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# BOUNDED RATIONALITY CONCEPT AND FARMING VALUES IN LATVIAN AGRICULTURAL SECTOR

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IGO CALS\*  
University of Latvia

**Abstract.** Work values of agriculture are generated by both classical entrepreneurial model expressed through the rational utilisation concept of available resources (land, farm cattle, technology and its means) and rural lifestyle the contribution by which can be characterised through 'bounded rationality' concept. Consequently, agricultural entrepreneurship has explicitly at least dual nature: on the one hand, it embodies the classical manufacturing function, and, on the other, rural lifestyle as a certain value ensures tangible financial and social income to economic agents.

In this respect, a rural entrepreneur has to be able to run a farm, taking into consideration the challenges of global economy and retaining dimensions of local social affiliation. Therefore, rural manufacturer's values have to fit simultaneously into social field paradigms of at least two different levels, and as a result farmers should be able to benefit from access to resources of both socio-economic fields.

The dual values of rural manufacturing manifest themselves both as financial income arising from the output of goods for the global market and, for example, as an income revenues from the EU's standardised area payments towards operating in less favourable areas, or from cleaning up the environment and providing rural tourism services. The economic resources of agriculture are formed not only by entrepreneurship as an institutional process but also by rural lifestyle as a socio-economic value in itself.

In summary, rural work values are a rural entrepreneur's ability to combine in an organic way dual and sometimes conflicting economic functions: global manufacturing and local lifestyle.

**Key words:** *bounded rationality, rural entrepreneurship, multiple value system*

**JEL code:** D03, Q19, Z13

## INTRODUCTION

In scientific studies on contradictions within contemporary agricultural production practices, theoreticians of economic science mostly analyse the contradiction between challenges caused by globalization and prevailing small-scale production of agricultural production (Phillipson, J. et al. 2004;

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\* Phone: +371 26495000, e-mail: [igo.cals@vaderstad.com](mailto:igo.cals@vaderstad.com)

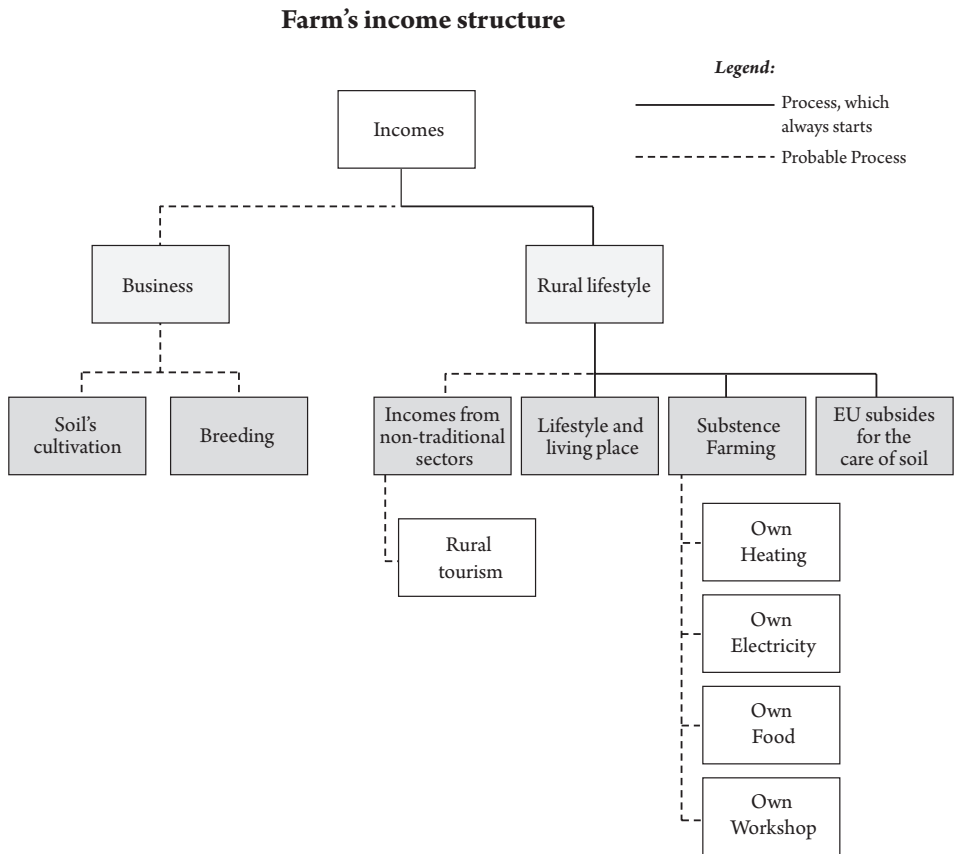
Slangen, L. et al. 2004; Fuller-Love, N. et al. 2006). In the literature of economic science, considerably lower attention is paid to another essential contradiction of rural entrepreneurship – the one between economic efficiency of production and a rural lifestyle as a certain system of values. Such approach is applied towards, for instance, farming (Pyysiainen, J. et al. 2006); however, farming as interrelationship of two contradictory value systems has not been researched sufficiently at a theoretical level. The empirical materials collected by authors confirm that the contradiction in the value system of rural manufacturers between rural entrepreneurship with the objective to gain maximum profit from economic activity, on the one hand, and tangible and intangible income from rural lifestyle, on the other hand, results in a significant unconformity of the respondents' value systems.

The field study carried out by the author in the time period between September 2011 and March 2012, comprising participant observations, in-depth interviews, data interpretation and analysis research method in combination with theoretical concept research, resulted in putting forward a hypothesis that the value system of rural entrepreneurs can be viewed as one of the crucial sources allowing rural entrepreneurs to combine rather contradictory global agricultural production and local life style concepts.

The objective of the study was to find out whether rural entrepreneurs perceived a contradiction in the value systems of aforementioned concepts and, in case of a positive answer, what suitable solutions were considered. The study includes interviews with 42 Latvian rural entrepreneurs from different Latvian regions conducted from March to December 2012. Selected for the study were Latvian rural production companies with agricultural land of minimum 300 hectares which offered their output in the global agricultural commodity market and the owners of which had defined themselves as rural entrepreneurs. Out of the total number of owners of the selected farms, 34 lived in a house on their farm, while eight (8) had chosen to reside in a nearby regional centre or Riga, the capital city of Latvia.

## THEORETICAL ASSUMPTION

A rural entrepreneur's income is mostly made up of two sources: for the most part, tangible income from agricultural production and tangible and non-tangible income provided by rural life style. (Shane S., Venkataraman S. 2000). The authors have developed the following graphic layout to project a hierarchical structure of the potential income from an agricultural farm