG RS 13/1992, as amended.

473 Of 6 August 1993, OG RS 42/1993, as amended.

474 Individual specific provisions on employees' co-management are integrated into the special laws for different economic sectors, e.g., the Energy Law, Banks and Savings Banks Law, Insurance Company Law.

e) Draft Legislation (2002, Rejected)

According to the Slovenian Economic Ministry's expert group proposal, firms should implement employee share ownership plans upon the approval of the Workers' Council, the Securities Market Agency (when firms' shares are listed at the stock exchange) and the tax authorities. Shares currently held by employees should be tied up in a special trust or fund, managed by a professional management company according to the adjusted provisions of the Law on Investment Funds and Management Companies. At least 90% of shares in the fund are to be invested in the main (parent) company, while the remaining shares are kept in bank deposits. The fund is to be financed through: i) new cash or share contributions by the employees; ii) dividends of the parent company; iii) profit contributions on behalf of the employees by the parent company (deferred profit-sharing); iv) bank loans up to 10% of the fund's market value. Profit contributions by the company (when below 20% of gross annual salary) are to be exempt from all social taxes and contributions, deductible from corporation tax and other charges or contributions on wages. No employee should hold more than 5% of the fund's shares; the latter can hold up to 25% (optional 40%) of the capital in the parent firm. Employees who are shareholders can influence and supervise the management of the fund through the Council of Employees, which is actually the leading force of the meeting of employee owners.

A similar proposal was provided by Simoneti, Bohm, Gregoric, Cankar and Borec (2002). Instead of the management company and employee share fund, the authors propose that the firms should exploit the existing institute of worker associations (WAs). According to the proposal, employee shares are to be tied up in the association (a limited liability company) and managed by the latter; the WA invests at least 75% of its funds in the parent firm or in the form of loans to employees for new share acquisitions. The WA's management should be completely independent from the management of the parent company; employees should be able exit the share ownership plan twice a year by selling their shares according to a professionally and independently determined price or by transferring their ownership right to a pension scheme. The WA should finance the 'exits' through: i) the sale of shares of the parent company on the market (if listed) or directly to the parent company itself (upon the acquisition of own shares); ii) new contributions by employees (in cash or shares) or by the parent company (deferred profit-sharing); iii) limited borrowing. This alternative proposition also supports the implementation of tax allowances in order to stimulate the adoption of employee ownership schemes in the firms. The dividends received by employees from their participation in WA are to be exempt from income tax if the shares are tied-up long-term (at least 5 years with a further transfer of benefits to the pension scheme). The WA is to be exempt from corporate tax; the contributions by the parent company are to be exempt from corporate tax and any other contributions on wages (up to 10% of gross annual salary). If tied in the association on a long-term basis, individual contributions up to the value of 1 monthly salary should represent a tax concession for the employees.

The draft of a new Law on Employee Financial Participation was submitted to Parliament by the Social Democrats on 30 April 2005. The law is partly based upon the experience of Western European Countries and the propositions of Simoneti, Bohm, Gregoric, Cankar and Borec (2002) but, contrary to the latter, it makes employee financial participation mandatory for all the firms with at least 30 employees. The draft Law was discussed in Parliament on 30 September 2005 and finally rejected.

3. PEPPER Schemes in Practice

a) Share Ownership in Privatisation

Nearly 90% of companies in the process of ownership transformation chose internal distribution and internal buy-out as the prevailing privatisation method. In total, inside owners (employees, including managers; former employees and their relatives) obtained about 40% of the capital subject to ownership transformation. In 319 companies (24.4% of all privatised companies) the inside owners obtained more than 60% of the firm's capital (20% upon internal distribution + 40% upon internal buy-out); while these companies employed more than 16.1% of employees, their capital represented only 8.1% of the total capital under privatisation. On the other hand, in 82 companies (6.3% of all firms) accounting for nearly 30% of the total capital under privatisation, insiders did not obtain more than 10% of the companies' shares. The distribution of insider ownership (see Annex Table 1) is the only official and complete database of employee ownership in Slovenian privatised firms. All further studies reported below, unfortunately, rely on sample data.

Insider ownership prevailed in smaller, labour-intensive companies. In fact, the final share of inside owners was determined by the employees' financial capacities (wealth constraints, firm size) and their willingness to acquire firm shares; and the latter mainly depended upon the firm's success prior to privatisation and its long-term prospects (export orientation etc.). Apart from the large successful firms that were listed on the stock exchange, insiders ended up privatising the most successful firms; the probability of insider domination was also positively related to the number of employees and firm leverage (Simoneti et al., 2001). In relation to the dominance of insider versus outsider ownership and the power of outside investors (due to regulations, listing rules etc.), Simoneti et al. (2001) distinguish between three main groups of firms: i) public firms with shares listed on the capital market, subject to detailed regulations regarding transparency and minority investor protection; ii) insider non-public firms, where inside owners gained the majority share; and iii) outsider non-public firms, where insiders held less than a majority share but enough power to oppose the most important decisions (strategic sale of the firm, listing on the Stock Exchange, etc.). In a sample of 183 Slovenian firms, analysed by Simoneti et al. (2001), inside owners on average obtained 44% of firm capital; where dominant (insider firms), they gained slightly below 56.66% of firm capital (see Annex Table 2). Damijan et al. (2004) for a sample of 150 companies (employing on average 500 employees) at the end of 1998, report a 37.52%

level of inside ownership; in half of the firms the percentage of employee-owned capital exceeded 50%. Managers at that time held around 2.29% of firm shares. Employees (and former employees) held the largest aggregate stake in comparison to other owner groups in 74 (50%) of the firms in the sample.

All the above stated empirical findings support the thesis about the decline in inside ownership from the end of privatisation. The strongest is the fall in employee ownership in listed companies; for the latter Simoneti et al. (2001) report a decline in insider ownership by 6.5% in comparison with a much lower 1.82% decrease in insider firms. However, the increase in insider ownership in the outsider firms (by 10.22%, of which 7.16% was due to an increase in managerial ownership) indicates that in these firms, inside owners have been trying to outweigh the outsiders. Prašnikar et al. (2002) report a decrease in insider ownership by 13% in the period 1996-2001 (from 38.73% to 25.32%) for 124 medium and large joint stock company. Damijan et al. (2004) observe that insider ownership decreased by more than 10% in the period 1998-2002 (from 38.52% to 26.17%). The number of firms in the dominant ownership of employees (managers excluded) declined from 74 to 26 (see Table 3 below). Amongst these firms, 10% of firms had no employee owners, in 25% of firms the employees held less than 5% of shares, while in half of the firms in the sample, the aggregate level of employee ownership did not exceed 18.4%. There were only 25% of firms in the sample with employee ownership exceeding 40% of firm capital. Managerial ownership, on the other hand, has been increasing (see also Simoneti and Gregoric, 2005), although less than expected. By contrast to other countries, the reduction in employee ownership has led to an increase in outside ownership rather than in managerial ownership (Mygind et al., 2004). If the firms from the sample analysed by Damijan et al. (2004) are to be classified according to their dominant owners (that is, the investor group aggregately holding a larger share than any other investor group), the tendency of redistributing power from inside to outside owners becomes evident. Only 26 (23+3) firms that were dominated by employees at the end of privatisation remained in the domination of inside owners (either employees or managers) at the end of 2003. In most cases, the dominant ownership went from inside owners to domestic non-financial firms (in 24 cases), while in 21 firms the change in domination went from employee to funds.

The only institute designed to gather and represent employees, the worker associations (WA), is not widely spread and in practice does not seem to serve its purpose well. For instance, there were only 36 companies amongst the 855 firms with shares in the Securities Clearing Corporations at the end of May 2001 that constituted a worker association. These firms on average employed 344 employees. The average size of the share block held by the association was relatively high, 46.7%. In most cases (77%), the WA also represented the first largest shareholder. In half of the firms, the concentration of voting rights within the WA provided its beneficiaries (inside owners) with majority control of the founding company, while in most of the remaining cases inside owners faced a stronger outside owner, either a Privatisation Investment Fund of State-controlled Fund (in 13 firms) or another non-financial company (4 firms). Worker associations held non-controlling stakes (less than 25%) in 4 firms with the smallest share amounting to 6.43% (Gregoric, 2003).

b) Profit-Sharing

Rooting in the compulsory profit-sharing socially owned companies, in the early 1990s as a rule, 5% of the profit was to be distributed amongst the workers. This was especially respected in mixed and newly privatised companies under the influence of the social environment that experienced difficulties in accepting the fact that the profit now belonged to the founders alone. Kanjuo-Mrčela (2002) finds that only about 7% of the 41 large Slovenian firms have actually constituted a ‘fund of own shares’ in order to remunerate their employees. About 32% of the firms introduced the possibility of employee profit-sharing in their Articles of Association. This possibility however often remains unexploited (in 22% of firms in the sample). The implementation of individual schemes, namely the distribution of profits to the members of management and supervisory boards is also rather limited. In the Kanjuo-Mrčela (2001) sample, half of the firms reward their managers out of profits, while supervisory board members participate in the profits of 44% firms in the sample. Slapnicar et al. (2005) report even lower numbers: amongst the 104 firms listed on the Ljubljana Stock Exchange in the period 1998-2002, only about 20 firms actually rewarded their board members out of profits. In this regard, they distributed around 1% of their yearly profits (0.41% for management board members; 0.67% for supervisory board members).

b) Cooperatives

At the end of 2003, cooperatives employed 0.9% of employees and produced 1.3% of total value added. They are rather limited in number (327) and mostly operate in the sector of agriculture and forestry (Novak, 2005). The number of workers’ cooperatives is very small and decreasing.

4. Evidence of the Effects of PEPPER Schemes

Most of the studies so far find no persuasive evidence of the negative effects of employee ownership on firm performance in Slovenia. Prašnikar and Svejnar (1998) for example, analyse the investment and wage behaviour of a panel of 458 Slovenian firms in the 1991-95 period; they find that firm investment behaviour is largely influenced by the trade-off between investment and wages and the availability of internal funds (imperfect capital market hypothesis). Given their power, insiders might influence firm decision-making at the expense of strategic restructuring and appropriate some internally generated funds for wages rather than investments. In this regard, the authors observe that the type of privatisation makes a difference; firms that were ultimately privatised to insiders have a significant positive relationship between investment and value added and are hence more dependent upon internal funds for restructuring than firms that were ultimately privatised to outsiders. Firms that were about to end up in the hands of insiders display a stronger link between wages and firms' surplus; insiders in these firms are less likely to appropriate depreciation funds as wages than owners in firms with eventual external privatisation. The latter is also due to the fact that insider privatised firms were on average also more profitable; the insiders have in fact been able to cherry-pick the firms that they subsequently privatised (Prašnikar and Svejnar, 1998).

From a sample of 130 large and medium-sized firms, Prašnikar and Gregoric (2002) show that there is a 'leading' group of firms with stronger management, which have adapted to international competition better than other firms. They give more importance to financial goals, promote internal growth and develop strategic thinking better than other firms. In these firms inside (employee) ownership exerts a positive effect upon the power of managers; hence, the employees behave more like firms' shareholders than other stakeholders since any 'employeeistic' behaviour would damage their international competitiveness in the long term. The latter, on the other hand is not the case when we look at the role of worker representatives on the board; a higher percentage of workers on the board results in lower power for the management and, consequently, less market-oriented firm behaviour.

With regard to firm restructuring, Domadenik and other (2003) and Domadenik (2003) studied defensive (cost-related) and strategic (revenue-focused) restructuring in Slovenian firms. They observed no significant effect of employee ownership on investment activities (strategic restructuring). Consistent with the findings by Prašnikar and Gregoric (2002), they observe that a group of leading firms with international recognition has carried the largest share of the burden of Slovenian transition. In these firms, employee ownership had no negative effect upon the speed of defensive or strategic restructuring. There are, on the other hand, firms that lag behind and are less successful in adapting to a market environment. In both groups, the speed of strategic restructuring and investments in fixed and soft capital are mainly dependant upon the institutional environment, that is, firms' access to finance, the inefficiencies of the financial system, labour markets and restrictive employment legislation (Domadenik and Prašnikar, 2004). With regard to employment, Domadenik et al. (2003) analyse the efficiency of defensive restructuring in a sample of 157 large and medium-sized enterprises over the 1996-1998 period. They find that firms with a higher percentage of workers on board were slower in implementing defensive (cost-related) restructuring in the period 1996-1998; the negative effect vanished in the following 1999-2000 years (Domadenik and Prašnikar, 2004). On the other hand, ownership structure did not have any significant effect upon the level of employment and hence, defensive restructuring in that period.

In one of the latest studies, Simoneti and Gregoric (2005) find some evidence of the negative influence of inside ownership on firm productivity (183 privatised firms).

However, the impact is negative only with regard to firm efficiency (not financial performance), with regard to inside stakes below 25% and only for listed firms. A possible explanation for the latter result might be that with minority stakes (that is, stakes below 25%), inside owners have no substantial power on decision-making and hence, find it more difficult to identify with the firms. In a second study involving 150 large and medium-sized firms in the period 1999-2002, Damijan et al. (2004) evaluate the impact of ownership concentration and owner identity on firm economic efficiency and financial performance. The authors find that when dominant, inside owners and domestic non-financial firms perform better (in terms of firm financial performance) than State-controlled Funds (used as the reference group). With regard to the same period (204 firms), Knezevic and Pahor (2004) find that inside (employee and managerial) ownership decreases the probability of management turnover and consequently, increases the inefficiencies of corporate boards. This 'entrenchment' effect is not confirmed in the empirical analysis concerning managerial remuneration in 104 listed firms in 2002/2003; Slapnicar et al. (2005) find no evidence that firms with higher managerial ownership pay their executives more than other firms.

There is mixed (although not substantial) empirical evidence on the efficiency of Worker Associations (WA) in Slovenia, most often nothing more than a tool for supporting firm management. Since the WAs are exempt from the mandatory bid, managers mostly created these associations in order to 'capture' the votes of the inside owners and take control over their firms without a public bid, while at the same time building a defence against outside takeover. In fact, it is not unusual that the managers of the WA are at the same time also the managers of the founding companies.[475]

[475] For more details, see Gregoric (2003).

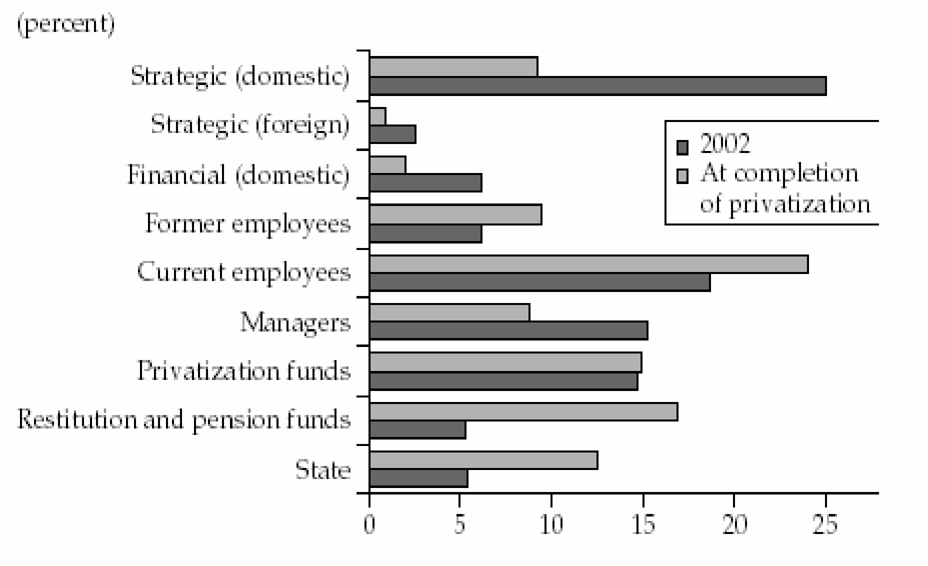
Annex

Table: Distribution of companies, the value of capital, and the number of employees by percentage of insider ownership (N=1310) 1999

Insider share	Total Capital (000 SIT)	Total Cap. %	Number of Comp.	% of Comp.	Number of Employees	% of Employees
0 to 10 %	238,909,289	29.0	82	6.3	20,912	7.8
10 to 20 %	128,067,033	15.5	68	5.2	18,570	6.9
20 to 30 %	92,248,314	11.2	81	6.2	27,714	10.3
30 to 40 %	93,379,520	11.3	122	9.3	31,700	11.8
40 to 50 %	82,526,405	10.0	155	11.8	47,302	17.6
50 to 60 %	122,317,335	14.8	483	36.9	78,990	29.3
More than 60%	66,778,045	8.1	319	24.4	44,083	16.4
Total	824,225,941	100.0	1310	100	269,271	100

Source: Agency for Restructuring and Privatisation (1999), p. 145.

Figure: Ownership structure of privatised companies at the time of completed privatisation and at the end of 2000 (in % by types of owners)



Source: Simoneti et al. (2004).

Taxation Issues

Under the effective tax law, there are no special provisions on taxation in connection with the financial participation of employees. Profit-sharing is, under the Personal Income Tax Act (PITA), treated as income from employment (Art. 25 (1.9) PITA). From the income that represents the profit share, the employer must pay a 25% advance on income tax, while the rest is settled on the basis of the level of income taxation, depending upon the class (Art. 116 PITA). Thus profit-sharing is not treated as a dividend of the shareholder, which is always taxed at 20% and is not included in income tax. On the profit paid out to him and his salary, the employee must pay all social and other contributions (health insurance, pension, invalid insurance) and the general income tax on income from employment. Profit-sharing, as salary, is taxed at a level between 0% and 11.8% in the year 2006, while in 2007 the tax level on a monthly salary will be between 0% and 8.9%, and in 2008 between 0% and 4.4%. For pension and invalid insurance workers pay a 15.50% contribution and employers pay a 8.85% contribution, while for health insurance the workers must pay a contribution in the amount of 6.36%.

XIV. Turkey

On the whole, the financial participation of employees has not played any notable role and financial participation has remained limited in Turkey. Share ownership schemes have been implemented mostly in the context of privatisation and in multinational companies while profit-sharing is found amongst private companies. Anecdotal evidence has been found for ESOP-like schemes based upon associations and foundations which collectively hold the shares of the employer firm for employees, who benefit from contributions of company profit in the acquisition of these shares. The legal framework contains no special regulations concerning PEPPER schemes and in some aspects even inhibits their further development, although reforms of the Commercial Code are underway. Except for the tax deductibility of employers' contributions to specific tax exempt associations and foundations, there are no direct incentives to set up PEPPER schemes.

1. General Attitude

Employee ownership was initially discussed by the Tax Reform Commission in 1968. In 1969 the Commission prepared a preliminary report entitled 'Report on Precautionary Measures for Capital Markets" which positively addressed the issue of employee ownership. According to the report, employee ownership would lead to employee participation in decision-making and, eventually, to widespread participation by the public in the development of the economy, to a fair distribution of the national income and thus to a strengthening of the fundamentals of ownership. Furthermore, employee participation should develop a greater sense of involvement of employees in the company and, thus, higher work motivation. Generally, PEPPER schemes were supported in academic debates within the context of tax reforms and it is assumed that the academics' point of view on the subject is still in favour of the implementation of share ownership schemes.

Compared to Eastern European countries, privatisation was not the all-determining economic issue in Turkey, and only a comparatively small number of enterprises were privatised. However, participation of employees in privatisation on preferential conditions was considered to have positive effects by the majority of policy makers as well as social partners and most political forces, so that the employees of many privatised enterprises have become share owners and incentives such as discounts, payment by instalments and loans were used. According to three surveys conducted at the Konya Cement Factory and in the Turkish Milk Industry between 1989 and 1990, the percentage of employees in favour of being owners of the company they worked for was between 85% and 100% (Gürol, 1994, p. 103). In the mid 1990s, with regard to majority employee owned enterprises, it was proposed that companies with sufficient financial resources and management facilities should administer the shares of their employees (Gürol, 1994, p. 78). Furthermore, employees should be entitled to buy the shares if the enterprise was to be privatised or was going bankrupt. However, while the former proposition was not taken up by the government, the latter facilitated the development of a new privatisation approach supporting employee ownership to a very broad extent. The privatisation of KARDEMİR ended with the transfer of 51.8% of shares to employees and was crucially important as, for the first time, unions actively participated in the privatisation.

Today, employee financial participation is not a current issue for trade unions, their position is inconsistent probably due to lack of knowledge about possible schemes. Their attitude can be described as generally positive, considering that, with a consistent legal framework established by the government, employee ownership can be beneficial not only for employees, but also for the economy.[476] On a national level employees are represented by the Confederation of Rights of Turkish Workers' Trade Unions (Hak İş), the Confederation of Turkish Workers' Trade Unions (Türk İş) as well as the Confederation of Revolutionary Workers' Trade Unions (DISK). During the discussion of the Tax Reform of 1968, the attitude of the Conservative Hak-İş towards employee participation was more positive and clear than the attitude of the Türk-İş. Employers, generally, present themselves as opposed to employee participation, in particular to participation in decision-making and employee ownership, and most collective agreements are influenced by this attitude.[477] Employers are, primarily, represented by the Turkish Industrialists' and Businessmen' Association (TÜSİAD) as well as the Turkish Confederation of Employers' Associations (TİSK). However, according to a report of the TÜSİAD participation of employees in privatisation is considered as positive by broadening income distribution and avoiding labour disputes (TÜSİAD, 2002; Gürol, 1994, p. 95). Nevertheless, according to a survey conducted by the Capital Markets Board of Turkey (CMB) in 2004[478] amongst the companies listed at the Istanbul Stock Exchange (ISE), 56% of the responding companies were in favour of employee participation in the management of the company. Employee participation has been discussed by academics, politicians and trade unions since the tax reform of 1968.

[476] However, they believe that a developed capital market as well as government incentives are needed in order to develop an equity culture where the employees can direct their income to stocks as a long-term investment in a less volatile market. These opinions were given in interviews with two of the managers of major trade unions who wished to remain anonymous.

[477] Such was the basic line in an interview with Bülent Pirler, General Secretary of TİSK, and Enis Bağdadioğlu, Deputy Manager of their Research Department.

[478] Survey on the Implementation of Corporate Governance Principles conducted by CMB of Turkey in 2004; 249 companies out of 303 responded to the survey.

The 58th Government (Justice and Development Party) published its instant action plan in 2002[479] which encourages Turkish citizens working abroad to invest their savings in the privatisation of Turkish enterprises. According to the party programme, it is intended that companies subject to privatisation will be primarily offered to employees, along with other selected target groups. Accordingly, the Privatisation Law was amended in 2003[480] to stipulate that employees can participate in privatisation conducted by public offer.

2. Legal and Fiscal Framework

Under Turkish law there is no specific employee share ownership programme or any particular law or regulation governing specific issues of employee share ownership, as in other countries. The forms of employee financial participation covered by different laws are profit-sharing, stock options and – to a limited extent – regulations on the acquisition of shares by employees. Legislation permits employee share ownership, on the one hand in joint-stock companies during privatisation and on the other in private companies by setting up welfare funds and mutual assistance funds for the benefit of their employees. Apart from tax deductibility for employers' contributions to specially tax exempt associations and foundations, there are no direct incentives to set up PEPPER schemes.

a) Share Ownership

Privatisation (1984, 1994, 2003) – The privatisation programme in Turkey was initiated in 1983. Privileges for employees in connection with privatisation were introduced by Decree no. 18514 of the Public Participation Fund of 13 September 1984, regulating the administration, usage and other issues of the fund. Pursuant to the regulation, specific provisions benefiting employees as well as the local population could be introduced in the case of share sales. In 1984 the first related Law No. 2983 was enacted, followed by Law No. 3291 in 1986.[481] According to Decision no. 54 of the Housing Development and Public Participation Board[482] of 30 April 1987, shares of enterprises to be privatised should primarily be offered to employees, local residents, and Turkish citizens working abroad. Pursuant to Art. 18 of Law No. 4046 on the

479 The plan published in 2002 after the Justice and Development Party came into power classifies the activities to be undertaken into 205 groups and phases them into periods of 3 months, 6 months, one year, continuous, long term etc. taking into consideration the scheduled deadlines.

480 Law No. 4971 of 15 August 2003.

481 See <http://www.oib.gov.tr/baskanlik/yasal_cerceve_eng.htm>.

482 A policy making body at Ministerial level under the Prime Ministry to carry out the policy.

Implementation of Privatisation of 27 November 1994[483] (hereinafter referred to as PrivL), privatisation could be conducted by sale, lease, the granting of operational rights, the establishment of property rights other than ownership, profit-sharing and other legal dispositions depending upon the nature of the business. In the context of a share deal, the sale of shares to employees is expressly regulated and - depending upon the privatisation decision in each individual case - employees may be entitled to purchase shares at a discount and/or to pay by instalment. Furthermore, Law no. 4971 of 15 August 2003 amended some laws and the decree law on the establishment and duties of the General Directorate of National Lottery Administration, amending Art. 7 PrivL, stipulates that employees can participate in privatisation conducted by public offer. In this context the possibility to grant credit to employees from funds of foundations set up by the employer company (see below d) ESOPs) according to Art. 468 and 469 of the Turkish Commercial Code[484] (hereinafter referred to as CC) is important. Thus, acquisition on preferential terms, such as deferred payment by instalments, credit from established foundations and discounted prices, is amongst the possible incentives stipulated by privatisation legislation to leverage employee ownership in privatisation.

Private Companies (2003) – Turkish commercial law does not contain special rules on employee share ownership with regard to their acquisition, the limitation of the number of shares or the issue of employee stock, for any business form so that general rules apply. Nevertheless, the Corporate Governance Principles of June 2003 which are recommended by the Capital Market Board for adoption by individual listed companies promote PEPPER schemes.[485] Generally, corporations are not allowed to acquire their own stock (Art. 329 CC) and unlike regulations in other countries, exceptions to this general rule do not include special rules on employees' shares.[486] Thus, even if freely disposable equity of the amount necessary for this purpose is available, Art. 329 CC is an obstacle to all schemes that foresee the acquisition of shares by employees, if part of the price or the whole price of the stocks is paid for by the company (e.g. acquisition below market price, free shares, premium, bonus, etc.). However, there is no restriction to offering shares to employees on favourable conditions in the course of a capital increase provided that the price is not lower than the nominal value (Art. 286 CC). Furthermore, according to Art. 14/A of Capital Market Law (CML), if

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483 As published in the Official Gazette No. 22124 on 27 November 1994 and most recently amended by Law No. 5398 of 3 July 2005 published in the Official Gazette No. 25882 on 21 July 2005.

484 Law No. 6762 dated 29 June, 1956, enacted on 2 July, 1956, published in the Official Gazette No. 9353 on 9 July, 1956.

485 Employee financial participation is mentioned in connection with shareholders' rights (Principle 6.2), transparency of financial information (Principle 3.1), and participation of shareholders in management (Principle 3.2).

486 329 CC widening the exceptions is under consideration; this, in consequence, might open the way for companies to acquire their shares for their employees, although, employee financial participation is not mentioned in the draft. In parallel the Capital Markets Law is subject to an amendment and in this case acquisition of own shares with the object to give them to their employees including by publicly held joint stock companies is apparently under consideration.

permitted by the company's Articles of Association, publicly held joint stock corporations may issue and offer to the public non-voting shares that are preferred with respect to dividends.

If a foreign multinational company wishes to implement financial participation plans for employees working in its subsidiary or group companies in Turkey in accordance with the rules of the home country, it has to register the plan with the CMB which evaluates the application and approves or rejects it. According to Decree No. 32 regarding the Protection of the Value of Turkish Currency issued by the Ministry of State[487] and the Communiqué on Principles regarding Registration with the CMB and Sale of Foreign Capital Market Instruments[488], a foreign company which wishes to sell its shares within the scope of share ownership schemes to its employees in Turkey should conduct the sale through an intermediary institution such as a bank, special finance institution or a brokerage house. The company should apply to the CMB through an attorney in order to clarify whether the shares relating to the employment ownership plans are subject to registration at the CMB and whether the company needs to comply with any other legal requirements in accordance with the current legislation.

Employee Stock Ownership Plans (ESOP) – Although there is no implementation of genuine ESOPs in Turkey we observed ESOP-like schemes based upon associations or foundations which collectively hold the shares of the employer firm for employees with the employer company contributing from company profits to facilitate the acquisition of shares by employees. In fact, according to Art. 468 (1) CC, funds allocated for assistance to employees shall be set aside from the property of the company and a foundation can be set up in accordance with the provisions of the civil law with the funds being the estate of the foundation.[489] As such, welfare funds or mutual assistance funds created for the benefit of employees are allocated to the foundation (or association) which in turn can invest in the stocks or other securities of the founding company. Thus, by using the provisions of Art. 468 (1) and 469 (3) CC it is possible to overcome the constraints of Art. 329 CC prohibiting a company to acquire its own shares. Furthermore, the foundation deed may provide that the property of the foundation shall consist of a debt to the company resulting in the possibility to credit finance the acquisition of shares by employees. According to Art. 469 (3) CC - even if the Articles of Association contain no provision - the General Assembly can decide that funds are to be set aside for creating and maintaining assistance funds for employees. After setting up a foundation or other organisation for the benefit of employees, the founder company can provide the resources either by payments from profits on

[487] Put into force by decision No.: 89/14391 of the Council of Ministers on 7 August 1989. The Decree shall be executed by the Ministry of State to which the under-secretariat of the Treasury is attached.

[488] Serial: III No. 20 published in the Official Gazette dated 20 March 1996 numbered 22586.

[489] In accordance with Art. 468 I and 469 III other than the aforementioned vehicle of a foundation also an association, a cooperative, a corporation or any other organisation for the benefit of employees may be used.

the basis of a General Assembly resolution or from the optional reserves for social purposes. As a rule the allocations shall be regulated by the provisions regarding assistance funds determined by the Articles of Association. Employers' contributions to foundations (associations etc.) up to a maximum of 5% of the current year's profit that have been granted tax exemption by the Council of Ministers are tax deductible. Of course, employees can also contribute to the assets.

b) Profit-Sharing

Art. 323 of the Code of Obligations stipulates that any agreement can be set up by which a share in the profit is granted to employees in addition to their basic fixed wage. In publicly held joint stock companies this may only be the case where it is regulated by the Articles of Association (Art. 7 of a Communiqué of the CMB[490] hereinafter referred to as DivComm). In joint stock companies 10% of the net profit each year must be retained as a reserve until it equals 20% of the capital ('first allocation' Art. 466 (1) CC). If dividends to shareholders exceed 5% of the annual profit or if profit is distributed not as an entitlement from holding shares, e.g., to employees, foundations, management of the company, then an addition 10% of the amount of profit to be distributed must be retained as a 'second allocation'. No decision can be made to set aside profits in order to distribute them to employees, management or a foundation, unless the first dividend to the shareholders is paid and unless the aforementioned reserves are set aside. Art. 15 of the Capital Market Law[491] requires that the Articles of Association of publicly held joint stock corporations shall set forth a rate for the first dividend. Furthermore, the DivComm stipulates that the first dividend ratio may not be less than 20% of the distributable profit remaining after deducting the compulsory reserves and that, amongst others, employees may not receive interim dividends[492] if distributed.

Joint stock corporations with shares not traded on the stock exchange are required to distribute the first dividend principally in cash. However, companies that are not exempt from independent auditing[493] can distribute the first dividend in cash and/or in the form of bonus shares (share-based profit-sharing). Corporations which partly or wholly prefer share-based profit-sharing of the first dividend are required to obtain approval from their shareholders. Dividends of shareholders who did not exercise

[490] On Principles Regarding Distribution of Dividends and Interim Dividends to be Followed by Publicly Held Joint Stock Corporations Subject to Capital Market Law; Serial: IV, No. 27 published in the Official Gazette No. 24582 dated 13 November 2001, see Art. 8.

[491] Law No. 2499 as first published in the Official Gazette No. 17416 on 30 July 1981, most recently amended by Law No. 4487 published in the Official Gazette No. 23910 on 18 December 1999.

[492] Dividends from profits shown on quarterly financial statements, independently audited, cannot be distributed to the holders of preferred stock or to persons and/or entities that have received a profit share but are not shareholders.

[493] In accordance with Art. 3 (a) DivComm of the Communiqué on Principles Regarding Exemption Requirements for Issuers and Removal from the Board's Register Serial: IV, No. 9 published in the Official Gazette No. 22154 on 27 December 1994.

their right or had no opportunity to do so are paid out in cash. In cases of making donations or distributing profit shares to foundations (see the foundations discussed above in the ESOP section) another Communiqué of the CMB[494] further requires that these payments should not result in 'inconsistent' transactions[495], that information regarding the donations needs to be given to shareholders at the General Assembly and that the necessary information needs to be disclosed and published in the ISE Daily Bulletin.[496]

c) Cooperatives

Cooperatives are regulated by the Law on Cooperatives of 24 April, 1969[497] (hereinafter referred to as LC). Special rules apply to construction cooperatives. Cooperatives may be established by natural and legal entities as well as administrations, municipalities, villages, societies and associations. Generally - unless the Articles of Association stipulate otherwise - the cooperative is only responsible for its creditors with its assets (Art. 28 LC). The Articles of Association may render each member liable for the cooperative's debts in excess of his own share in person and up to a certain amount.[498] The Rules may also put a burden of additional payment on the members. However, it is obligatory to use the additional payments only for the purpose of covering balance deficits. The additional payment burden may be limited as a proportion of specific amounts or volume of work or shares (Art. 31 LC). The name of the cooperative shall contain words indicating the extent of liability. Shares may not be transferred to a third party until they have been paid in full and then only with the approval of the General Assembly or the Board of Directors under the conditions provided in the Articles of Association. If share certificates have been issued they shall be registered. It can be stipulated by the Articles of Association that members are not allowed to withdraw from the cooperative for a period not exceeding 5 years (Art. 10 LC). As the management body of a cooperative, the Board of Directors consists of three persons who must be members of the cooperative and also Turkish citizens. The Board of Directors or the Supervisory Board or 1/10 (at least 4) of the members can call a Gen-

494 Communiqué on Principles and Rules on Financial Statements and Reports in Capital Markets Serial: XI, No. 1 published in the Official Gazette No. 20064 on 29 January 1989.

495 Defined by Art. 15 (6) Capital Market Law: in the case of transactions with another enterprise or individual with whom there is a direct or indirect management, administrative, supervisory, or ownership relationship, publicly held joint stock corporations shall not impair their profits and/or assets by engaging in deceitful transactions such as by applying a price, fee or value clearly inconsistent with similar transactions with unrelated third parties.

496 According to Communiqué on Public Disclosure of Material Events Serial: VIII, No. 20 published in the Official Gazette No. 21629 on 06 July 1993, amended with Serial: VIII, No. 39 published in the Official Gazette No. 25174 on 20 July 2003.

497 Published in the Official Gazette No. 13195 on 10 May 1969.

498 The amount that the members will personally be liable for may also be shown as proportional to the amount of their shares in the cooperative (Art. 30 LC). Furthermore, the Articles of Association may include an article providing that members can be obliged to be responsible for the debts of the cooperative in person and in an unlimited manner in succession (Art. 29 LC).

eral Meeting to be held at least once a year. Each member has one vote at the General Meeting irrespective of the number of shares owned.

3. PEPPER Schemes in Practice

No comprehensive information is available on the overall incidence of PEPPER schemes in Turkey; therefore the evidence presented is rather anecdotal. No data is available to assess the extent of the coverage of existing schemes except for cooperatives, but from anecdotal evidence it seems that financial participation of employees is low.

a) Share Ownership

Privatisation – Between 1985 and 1989, privatisation was aimed at ensuring the broad participation of the public, including employees. After 1989, the goal of privatisation changed towards maximising proceeds with the block sale method becoming the most commonly used privatisation method up to the present time. Currently, 31 companies, including 21 in which the state holds more than 50% of the shares, are listed for privatisation.[499] Since no research has been conducted on employee participation, only several sample cases can be presented (see Annex table 1). For the first time, broad privileges for employees were granted in the privatisation of the Karabük Iron and Steel Factories (Karabük Demir ve Çelik Fabrikaları Müessesesi). During the privatisation transaction the state enterprise, de facto bankrupt due to debt, over employment, high cost production and out of date technology, instead of to being wound up was transformed into a joint stock corporation with its shares being transferred to the newly founded Kardemir A.Ş. at a symbolic price of 1 TL in February 1995. Art. 329 CC did not apply since the privatisation of Kardemir was governed by special law no. 7462, stating in Art. 3 that all related issues would be determined by the Articles of Association. These stipulated that the company was allowed to acquire its own shares upon the condition that this would not lead to a reduction in capital. The transaction envisaged a free transfer of 35% of the shares of the new company to the employees, 30% to the Karabük-Safranbolu Sector Chamber, 25% to the pensioners of the enterprise and local public and 10% to Karabük-Safranbolu Trade Association members. In the end, employees held 51.8% of shares in this company with part of the purchase price being paid from their severance payments and payments in lieu of notice of the bankrupt state enterprise.

In the current sale of Türk Telekom shares (January 2006), 5% of shares are to be allocated to the employees of Türk Telekom, the General Directorate of Post, Telegraph

499 See <http://www.oib.gov.tr/portfoy/portfoy_eng.htm>.

and Telephone, and PTT (T.C. Posta ve Telgraf Teşkilâtı Genel Müdürlüğü) as well as to small investors of the companies. The sale shall be conducted by the public offering method in accordance with the Capital Markets legislation. The appraisal of the shares to be sold, and in which proportion the reserved 5% of the shares will be sold shall be decided by the Council of Ministers after consideration of the proposal of the Privatisation Administration and the Ministry of Transportation.[500]

Private Companies – The only available reliable information concerning share ownership schemes outside privatisation refers to foreign multinational companies since they are obliged to apply to the CMB in order to clarify whether their schemes are subject to registration at the CMB and whether the company needs to fulfil any legal requirements in accordance with the current legislation. To date 26 foreign multinational companies have implemented employee share ownership schemes in Turkey.[501] Out of 35 applications, 32 are already approved and 3 are waiting for approval. Some of these share ownership plans were option plans, others were oriented towards share ownership by employees. It should also be noted that, in Turkey, employee stock options are not used by SMEs.

Employee Stock Ownership Plan (ESOP) – According to a research report by TISK, a new trend exists amongst management strategies which favours, besides others, the strengthening of employees in organisations by the introduction of employee ownership plans such as ESOPs.[502] How many ESOP-like transactions involving sale to a Fund or Association that collectively holds shares for employees exist in Turkey today cannot be calculated since there are no empirical studies available. One example is the Adana Kağıt Torba Sanayii T.A.Ş. which sold 60% of its shares to the 'Turkish Cement Industry Joint Stock Corporation's Staff and Officials Mutual Support Association' (Türkiye Çimento Sanayi T.A.Ş. Memur ve Hizmetlileri Yardımlaşma Derneği"), established according to Art. 468, 469 (3) CC. Another example is the Teletaş Telekominikasyon Endüstri Ticaret A.Ş., that has a fund operating, which likewise was established as an Association according to Art. 468, 469 (3) CC. By a share purchase plan for the employees of the company, the Administration of Public Participation accepted the sale of 10% of the shares of the company to employees (private placement). Employees were permitted to buy a maximum of 600 shares each in instalments of 3 month periods. In the end, 8.14% of the share capital was sold to employees; 386 employees paid in cash, 1,081 purchased shares on instalments and 2,286 bought shares through the TELETAŞ Fund.

500 See <http://www.ttvan.telekom.gov.tr/hukuk.htm>.

501 As at the beginning of 2006, according to the Capital Markets Board of Turkey (CMB) that evaluates, approves or rejects the applications.

502 National Competition Power Policy Regarding Production and Employment in Turkey, rewarded in the Research Study Competition for Production and Employment Policies for a Strong and ExpandedTurkish Economy, see <http://www.tisk.org.tr/yayinlar.asp?sbj=ic&id=872>.

b) Profit-Sharing

The distribution of optional reserves (retained profits) as 'dividends' to shareholders and sometimes also to employees is reported to be a fairly widespread practice in Turkey; it is doubtful, however, whether such a practice is motivated by any social considerations other than the aim of declaring dividends (Tekinalp, 1994). No research has been conducted on profit-sharing in Turkish companies. A screening of 50 randomly selected publicly held joint stock companies in the context of this project found that in more than 80% of these companies (41) the Articles of Association included profit-sharing to their employees. In the majority of them profit-sharing schemes would fall under a regulation according to the standard provisions of Art 15 of the Capital Market Law which, after the setting aside of the legally required reserves, allows amongst other things, the use of profits for distribution to employees.[503] In 16 cases the internal rules contain a separate clause referring to the distribution of a percentage of the company's profits to employees and/or board members after the decision of the General Meeting or the Board of Directors; 12 of them grant profits to both board members and employees in different percentages after the first dividend has been distributed, while 4 of them grant a certain percentage of the profits only to the employees or workers of that company either as a dividend or as a bonus. Most of these Articles of Association state that the form and time of the distribution of the share of profits will be decided by a decision of the Board. In 3 cases the profit-sharing of employees was foreseen through a foundation (see above 2.d) ESOPs). The percentage of the share of the profits for employees and/or board members ranged from 1% to 20% of the distributable profit. In only 8 cases was profit-sharing limited to board members[504] upon the decision of the General Meeting and in 1 case to the management upon decision of the Board members.

c) Cooperatives

In Turkey, there are 26 types of cooperative in different operational areas (see Annex table 2). According to the records of the Ministry of Agriculture and Rural Affairs and the Ministry of Industry and Trade, the total number of cooperatives in 2004 was 86,335 (58,210 of them are active) and the total number of member was 9,681,897 (the active number of shares is 8,748,982). Amongst unit cooperatives, 11.9% are agricultural cooperatives and 52.1% of cooperative members are members of agricultural cooperatives (Demirci and Tanrıvermis, 2005, pp. 31-59).

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503 Standard provisions according to Art 15 of the Capital Market Law: 'No decision may be made to set aside profits for other reserves, to transfer profits to the following year, or to distribute a share from the profits to the members of the Board of Directors, officials, employees, workers, privileged shares owners, or a foundation established for specific reasons or similar persons/institutions unless the first dividend is paid as provided and unless the reserves required to be set aside as required by law have been so set aside.'

504 Ranging from 0.1% to 10% of the distributable profits: in 1 case 0.1%, in 2 cases 3%, in 2 cases 4%, in 1 case 2.5%, in 1 case 5%, and in1 case the maximum 10% of the profits.

4. Evidence of the Effects of PEPPER Schemes

To date, no research has been conducted on the objective results of PEPPER schemes. In 1996, the first empirical study (Atasoy, 1997) on the basis of a questionnaire was undertaken regarding the opinion of Turkish employees about share ownership and the ways to further develop employee participation schemes, in particular in connection with privatisation. 114 persons were questioned.[505] Respondents were asked to give their opinions about the main goals of employee ownership. Most of the respondents regarded ownership as a tool to improve productivity, as an investment tool and as a tool to prevent plant closure. Furthermore, they were asked if they would like to obtain shares in the company they were employed by and to give reasons for their answers. 85.1% of the respondents were interested in purchasing shares. The most frequently given reasons were; adequate reward for good performance and participation in decision making. The circumstances which were seen as obstacles were lack of share offers and lack of capital to obtain shares. Respondents were invited to indicate their agreement or disagreement about a number of statements reflecting the effects of employee ownership on the privatisation process. Most employees believed that employee ownership may help to provide an incentive to increase productivity, and some employees expressed the opinion that it can help to reduce labour disputes. A very high percentage of employees agreed that employee ownership may help to speed up the privatisation process. 73.7% of the respondents agreed that employee ownership may prevent plant closures. Since share ownership schemes have traditionally been organised to avert plant closures, employees may invest in their company in order to preserve their jobs. The employees consider that the main effect of employee share ownership is the creation of a direct connection between personal performance and rewards.

[505] 45% of the companies which the respondents work for were public, 32% private, 19% organisations accepted as a public company and 4% other companies; 43% of the respondents were female and 57% male, 43% of all were trade union members.

Annex

Table 1: Privatisation by the sale method, particularly 'sale to employees'

Company	**Method Used**	**Date of Sale**	**Amount/Percentage of Stocks sold to employees**	**Preferential conditions**	**Source of data**
POAŞ	Public offering	1991	Max. 20,000 shares plus an additional max. 2,000 shares for POAŞ employees/retired	Instalments, Opening loan	public offering prospectus
	Public offering	2002	POAŞ employees (currently working and retired) could claim maximum 300,000 shares	Discount, Instalments	<http://www. milli-yet.com.tr/2002/02/08/ekonomi/eko04. html>
TÜPRAŞ	Public Offering	1991	Max. 2,000 shares for every employee	Instalments, esp. employees with lower salaries	public offering prospectus
	Public Offering	2000	1,830 employees claimed the shares (169,553,000).	Discount if cash payment	<http://www.oib. gov.tr/duyuru/ 2000>
TELETAŞ	Public offering	1988	37% of the offered shares were sold to employees. (8.14% of the total shares)	Instalments; payment by the foundation	<http://www.Ekutup.dpt.gov.tr/kit/ kilcim/ozel6.html>
PETKİM	Public offering	1990	4,397 employees	n. a.	public offering prospectus
	Public offering	2005	204 current and retired employees (1,500,000,000 unit) 2,719 employees (2,000,000,000 unit)	Discount, Instalments	<http://www.oib.gov.tr > <http://www.referansgazetesi.com/ haber.aspx?HBR_KOD=5270>
THY	Public offering	2004	n. a.	Discount Instalments	Prospectus
ERDEMİR	Sale to employees	1987	n. a.	Instalments	<http://www.oib. gov.tr>
İSDEMİR	Assigned to Ereğli Demir	2002	11% of the shares of the company will be transferred to the employees by a foundation	the shares are transferred free of charge	<http://www.oib. gov.tr>

Table 2: Cooperatives

Type of Cooperative	# of Cooperatives	# of Members
Housing Cooperative	62,240	2,350,890
Consumer Cooperative	3,544	362,932
Carrier with Motor Vehicles Cooperative	5,161	160,799
Small Traders/Artisans/Credit/Guarantee Cooperative	980	604,081
Small Industrial Estate Construction Cooperative	1,093	146,059
Business Site Construction Cooperative	1,851	118,059
Other Cooperatives	2,498	853,645
Unions of Cooperatives	481	13,173
Total	**77,848**	**4,609,638**

Source: <http://www.sanayi.gov.tr>.

Taxation Issues

Taxable employment income includes all amounts whether in cash or in kind arising from an office or employment. Apart from salaries, bonuses, commissions, and cost of living allowances, etc. are subject to personal income tax which is a progressive tax varying from 15% to 35%. The income tax of the salaries of employees is collected as a withholding tax on income at source.[506] Employee stock options fall under the definition of employment income. Since employment income is taxed according to the cash principle stock options are not taxed on the Grant date. When the option is exercised, the amount taxed equals the difference – if any – between the market value and exercise price paid. If the participant sells the shares after more than one year the difference between the exercise price of the option and the sale price of the shares is considered to be a capital gain. In 2005 the inflation-adjusted capital gain had to exceed 13,000 YTL in order to be taxed. Furthermore, if the participant received dividends during the holding period, 50% of the dividends, provided that the amount exceeded 15,000 YTL, were subject to capital gains tax in 2005. Profits from private pension funds (up to a limit) and 50% of dividend income from a resident company are exempt from personal income tax.[507] For shares acquired before 1 January 2006 capital gains are taxed at a rate from 20% to 40%; proceeds from the further sale of listed stocks are not taxable if held by the buyer for 3 months (one year for unlisted stocks). Law No. 5281[508] introduces an income withholding mechanism to be applied by local banks and brokerage houses, at a flat rate of 15% on capital gains and interest income for listed

506 See Art. 94 Income Tax Law and Art. 24 Corporate Income Tax Law.

507 <http://www.worldwide-tax.com/turkey/tur_exempt.asp>.

508 Official Gazette No. 25687 as of 31 December 2004.

stock acquired after 1 January 2006.[509] Proceeds from the further sale of unlisted stock acquired after this date are not taxable if held by the buyer for two years, otherwise capital gains are taxed at a rate from 20% to 40%.

Corporations (joint-stock and limited liability companies), cooperatives, state commercial enterprises and commercial enterprises of associations and foundations are subject to corporate income tax. The corporate income tax rate was 30% in 2005. Recently Parliament changed the corporate income tax rate from 30% to 20% with effect from 1 January 2006. Companies also pay social security contributions between 21.5% up to 27% on salaries paid to employees[510] while the 15% contribution of the employee is collected by the company as a withholding tax. Social Security contributions as well as donations not exceeding 5% of the current year's profit, made to associations or foundations that are granted tax exemption by the Council of Ministers, are tax deductible. Capital gains derived from the sale of shares in a local company are considered corporate income and are subject to full taxation. There is no separate capital gains taxation in Turkey. Dividends are treated as part of corporate income and are not subject to separate taxation.

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[509] However, the provisions of Law No. 5281, Art. 67 does not apply to shares belonging to fully liable corporations, held for a period of more than one year and traded at the Istanbul Stock Exchange (ISE) as well as to the collection of dividends on behalf of the owners of the shares.

[510] Subject to a ceiling for upper level earnings.

Part 3 – Recommendations

Towards a European Platform for Financial Participation

Jens Lowitzsch

I. Finding Solutions at a European Level

A variety of concepts have been established in the Member States, where the executive and legislative branches and the social partners (as well as particular companies) have made great efforts to advance 'employee participation in productive property'. Within the European Union as a whole, reinforcing the integrational function of ownership by making ownership more broadly accessible requires a legal foundation for the implementation and support of financial participation schemes. This involves two main goals: Firstly, to develop regulations concerning financial participation at a European level, providing for a broader incentive system in order to support financial participation more actively and to overcome national differences in taxation policy; and secondly, to attain a general inclusion of the principle of financial participation of employees in the legal framework of the European Social Constitution.[511]

1. Focus: Legislating Financial Participation Schemes

Although tax incentives are the most common way of encouraging financial participation schemes, a common European legal framework imposing such tax incentives would collide with the national legislative sovereignty over taxation. Under the European Union each Member State retains exclusive power over all matters involving taxation; any Directive involving taxation requires the unanimous consent of the Member States. Therefore a European approach to the problem must provide a broad incentive system going beyond the classical instruments of tax legislation. Establishing such schemes through legislation is of primary importance, as it gives companies a distinct

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511 EU Treaties in the actual form of the Nice Treaty. See Title XI, Art. 136 ff.; Title XVII, Art. 158 ff.

legal entity and provides them with a clear framework for company decisions and actions. At the same time, establishing a legal framework delineates what is possible for companies without inviting sanctions from regulatory, legal or taxation authorities (Pendleton, 2001, p. 9).

2. Unanimous Decision vs. Majority Vote

Diverse national approaches to both financial participation and participation in decision-making constitute further impediments to change. For obvious reasons, it is very difficult to reach a unanimous supranational compromise either in the Commission or in the Council. The law of European Treaties in general permits majority vote decisions in a limited number of cases, recently extended by the Treaty of Nice.[512] No less than 27 provisions have been changed completely or partly from unanimity to qualified majority voting, among them measures to facilitate freedom of movement for the citizens of the Union (Art. 18 ECT) and industrial policy (Art. 157 ECT). As to taxation (Art. 93, 94 and 175 ECT), however, the requirement of unanimity for all measures is maintained across the board.

In the field of social policy (Art. 42 and 137 ECT), despite maintenance of the status quo, the Council, acting in unanimity, can make the co-decision procedure applicable to those areas of social policy which are currently still subject to the rule of unanimity.[513] The Intergovernmental Conference has not, however, extended the co-decision procedure (Art. 251 ECT) to legislative measures which already come under the qualified majority rule (e.g. in agricultural or trade policy). Therefore the search for a legal foundation at the Directive level has to focus on those 'majority vote' regulations if it is to be successful. This is further true because the position of the governments in relation to the social partners, their role in society and their relation to each other varies significantly in the different Member States.[514]

3. Different Contexts, Different Approaches

A strict distinction concerning suitable options and legal procedure to create solutions at the European level has to be made between participation in decision-making and financial participation of employees. Participation in decision-making, whatever its

512 The Treaty of Nice has extended the scope of co-decision. This procedure will be applicable to seven provisions which change over from unanimity to qualified majority voting (Art. 13, 62, 63, 65, 157, 159 and 191; for Art. 161, the Treaty stipulates assent). Accordingly, most of the legislative measures which, after the Treaty of Nice, require a decision from the Council acting by qualified majority will be decided via the co-decision procedure.

513 This 'bridge' cannot, however, be used for social security.

514 E.g., the consensual continental contrasts with the Anglo-American confrontational model; likewise the strong position of the state in France contrasts with the powerful role of the German 'Tarifpartner' (collective bargaining parties, i.a. trade unions and employer associations), see Pendleton and Poutsma (2004).

form at the national level, is as a rule obligatory for enterprises in the given country.[515] Since community law would be equally binding, a supranational compromise can encompass only the smallest common features of the diverse national regulations.[516] Financial participation on the other hand is traditionally an optional instrument for improving company performance and corporate governance; enterprises are therefore free to introduce financial participation schemes.[517] Thus, provided that they are granted voluntarily on the national level, a supranational platform can offer a variety of incentives from which to choose.

A European Regulation should thus encompass a broad incentive system which provides different and flexible solutions, compatible with those already established in the Member States. An adaptable scheme can provide for a solution suitable for use throughout the European Union, comprising best practises of national legislation and customs.[518] Combining them in a single program with alternative options leads to a 'Building Block Approach', with the different elements being mutually complementary. While profit-sharing schemes, stock options and employee shares are relatively widespread in the European Union, Employee Stock Ownership Plans (ESOPs) are predominantly to be found in countries with an Anglo-American tradition, e.g. the United Kingdom and Ireland.[519] Originated in the United States as a technique of corporate finance, the ESOP, using borrowed funds on a leveraged basis, has the capacity to create substantial employee ownership and can be used to finance ownership succession plans, an important feature, especially for European SMEs.[520] Furthermore, it can be used to refinance outstanding debt, to repurchase shares from departing plan participants, or to finance the acquisition of productive assets.[521] The last two functions are also both possible on an unleveraged basis. In the unleveraged case, of course, less stock can be acquired in any given transaction.

515 As, for example, the German 'Mitbestimmung' and the Works Councils in France and the Netherlands.

516 This problem is well illustrated by the prolonged controversy over the so called European Workers Council, and as a consequence the rather minimal compromise of the regulation in the European Company Statute.

517 A rare exception exists in France where enterprises with more than 50 employees are required to establish a participation fund. See PEPPER II Report (1996), COM (96) 0697, C4-0019/97, pp. 19-20.

518 Compare White & Case (2001), p. 4.

519 For Ireland, see Shannahan and Henessy (1998), p. 9.

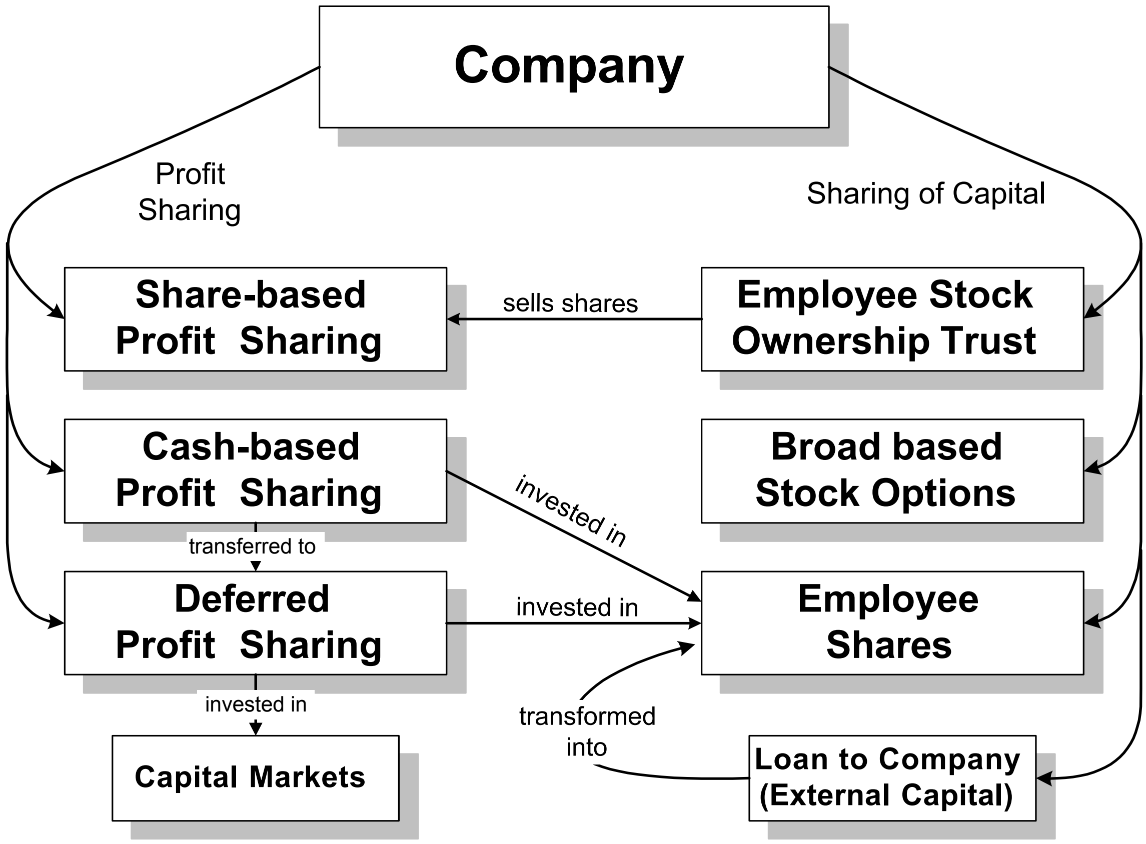
520 One of the key areas defined in the Final Report of the MAP 2002 Project, European Commission Enterprise Directorate-General (2003).

521 From an entrepreneurial point of view, see Ackermann (2002).

II. The Building Block Approach

Regardless of the form profit-sharing takes, the resulting funds may be used to create employee share ownership, as in the case of share-based deferred profit-sharing practised in various other combinations in France, the United Kingdom and Ireland. The existing variety of national profit-sharing schemes (often involving an institutional infrastructure) would be compatible with a supranational platform resting basically on the two forms of employee share ownership: individually held or held through a trust. Therefore the building blocks should consist of the three basic PEPPER elements:[522]

- Profit-Sharing (Cash-Based, Deferred and Share-Based);
- Individual Employee Share-holding (Stock Options and Employee Shares); and
- Employee Stock Ownership Plans as Collective Schemes.

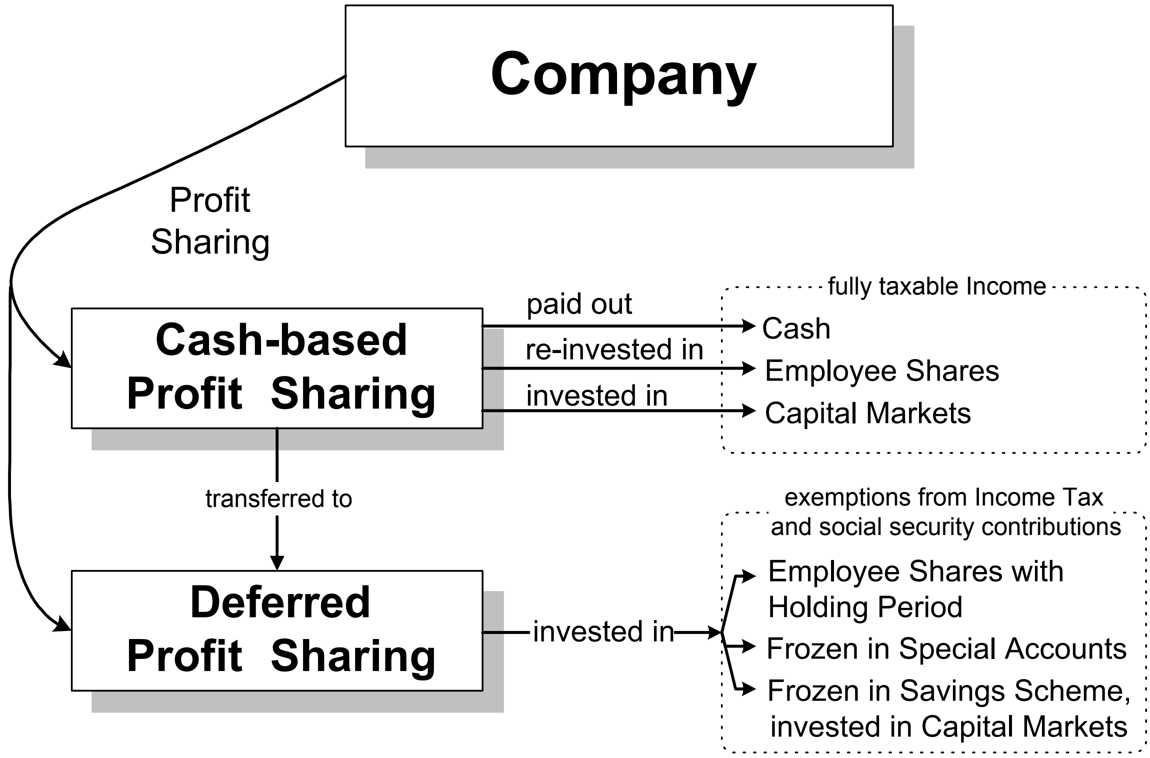


Referring to the catalogue of minimum requirements (e.g. being transparent, broad-based, etc.), the basic scheme reflects the existing postulates of the European policy-

[522] For a detailed technical description of the different mechanisms and schemes see Part 1, Chapter IV and Uvalić (1991), PEPPER Report.

makers which neither relies on nor excludes tax incentives. All of the different elements are voluntary for both enterprises and employees. They can be put together in any combination with the different building-blocks tailored to the specific needs of the given enterprise.

1. Cash-Based and Deferred Profit-Sharing



In cash-based profit-sharing (CPS) and deferred profit-sharing (DPS) schemes, part of an employee's remuneration is directly linked to the profits of the enterprise. In contrast to individual incentives, this concept involves a collective scheme which generally applies to all employees. The formula may include profits, productivity and return on investment. Bonuses are normally paid in addition to a basic fixed wage and provide a variable source of income. They may be paid out in cash or on a deferred basis into a company saving scheme, and can be invested in the capital markets or the company's shares.

A considerable body of evidence suggests that the introduction of profit-sharing correlates with a rise in the level of productivity in a company (Kruse and Blasi, 1995; Jones and Kato, 1995, pp. 391-414). The consistency of the findings on the incentive effect on profitability is remarkable. Profit-sharing is associated with higher productivity levels in every case regardless of the methods, model specification, or data used.[523] Although profit-sharing schemes operate successfully even without tax or social security exemptions (e.g. in Germany), a disadvantage of these schemes in the context of a European Platform is their dependency on the legislative framework and the necessary administrative infrastructure, as well as the fact that they are typically based on individual firm rather than controlled group profits.[524]

Financial participation schemes and in particular profit-sharing bonuses which are paid in cash should also have the effect of making total remuneration more flexible and therefore more responsive to macroeconomic shocks. This wage flexibility is seen as a means of reducing the risk of unemployment in periods of recession and therefore promoting greater employment stability.[525] In some Western countries recent findings have confirmed this effect while, in contrast, other studies suggest no relationship, or question the methods and outcome due to the periods of investigation. [526]

2. Broad-Based Stock Options and Employee Shares

In share ownership plans, shares may be distributed for free or may be sold at the market price or under preferential conditions. The latter may include sale at a discount rate (Discounted Stock Purchase Plan), sale at a lower price through forms of delayed payment (usually within a capital increase), or by giving priority in public offerings to all or a group of employees. To defer the valuation problem[527] in unlisted SMEs, capital participation may initially take the form of an employee loan to the company, creating corporate debt (external capital) subsequently converted into company shares.[528] Valuation of the shares designated for acquisition through the loan can be postponed until the moment of the actual conversion into shares (debt-to-equity) without impeding the implementation of the scheme.

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523 Summarizing OECD (1995) and Uvalić (1991), PEPPER Report, the experience to date suggests that cash-based schemes have had significantly greater incentive effects than share-based schemes.

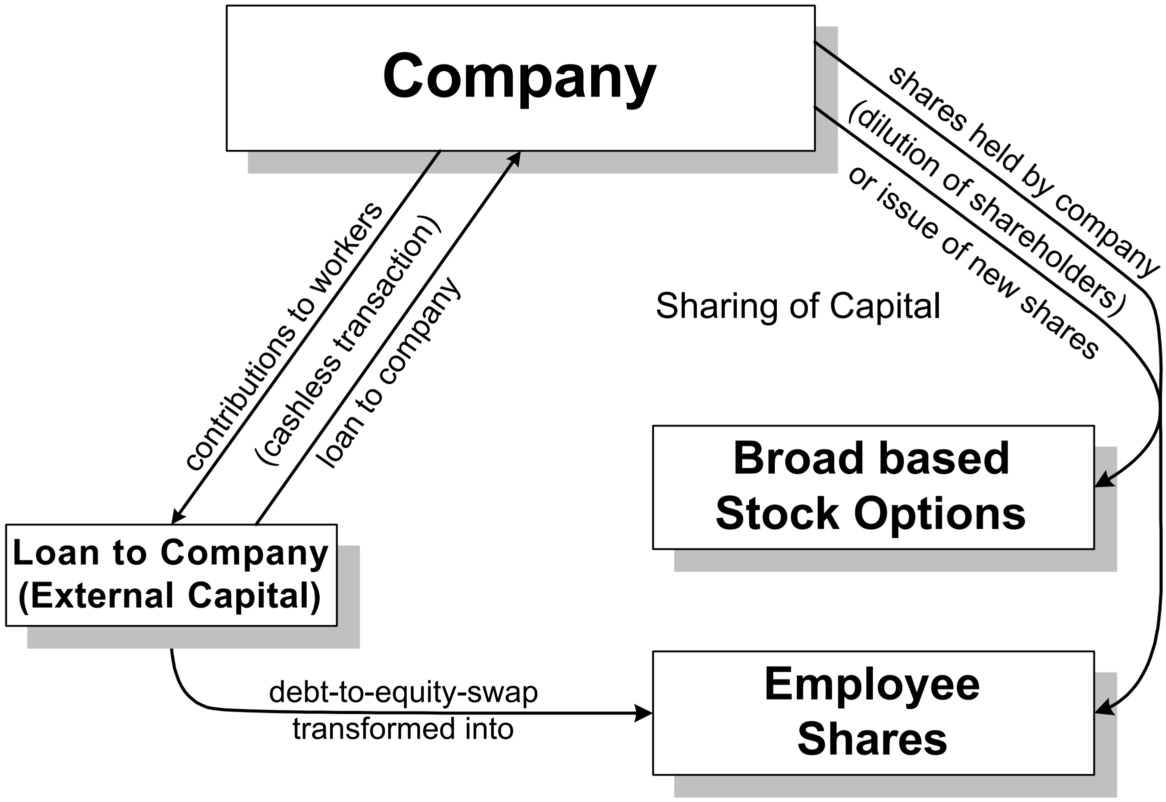
524 See Report of the High Level Group of Independent Experts on cross-border obstacles to financial participation of employees for companies having a transnational dimension, Brussels, December 2003, p. 7.

525 Vanek (1965) was the first to argue that profit-sharing could have a positive macroeconomic effect on employment.

526 Positive: Vaughan-Whitehead (1992), Kruse (1991). Negative: Whadhwani and Wall (1990), pp. 1-17.

527 The valuation of the shares prior to the acquisition may create unreasonable costs particularly in a small firm. This problem is exacerbated when the valuation is repeatedly necessary for different share acquisitions not occurring simultaneously.

528 See the Annex of the Committee on Employment and Social Affairs Report on the Commission communication “on a framework for the promotion of employee financial participation” COM(2002)364, 2002/2243(INI); “Models for Employee Participation in SMEs”, PE 316.420.



Employee stock options (Pendleton et al., 2002), unlike executive stock options granted to reward individual performance, are broad-based. The company grants employees options which entitle them to acquire shares in the company at a later date, but at a per share price fixed at the time the option is granted. Potential gain from rising stock values is the primary reward conferred by options. Unlike conventional options, employee stock options as a rule cannot be traded, and the holder cannot usually hedge against the risk of a decline in value. Furthermore, employee stock options are normally subject to forfeiture prior to vesting should the employee voluntarily leave the firm.

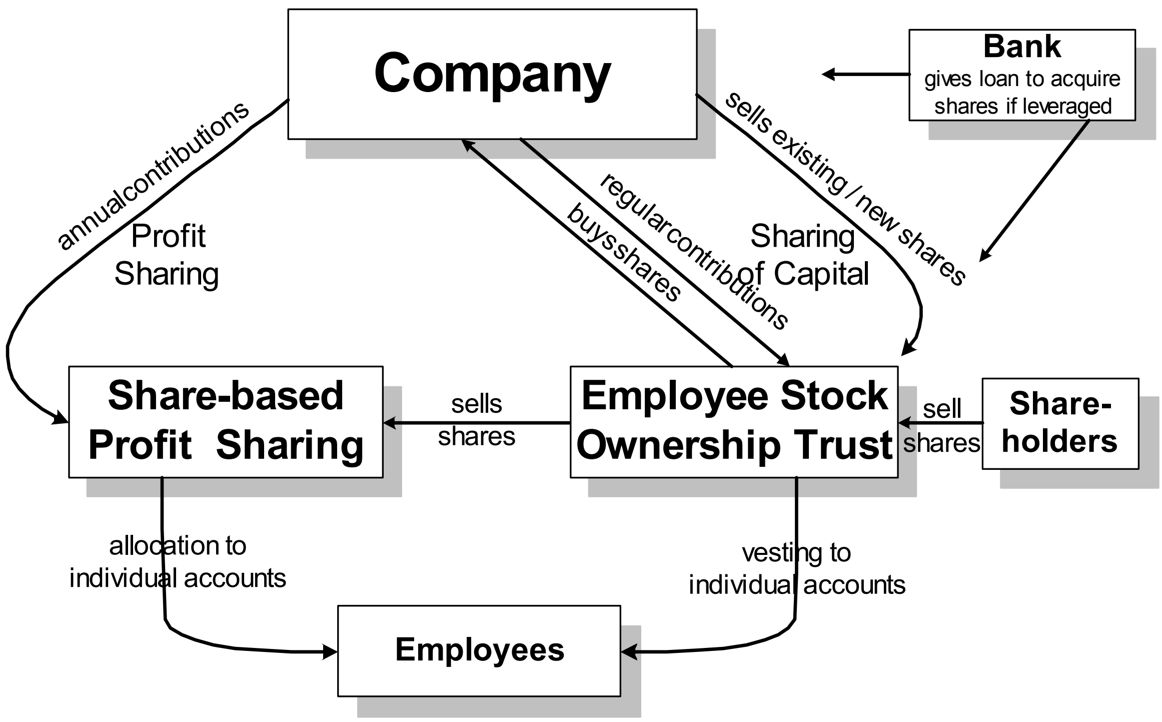
When a company contributes newly issued stock to its employees, the current stockholders suffer a dilution in equity per share. Theoretically, this dilution can be compensated for by increased productivity and profitability as a result of higher employee motivation and increased working capital, which increases the value of all company shares. Although some studies (Chang, 1990; Jones and Kato, 1995; Meihuizen, 2000; Sesil et al., 2000) confirm this result, the issue remains widely disputed (except in 100% ESOPs or in buy-outs where no newly issued shares are involved).

Sceptics voice concern that share ownership subjects employees to an additional risk. Since they are encouraged to put a part of their wealth into the shares of their own companies, rather than other companies, risk is concentrated rather than diversified.[529]

[529] An argument commonly used by German trade unions. See Tofaute (1998), Lipton and Sachs (1990).

The advocates of share ownership hold against this that – depending on the extent – investment in shares of their own companies represents a good portfolio allocation, since shares in their own companies are positively correlated with the return on their most valuable asset, their own work. On the whole this theoretical debate has not yet produced decisive results. It seems that collective investment funds operating on a branch level,[530] or investment and credit insurance backed by the government,[531] could spread the risk and thus compensate for the 'double-risk'. However, the risks are very limited if the scheme only involves a benefit in addition to the basic wages.

3. Employee Stock Ownership Plans and Share-Based Profit-Sharing



Share-based profit-sharing (SPS) is a form of deferred profit-sharing with the profit share being paid in shares of the company, which are usually frozen in a fund for a certain period of time after which workers are allowed to dispose of them. Similarly, Employee Stock Ownership Plans (ESOPs) are funded by the company either contributing shares to the plan, contributing cash that the plan uses to buy shares, or by having the plan borrow money to buy new or existing shares. The schemes may be combined, resulting in the following essential structure:[532]

530 In Germany the possibility of linking these 'Tariffonds' with the reform of the social security system is currently being widely discussed; see *Die Zeit*, 10 December 1998.

531 As proposed for American ESOPs, see Kelso and Hetter-Kelso (1991).

532 As defined in Shanahan and Henessy (1998), p. 9.

- The company establishes an Employee Share Ownership Trust (ESOT) in favour of its employees.
- The trust is usually financed by a combination of company contributions and borrowings. Company contributions often are as part of a profit-sharing agreement with the employees. The trust may borrow money directly from a bank or from the company, which in turn may take a loan from a bank or other lender. Shares are either acquired directly from the existing shareholders or by means of a new share issue. The trust loan is usually guaranteed by the company, but in some cases it is without recourse to the company.
- The shares are held collectively in the trust, and are only allocated to individual employees accounts, or distributed, after a particular holding period. This holding period may be either a matter for the trustees to determine, or it may be driven by the need to repay borrowings before distributing shares, or it may be driven by tax holding periods before the shares can be distributed free of income tax. Most commonly, it is a combination of all three.
- When a share-based profit-sharing scheme is used to distribute the shares, the shares are usually transferred by the ESOT to the profit-sharing scheme without the profit-sharing scheme being required to pay for them. Alternatively the company can make a payment to the profit-sharing scheme to allow the scheme to acquire the shares from the trust. In either case, the shares will be vested in individual employees once they are transferred to the profit-sharing scheme.
- The loan may be repaid by direct cash contributions from the company to the trust, monies received from sale of shares to the share-based profit-sharing scheme, or dividends on the shares held in the trust.

Unlike a pension plan, which as a rule requires diversification, an ESOP is specifically designed to hold employer securities. An ESOP can be used by a company which does not have a listing for its shares to create an internal market for the employees to buy and sell the company's shares. This can be done if the ESOP both distributes shares to the employees, and also operates a market whereby employees can sell their shares and acquire further ones. Usually, a process such as a bi-annual share auction is used. The ESOP can provide liquidity to this internal market if it is also a buyer of shares in this internal market. The shares which the ESOP buys will then be distributed to employees in subsequent distributions. The creation of a market for the shares of an otherwise illiquid company makes the ESOP a financial tool which benefits both employees and the employer company. In this context an important feature of an ESOP is that it can be leveraged by taking out an external loan to buy shares in the employer company. This leverage potential is most important because it can accommodate large transactions for the company and its shareholders while creating particularly sizeable capital ownership in employee accounts. The ESOP debt is funded by appropriately timed contributions from the company to the ESOT. Of course any dividends earned by the stock may also help to pay off the loan, but this is more of a complementary element.[533] As with any other bank loan, ESOP loans must be repaid regardless of whether the dividends on the stock are sufficient to pay off the loan. By making the loan payments tax deductible to the corporation, as, e.g., in the US, the loan is repaid with tax-free income, in contrast to a conventional re-capitalisation loan that must be paid back with after-tax income.[534]

Utilizing corporate credit to guarantee the loan which funds the acquisition of employee shares by the ESOT and writing off loan repayments as expenses deductible from taxable corporate income substantially reduces the financing costs.[535] Given the additional advantage that the shares are not sold to outsiders, thus eliminating the risk of loss of control, the ESOP solution in most cases will be preferable to a conventional bank loan. Of course any of the objectives of an ESOP, resulting in any percentage of shareholding from 1% to 100%, can be achieved on an unleveraged basis over time.

An ESOP, considered only as an umbrella term to cover a trust set up by a company to put shares in the hand of its employees, is similar in many ways to a share-based profit-sharing scheme but most importantly is not as limited. While the latter has only one source of funds (i.e. direct contributions from the employer company), the ESOP can be financed from such different sources as:

- a loan from the employer company, from a selling shareholder or from a financial institution such as a bank;
- dividend earnings;
- sale of shares to its related share-based profit-sharing scheme;
- contributions from the employer company.

Share-based profit-sharing schemes, while providing the company with a vehicle to deliver shares to the employees, offer a very limited market for those shares. The ESOP not only provides a new source of shares which can be sold to a profit-sharing scheme, it has the advantage of providing workers with an internal market to which they can sell their shares, which at the same time recycles shares for the accounts of

533 If the P/E ratio is 5 and the interest rate is as low as 5%, a standard 7 year level-principal loan amortisation schedule would require P/7 + P x .05 or almost a 20% dividend in year one to service the loan.

534 For the US, see Bachman and Butcher (2002).

535 In a variation of the described loan structure the lender often prefers to make the loan directly to the company, followed by a second 'mirror loan' from the company to the trust. The tax results will be the same as in the case of a direct loan to the trust. The principal repayments will still be deductible because the company has to make annual deductible payments to the trust in amounts sufficient to amortise the internal loan from the company to the trust. The amounts paid by the ESOP trustee to the company to amortise the internal loan will usually constitute tax-free loan repayments and can be used by the company to amortise the external bank loan. The 'mirror loan' structure provides the lender with a stronger security interest in the assets pledged to secure the loan. In the case of default the lender will be in a better position to defend against claims of fraudulent conveyance if it has taken collateral directly from the borrower rather than from a guarantor of the loan.

future employees. This internal market is of major importance in unlisted SMEs for which no other ready source of liquidity exists.

Leveraged employee share ownership, on the other hand, as in the case of ESOPs, involves an additional element of risk. Whereas profit-sharing plans represent a variable financial burden, leveraged schemes require fixed loan amortisation payments regardless of the company's financial performance - a condition similar to taking on debt. In fact, such loans are treated as a liability if the company guarantees the loan or commits to future contributions to service it. Thus, if a company is not growing or becomes unprofitable, the repayment obligation can threaten its ability to survive. Furthermore, closely-held companies may be obligated to purchase the shares of departing plan participants because of the absence of a public market for their stock.[536] In such a case the repurchase liability in a successful company generally increases over time as the appraised value of the company's stock rises, although it does not usually increase as a percentage of the company's free cash flow.[537] If a company does not plan adequately to meet this liability, it may be forced to make a public offering of its stock to eliminate the repurchase obligation, an expedient which is not only very expensive but also involves a loss of control and independence and the loss of opportunity to future employees.[538] A better alternative is the creation of a 'sinking fund', although in small companies it may be difficult to develop accurate actuarial assumptions.[539] Where a relatively large portion of the repurchase liability is attributed to a few plan participants, the use of life insurance may be appropriate (Bye, 2002).

Finally, the costs of designing and implementing a financial participation scheme can be considerable. To these must be added the ongoing costs for administration, legal services and employee communication. An additional expense for closely-held companies arises from the need for an annual appraisal of the company's value by an outside expert. For a medium-sized US ESOP company, the installation costs are approximately US$ 40,000 with the annual administration costs, including appraisal, ranging to about US$ 15,000[540] Generally speaking, unless a company is medium-sized or

536 If local company law, as in the US, or bylaws of the company requires this. In Ireland, for example, departing employees have no right to be bought out at market value.

537 The percentage of a company's free cash flow which will be required to service the repurchase liability on average over a period of years is fairly constant unless the multiple of the company's earnings (price/earnings ratio) alters dramatically. The average company will require cash equivalent to 7.5% of the value of the allocated stock in the trust for repurchase liability purposes each year. This is equivalent to a 7.5% dividend on the stock, but only on the stock already allocated to employee accounts in the trust. See Lyon (1989), p. 4 ff.

538 Thus the ESOP transaction should be modelled in advance to ascertain that the company can afford this amount of 'dividend'. Otherwise, there should be a limit on how large a percentage of the company's total stock may be acquired by the ESOP. A growing company may require almost all of its free cash flow to fund future growth, but a company growing this fast may well want to go public.

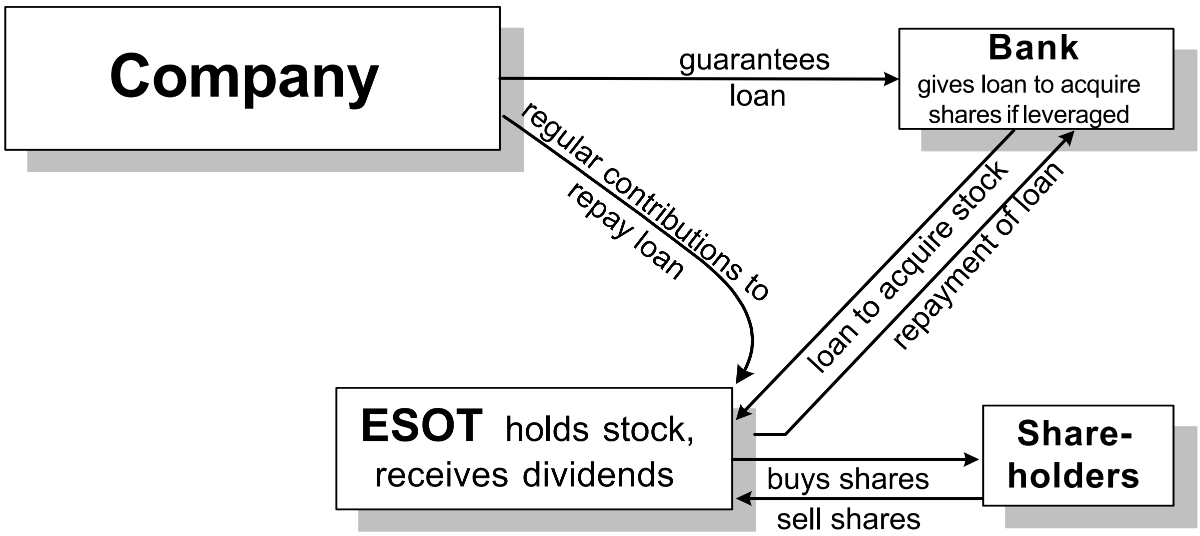
539 For US ESOPs, see Ackermann (2002).

540 Information provided by Menke & Associates, Inc., San Francisco CA. Costs are generally lower for smaller companies where the ongoing annual appraisals are generally around US$ 5,000.

larger, these costs may outweigh possible tax advantages (Poutsma and Van den Tillaart, 1996).[541]

a) ESOP as a Vehicle for Business Succession

A full or partial ESOP buy-out provides an ideal vehicle to facilitate changes in the ownership and management of closely-held companies. This field of action has recently been highlighted by the European Commission's explicitly stressing the importance of ownership transfers to employees as a specific measure for facilitating business succession in SMEs.[542] ESOPs may easily buy-out one or more shareholders while permitting other shareholders to retain their equity position. This is one of its major advantages from the shareholders' perspective. At the same time, ESOPs give business owners the opportunity to diversify their investment portfolios without the costly process of going public.[543] Furthermore, there is no dilution in equity per share of current stockholders since no new shares are issued and all shares are bought at fair market value.[544]



As stated above, the ESOT borrows money to buy shares, the company repays the loan by combining any dividend income of the trust with its own tax-deductible con-

541 Set-up expenses are, however, usually tax deductible as, e.g., in Ireland. See Shanahan and Henessy (1998), p. 33.

542 One of the key areas defined in the Final Report of the MAP 2002 Project, European Commission Enterprise Directorate-General (2003).

543 For US ESOPs, see Ackermann (2002).

544 Theoretically, there is a loss in the potential of the company caused by the burden of the loan, since the borrowed funds used for the buy-out otherwise might be used to finance further growth. It is unlikely, however, that a trade sale to an outsider, if at all possible, would trigger the same increase in productivity and profitability as a result of higher employee motivation.

tributions to the plan. As the loan is repaid, a number of shares equal to the percentage of the loan repaid that year is allocated to employee accounts, usually on the basis of relative compensation. In this way the ESOP creates a market for retiring shareholders' shares at a price acceptable to the owner - a market which otherwise might not exist. At the same time, when a change of control is appropriate, ownership is transferred to motivated employees who have a vital interest in the company's long-term success.

Thus the ESOP may be an attractive alternative to selling the business to outsiders, especially when there is a desire to keep control of the business within a family or a key-employee group.[545] As a trusteed plan, the ESOP is designed to separate control over the shares in the trust from the 'beneficial owners.' The trustee exercises the voting rights while the employees are the financial beneficiaries of the trust. The trustee may, in fact, be the very person who has just sold some or all of his shares to the trust. For smaller firms especially, it is much easier to contemplate a gradual transfer of ownership by making a market for the shares of those who wish to sell at the present moment, while enabling those who wish to hold their shares to retain their equity interest permanently or at least until some later date. The result is the opportunity of gradually cashing out without giving up immediate control.[546] The great virtue of an ESOP is that it can easily accomplish a 100% buy-out over time without subjecting the company at any given moment to 100% leverage.[547]

b) ESOP Enhancing Cash Flow

The ESOP may also be used to enhance the cash available for any legitimate corporate purpose. This involves the issuance of new shares or the sale of existing stock held in the company treasury. Besides creating employee share-holding, the employer company, under certain circumstances, by selling shares at full market value to the trust, receives an equity injection. This is the case when tax advantages are available for paying off leveraged principal with tax-deductible plan contributions. It also occurs when the company acquires cash from the employees directly. However, even without these conditions, the company, through its contributions, fully funds the 'equity'.

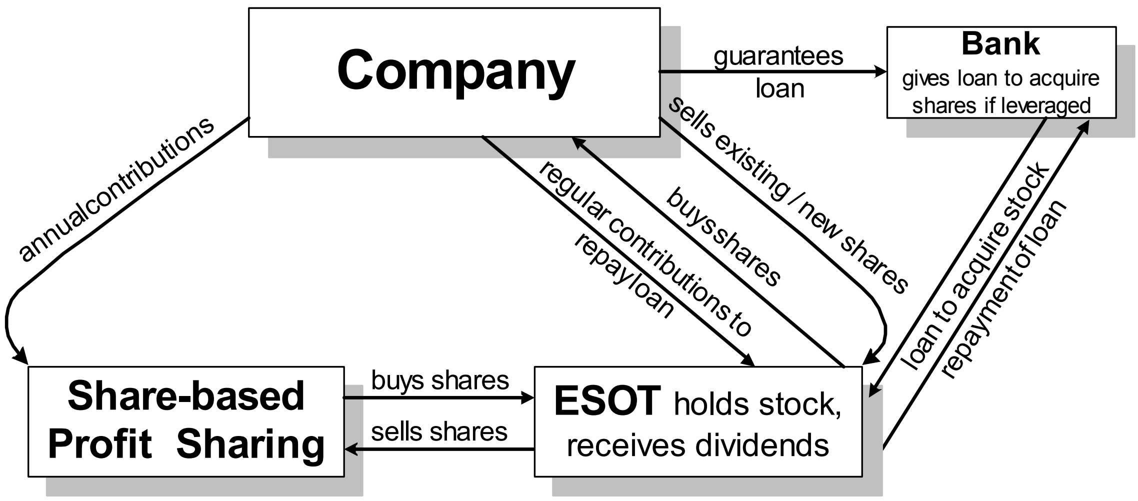
Usually the dilution of the current stockholders is partly offset by any available tax advantages. It can furthermore be compensated for by increased productivity and profitability of the company as a result of higher employee motivation, which in the process raises the value of its stock. An increase in working capital can occur if the ESOP is replacing some other program which would have diverted cash out of the company

545 The ESOP may also be used to buy out dissident shareholders.

546 Once the loan is paid off, of course, most companies make some arrangement for the presence of employee representatives on the plan committee.

547 One hundred percent buy-outs are very difficult for most companies to finance without a significant tranche of capital from lenders who demand a very high rate of return (35%-40%). The costs for arranging the financing can amount to millions of Euros, which is certainly beyond the range of the SMEs.

(e.g. a pension or profit-sharing plan invested in non-employer securities). The same is true if, in the absence of an ESOP, the company has to purchase shares from a departing founding shareholder with after-tax income rather than pre-tax income.



III. Compliance with the Postulates of the European Policy-Makers

1. Achieving Competitiveness While Maintaining Diversity

Financial participation of employees is closely linked to the objectives of the Lisbon summit for making the European economy 'the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion'.[548] The proposed European Platform refers – as does the Commission[549] – particularly to the experience in the US that demonstrates the impact such a model can have 'in terms of economic growth, fostering industrial change and making sure that all workers participate in this growing prosperity'. Therefore, in order to harness the potential – still largely unexploited in Europe – of the further development of financial participation as part of an overall strategy for stimulating the growth of new, dynamic companies as the Commission requires, we advocate the development of ESOPs.

Although the thesis that democracy requires a broad distribution of wealth is widely accepted, present social policy has not yet responded to the growing concentration of wealth; no regulations have come into force either at a national or a European level.

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548 See point 1.5 of the Presidency Conclusions of the Lisbon European Council (23.-24.3.2000).

549 Commission communication seeking 'a framework for the promotion of employee financial participation', COM (2002) 364 Final, 5 July 2002, pp. 3, 10.

Social attention so far has been focused on the growing wealth of the few (e.g. anti-monopoly legislation).

2. Meeting Essential Principles

The proposed European Platform fully complies with the essential principles of financial participation schemes which the Commission sets forth in the cited communication:

- All elements of the base scheme are voluntary for both enterprises and employees.
- The building blocks can be put together in any combination depending on the specific needs of the given enterprise so as to produce individually tailored, clear and comprehensible plans.
- Discrimination, e.g. against part-time workers or women, would exclude any national company scheme from being integrated into the supranational European Platform. The proposed share ownership schemes that have been established in the United States and the United Kingdom for decades include adequate training programs and educational materials which allow employees to assess the nature and details of the schemes.
- Unreasonable risks for employees are buffered by the diversity of the scheme. The dissemination practices for employee information aim at, among other objectives, raising the awareness of the risks of financial participation resulting from fluctuations in income or from limited diversification of investments.
- By collecting the best practise of national legislation and customs, the rules on financial participation at the company level are based on a predefined formula clearly linked to enterprise results.
- The scheme is a complement to, not a substitute for, existing pay systems.
- It is the explicit aim of the scheme to be used throughout the European Union and as such to be compatible with worker mobility both internationally and between enterprises.

3. ESOPs: A Thrust for Innovation

In addition to well known forms of financial participation (e.g. employee shares and profit-sharing), the building block approach introduces a lesser known but flexible form of collective share ownership: the ESOP. While, for example, share-based profit-sharing schemes have only one source of funds (i.e. direct contributions from the employer company), the ESOP can obtain financing from such different sources as:

- a loan from the employer company, a selling shareholder or from a financial institution such as a bank;
- dividend earnings;

- sale of shares to its related share-based profit-sharing scheme;
- contributions from the employer company.

A full or partial ESOP buy-out provides an ideal vehicle to facilitate transitions in ownership and management of closely-held companies. This field of action has recently been highlighted by the European Commission. In this context, having an internal market for stock is of major importance to unlisted SMEs having no other ready source of liquidity.

Furthermore, the capacity of ESOPs to easily buy-out one or more shareholders while permitting other shareholders to retain their equity position is a major advantage from the shareholders' perspective. The ESOP creates a market for retiring shareholders' shares at a price acceptable to the owner -- a market which otherwise might not exist. The result is the opportunity for shareholders to cash out gradually without giving up immediate control. The great virtue of an ESOP is that it can easily accomplish a 100% buy-out over time without subjecting the company at any given moment to 100% leverage.

While share ownership generally involves additional risk for employees, the ESOP avoids this consequence. Although employees, as in other share ownership schemes, are encouraged to allot part of their wealth into the shares of their own companies rather than those of other companies, resulting in concentrated rather than diversified risk, there is this fundamental difference: ESOP debt is funded by appropriately timed contributions from the company to the ESOT. Thus the scheme provides an additional benefit to basic wages. The employee's salary remains unaffected. There is an additional advantage to the company: Shares are not sold to outsiders; thus there is no risk of loss of control.

ESOPs make employees more motivated and productive while at the same time making enterprises more competitive.

IV. Options for Creating the Legal Foundations of a European Platform

The proposed Platform Approach refers to the overall framework of employee participation in general, and already existing financial participation schemes in particular. As an alternative to the creation of a European Recommendation or Directive on financial participation, we suggest the application of existing national Company Law rooting in the second Council Directive on Company Law. Furthermore the amendment of existing European Company Law, i.e. the European Company Statute is considered.

1. Recommendation According to Article 249, Paragraph I, 1 ECT

The European Platform could be framed as a Recommendation according to Art. 249, para. 1, 1 ECT. The downside of such a solution, however, is that Recommendations according to Art. 249, sentence 5, ECT are not legally binding and thus implementation in the Member States would be far from certain. On the other hand, legislation of such schemes in any form whatsoever is a major step forward, as it sets up a distinct legal entity for companies to refer to and provides a framework for company decisions and actions in those countries that approve the European Platform.

One possible solution to the problem of national implementation would be a recognition procedure by Member States for financial participation similar to that proposed by the High Level Group of Independent Experts. As a result of this procedure, single Member States would recognise single elements from the European Platform drawn up in the Recommendation as equivalent to a plan drawn up under its own laws and provide equivalent benefits. In this way they would provide companies operating under their legislation with a legal framework that delineates what is possible without invoking sanctions from regulatory, legal and taxation authorities. Recognition is nonetheless a major step and would require considerable co-operation between the Member States and the Commission.

2. Directive Level: Amending Existing European Company Law

Considering the difficulties in passing and implementing European Directives, especially in sensitive areas where unanimous decisions may be required, it seems preferable to amend existing European legislation. Since employee share ownership fits into the framework of company law, rules to implement it could be proposed as an amendment of the 'European Company' legislation. Like the European Company Statute (ECS)[550], which provides an option for forming a supranational company, there could be an amendment to the ECS permitting such companies to create 'European Employee Shareholding' as an option. This option could be easily extended to other companies which do not fall under the ECS, provided that national legislation would then be adapted to the requirements of the supranational statute.

The EU Member States would have an incentive to implement legal rules pertaining to the 'European Employee Shareholding Statute' as an amendment to the ECS, choosing from a variety of incentives, possibly including tax breaks as well as other preferential treatment:

- Unlike the supplementary rules to the ECS concerning participation in decision-making, those on 'European Employee Shareholding' would be totally voluntary; they would apply only if the company decides to adopt one of the existing models of financial participation.

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[550] Council Regulation (EC) No. 2157/2001 of 8 October 2001 on the Statute for a European company (SE); OJ, L 294/1.

- As in the case of the supplementary rules to the ECS on participation in decision-making, the scheme would be, at first hand, proposed by the employers to their employees; in other words, a negotiated proposition. If the proposed scheme does not correspond to a catalogue of minimum requirements, or the parties so decide, a statutory set of standard rules would apply as a 'safe harbour'.
- The mechanism of the 'default standard rules' concerning participation in decision-making, foreseen in the ECS for resolving potential conflict while at the same time not imposing a solution, would even be suitable in the field of financial participation:
- As for the 'standard rules' for private and/or unlisted SMEs, an ESOP-trust would seem to be the most feasible vehicle since it may provide a relatively non-controversial solution to the question of employee voting rights and may buffer potential risk more easily, while at the same time solving the problem of business succession.
- As for the 'standard rules' for quoted medium-sized and large enterprises, a restricted broad-based employee stock option scheme (as practised in the United Kingdom) seems to be feasible since there has already been substantial development in European harmonisation on the one hand, and a remarkable initiative put forward by the Enterprise Directorate-General on the other.

3. National Level: Building on Existing National Company Law

Given the above described difficulties in arriving at a supranational compromise either in the Commission or in the Council, in order to reach a regulation at the supranational level, the simplest solution is to build on existing national legislation originating in the *acquis communautaire*. A rare example of such a legal 'common ground' are some of the national rules on listed and unlisted joint stock companies originating in the implementation of European Law, i.e. the Second Council Directive on Company Law 77/91/EEC, dating back to 13 December 1976. Art. 19 para. 3; 23 para. 2 and 41, para. 1 and 2 of the Directive allow Member States to deviate from the European legal framework of joint stock companies in order to encourage employee financial participation. Although primarily referring to share ownership schemes these – optional – regulations also leave room for combination with profit-sharing schemes.

Art. 19 para. 3 allows Member States to deviate from the restrictive rules governing exemptions from the general prohibition against a company acquiring its own stock. When the shares acquired by the company are earmarked for distribution to that company's employees or to the employees of an associate company, a general shareholders assembly decision is not obligatory although such shares must be distributed within 12 months of acquisition. Member States may lift the limit of the nominal value of the acquired shares (including shares previously acquired by the company and held by it, and shares acquired by a person acting in his own name but on the company's behalf) of 10 % of the subscribed capital though, according to Art. 41 para. 1. As an exception to the general prohibition against a company leveraging the acquisition of its own shares, Art. 23 para. 2 allows Member States to permit companies to advance funds, make loans, and provide security (financial assistance), with the intention of selling these shares to company employees. Art. 41 para. 1 further allows for deviations from general rules and restrictions to encourage employee financial participation during the process of raising additional capital. An example is the financing of the share issue from the companies' own funds or through a profit-sharing scheme. Finally, the opening clause of Art. 41 para. 2 of the Directive providing for the possibility of suspension of Art. 30, 31, 36, 37, 38 and 39 for companies under a special law issuing collectively held workers' shares, has not been used except in the case of France.

Table: Implementation of the 2nd Council Directive on Company Law 77/91/EEC

Country	Art. 19 (3) Permission to acquire company's own shares for its employees	Art. 23 Permission to advance funds, make loans, provide security (financial assistance), with a view to acquisition	Art. 41 (1) Derogation to encourage financial participation in case of capital Increases	Other general provisions in Company Law to promote financial participation
Austria	Also employees of affiliated firms; reserve fund for own shares to be established without reducing of equity capital or other reserve funds; Stock options without decision of General Assembly, but consent of supervisory board	No	Stock options for firm's/ affiliated firm's employees; General Assembly decision; nominal amount of options restricted to 10%, that of increase to 50% of equity capital; limit of 20% of equity capital for total amount of shares receivable	In firms with individual share certificates the number of shares has to be increased to the same extent as equity capital is increased
Belgium	Without decision of General Assembly	Also firms founded by employees who hold more than 50% of voting rights	5 years not transferable, limit: 20% of equity capital; max. 20% discount	No
Bulgaria	Not specific for employees, generally possible	No	No	No
Croatia	Also employees of associated firms; reserve from profits needed	Reserve needed; must not endanger equity capital	Among others to fulfill employees' claims to acquire shares	No
Cyprus	Without decision of General Assembly	Advance funds and make loans to employees	No	No
Czech Republic	Without General Assembly decision provided for reserve	In accordance with Articles of Association	Financing from company profits or profit-sharing; not public offering	Discount limit: 5% of equity capital, covered by firms own resources

Country	Art. 19 (3) Permission to acquire company's own shares for its employees	Art. 23 Permission to advance funds, make loans, provide security (financial assistance), with a view to acquisition	Art. 41 (1) Derogation to encourage financial participation in case of capital Increases	Other general provisions in Company Law to promote financial participation
Denmark	Limit: equity capital exceeds distributional dividend; share capital less own shares held must amount to not less than DKK 500,000	Also acquisition from employees; to extent that shareholders' equity of firm exceeds amount of not distributable dividends	According to Articles of Association issue of new/bonus shares; also subsidiary employees; also other than by cash payment	Deviation from subscription/ pre-emption rights by decision of General Assembly (2/3 of votes and equity capital) for benefit of employees
Estonia	Not specific for employees, generally possible	No	No	No
Finland	Not specific for employees, generally possible	No	No special regulation with a view to employees	Act on Personnel Funds
France	In context of share-based profit-sharing scheme, share savings plan or stock option scheme	Also in subsidiaries or companies included in a group savings scheme	For all schemes; General Assembly decision required; no public offering; no voting rights	Employee stock options; Share-based deferred profit-sharing; Save-as-you-earn schemes
Germany	Without decision of General Assembly; also (former) employees/of affiliated firms; reserve fund necessary without reducing of equity capital or reserve funds	Yes	Stock options for firm's/ affiliated firm's employees; General Assembly decision; nominal amount of options restricted to 10%, that of increase to 50% of equity capital	In firms with individual share certificates number of shares to be increased to the same extent as equity capital is increased
Greece	Also personnel of ancillary firms	No	Shares/stock options, free/discounted; 3 ys. not transferable without General Assembly approval	No
Hungary	Not specific for employees, generally possible	Also employees of controlled firms or organisations founded by employees	Both, free/discounted special 'Employee Shares', not considered public offering	Specific free/discounted 'Employee Shares'; limit: 15% equity capital; not transferable; obligation to sell back
Ireland	Not specific for employees, generally possible	Firm/ group firm; provision of money/ loans under share scheme; present/ former employees and members of families	No	Finance Acts: Share-based profit-sharing; Save-as-you-earn/ Share purchase schemes

Country	Art. 19 (3) Permission to acquire company's own shares for its employees	Art. 23 Permission to advance funds, make loans, provide security (financial assistance), with a view to acquisition	Art. 41 (1) Derogation to encourage financial participation in case of capital Increases	Other general provisions in Company Law to promote financial participation
Italy	No	Value of financial assistance within distributable reserves	Pre-emptive right of shareholders can be suspended for up to 25% of new shares with majority General Assembly vote; more than 25% require majority of capital held	Special 'Employees shares' can be issued in capital increase with specific rules for form, tradability and rights
Latvia	Firm may fully pay up stock, not transferable; for max. 6 months	No	Non-voting shares, max. 10% of equity capital, covered by firms profit; not public offering	'Employee shares' municipal/state firms; not transferable; obligation to sell back
Lithuania	Not specific for employees, generally possible	Advance funds or loan paid back by deductions from employees' salary	Non-voting shares f. max. 3-y. period in which share sale only to other employees	No
Luxembourg	As minimum requirements of Directive	Limit: net assets of firm not lower than amount of subscribed capital plus reserves	No	No
Malta	Without decision of General Assembly	For employees of firm or group firm; must not endanger firm's own funds	No	Free/discounted shares of mother firm for employees; no prospectus needed
Netherlands	Also employees of group firm; without decision of General Assembly, if Articles provide; equity capital reduced by acquisition price not less than amount paid for shares plus reserve funds	Yes	No	No
Poland	Also retired employees/ affiliated firms; reserve needed	Reserve needed, also employees of affiliated companies	Financing from firms' profits/profit-sharing; not considered public offering	No
Portugal	Not specific for employees, generally possible, if partnership contract does not provide for anything else	Also to employees of affiliated firms; liquid assets must not become less than subscribed capital plus not distributable reserves	General Assembly may limit/abolish pre-emptive right of shareholders for 'social reasons'	No

Country	Art. 19 (3) Permission to acquire company's own shares for its employees	Art. 23 Permission to advance funds, make loans, provide security (financial assistance), with a view to acquisition	Art. 41 (1) Derogation to encourage financial participation in case of capital Increases	Other general provisions in Company Law to promote financial participation
Romania	Financed by profits and/ or distributable reserves	Yes	No	No
Slovakia	In accordance with Articles of Association	Provided for this does not endanger companies' own funds	By General Assembly decision	Preferential share offers, discount max. 70% covered by firms' own resources
Slovenia	Also retired employees and of associate firms	Also employees of associate companies	Financing from profit-sharing possible	No
Spain	Also for stock options	Yes	No	No
Sweden	Not specific for employees, generally possible	Employees of firm/ group firm; total value limited; min. ½ of firms employees covered; advance/ loan to be repaid within 5 years	General Assembly can suspend shareholders pre-emptive right of; also group firm; also wife/ husband/ children	No
Turkey	Not specific for employees, generally possible	No	No	No
UK	Not specific for employees, generally possible	Firm/ group firm; provision of money/ loans under share scheme; present/ former employees and members of families	No	Finance Acts: Deferred share-based profit-sharing; Save-as-you-earn/ Share purchase schemes

As the table illustrates, a surprisingly large majority of Member States have adopted national legislation permitting a company to acquire its own shares in order to transfer them to its employees, and to facilitate this acquisition by financial assistance. Despite the fact that this legislation has rarely been used in some countries, the existence of corresponding regulations across the EU may serve as a foundation for a European Platform.

V. Suggestions for Initiatives

The analysis of the legislative framework in the ten new EU Member States and the four Candidate Countries has shown that there are practically very few laws specifically dedicated to employee financial participation. In both the former socialist states and the non-transition countries, the laws enabling forms of employee financial participation refer almost exclusively to employee share ownership[551], as there have been only a few cases of legislation on profit-sharing[552]. More recently, however, the conditions for employee ownership have generally been more restrictive and there has been a general tendency towards the reduction of ownership by non-managerial employees. Thus today, there are only a few countries which still have a substantial number of firms in majority employee ownership.

Given the limited incidence of PEPPER schemes, it is not surprising that the empirical evidence about the effects of schemes is available for only some countries – the Baltic States, Hungary, Poland, and Slovenia. Whereas much of the evidence is preliminary and refers primarily to the 1990s, when employee ownership played a more important role than today, these studies suggest that the performance of enterprises in employee ownership, frequently, has not been worse than performance of firms with other ownership forms. The comparative analysis of the general attitude of governments and social partners shows the lack of concrete policy measures supporting PEPPER schemes by policy makers, and limited interest both by trade unions and employers organisations.[553] Rather than being actively promoted as in some old EU Member States, employee financial participation has most frequently not been considered, or has been viewed with suspicion.

On the basis of these principal findings of the PEPPER III Report suggestions for future initiatives which could contribute to a more widespread diffusion of employee financial participation in the enlarged EU are being made to both the EU Member States as well as to the Commission.

551 Employee share ownership has largely developed in the course of recent privatisations, with different methods including sales of enterprise shares to insiders at privileged terms, employee-management buy-outs, leasing, mass privatisation, ESOPs and ESOP-type schemes.

552 Despite the fact that company laws in several countries do refer to the possibility of employees having a share of company profits, Romania is the only country that has specific legislation on a general scheme for cash-based profit-sharing in state owned companies (though implemented in a small number of companies). Among the non-transition countries, only Turkey has legislation on profit-sharing.

553 Only sometimes have trade unions been supportive of employee ownership, but they remain rather critical of profit-sharing. The employers have been generally indifferent towards financial participation, despite a few cases of active support (as in the case of ESOPs in Hungary).

1. Promoting PEPPER Schemes at the National Level

The potential beneficial effects of employee financial participation should not be neglected. A growing body of empirical evidence appears to back up these claims.[554] To summarise, existing evidence suggests that financial participation can deliver real benefits for employees, enterprises and national economies. However, despite this potential, it remains under-utilised in most Member States, and is very unevenly distributed within the EU.

- **The Challenge: Legislating PEPPER Schemes**

In conformity with much of the Western experience, the lack of specific legal provisions on employee financial participation, which would provide a different fiscal treatment or other type of incentive, seems to have been a major obstacle to its introduction. Probably some policy action in this domain in the new Member States and Candidates would be useful. The Western experience with profit-sharing and employee ownership clearly confirms that schemes have been most diffused in those countries where concrete measures have been introduced to support them.

- **Share Ownership Schemes: Developing a Long-Term Perspective**

Given the prevailing economic conditions in most of the incoming countries from Central and Southeastern Europe, the beneficial effects could be even more important than in the advanced EU economies. Nevertheless, share ownership has been introduced rather as a one-off incentive offered to employees within the privatisation process. Policies actively promoting not only the introduction of such schemes but also their continuous support have been almost non-existent. This has been one of the main causes for their decreasing incidence. On the other hand, employee financial participation has been actively promoted by a number of Western governments, as well as by the EU, precisely because it is expected to lead to a number of positive effects on the long run.

- **Profit-Sharing: Strengthen Incentives and Increase Productivity**

Regarding in particular profit-sharing, despite its limited diffusion in the newcomers from Central and Eastern Europe[555], the rich experience with these schemes in the EU-15 will probably become increasingly relevant in the future. The need to strengthen incentives and increase workers productivity in the future could generate more favourable attitudes towards flexible remuneration schemes such as profit-sharing. Nevertheless, such development needs support at the national level.

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[554] Financial participation has been statistically linked with greater productivity and with higher profits (profit-sharing, Festing et al., 1999; share ownership, Blasi et al., 2004). Furthermore, these effects appear to be strengthened by the presence of other kinds of employee involvement (Kim, 1998).

[555] In the early 1990s, the general economic conditions – recessionary trends, falling wages, low or negative profits – have not favoured the adoption of profit-related remuneration schemes. Changes in the area of labour relations have usually provided laws based on the standard wage employment contract, which together with rigid tax provisions, do not allow much flexibility in payments systems.

2. Promoting PEPPER Schemes at European Level

The development of financial participation schemes across the EU is strongly influenced by national policies, in particular by the availability of an appropriate legal framework, tax incentives and other financial advantages. As a result, different laws and sometimes mandatory rules in different countries, often require specific forms of financial participation, forcing companies to tailor the design of an international plan accordingly. Here the EU has an important role in promoting further employee financial participation in the now enlarged EU, as a continuation of its earlier initiatives in this area.

- **Informing Governments and Policy-Makers of the PEPPER Initiatives**

A Community initiative should aim at closing the information gap between PEPPER I/II (1991/97, EU 15) and PEPPER III (2006, 10 New Members / 4 Candidates) that currently prevent a full profiling of financial participation policy and practice. Providing information in a systematic way may also help to overcome the cultural differences in the social partnership, to raise the new Member States' awareness as well as to avoid and remove transnational obstacles.

- **Reporting on the Positive Experience Gained in Many EU Countries**

In line with prior Commission activities the benchmarking indicators developed by the European Foundation for the Improvement of Living and Working Conditions should be rolled out in all EU-25 and Candidate Countries. This facilitates a discussion of individual country's scores on the indicators against the background of comparable scores for the other EU Member States providing a contextual frame of reference for each single profile.

3. Developing a Common Model for Financial Participation Across the EU

An open platform model ideally responds to the need for developing schemes at the European level in order to support financial participation more actively and to overcome national differences in taxation policy. At the same time, such a framework, while providing a broader incentive system, delineates what companies may do without inviting sanctions from regulatory, legal and taxation authorities.

- **Providing a Broad Incentive System With Flexible Solutions**

A model must be compatible with those already established in the Member States[556]: Relatively widespread in the EU-15 are profit-sharing schemes, stock options and employee shares. In countries with an Anglo-American tradition, e.g. the United Kingdom and Ireland, but also in some transition countries, such as Croatia and Ro-

[556] The apparent difference in legal and political priorities between East and West is due to the fact that the first priority of post-socialist legislators was to change the socialist economic system through privatisation and re-privatisation; the development of PEPPER schemes does not necessarily constitute a progressive evolution of their pay system or their work organisation process.

mania, ESOPs are to be found. In general Central and Eastern European countries have developed share ownership systems rather than profit-sharing schemes with shares being distributed for free or sold at the market price or under preferential conditions. The Building Block Approach (see above II.) reflects this diversity, while opening national practise to new forms of financial participation.

- **Addressing Transnational Obstacles Identified by Commission**

Providing a broad incentive system going beyond the classical instruments of tax legislation, the basic scheme of the Building Block Approach neither relies on nor excludes tax incentives. In spite of the difficulty of implementing tax incentives, these still remain a powerful tool for enhancing and broadening financial participation. They could be voluntarily granted by countries singly or in groups, in the process creating an increasingly favourable environment. The pro-activism of countries with an advanced tradition like France or the United Kingdom would at the same time encourage others to emulate them. Employee ownership in general, and the ESOP model in particular, are more likely to be independent of differences in fiscal systems and in social security contributions on income because the level of European harmonisation concerning share ownership is more advanced than in the field of profit-sharing.

- **Implementing the Legal Foundations of a European Model**

The European Platform consisting of the proposed Building Blocks could be framed as a Recommendation while addressing the problem of national implementation through a recognition procedure by the Member States. As a result of this procedure, single Member States would recognise single elements from the European Platform drawn up in the Recommendation as equivalent to a plan drawn up under its own laws and provide equivalent benefits. This sets up a distinct legal entity for the chosen Building Block throughout those countries that decide for recognition.

- **Building on Existing National Legislation Originating in the *Acquis***

Given the difficulties in arriving at a supranational compromise, the simplest solution is to build on existing national legislation originating in the *acquis communautaire*. A rare example of such legal 'common ground' are some of the national rules on listed and unlisted joint stock companies originating in the implementation of European Law, i.e. the Second Council Directive on Company Law 77/91/EEC. Further investigation of other common existing regulations in this field is needed.

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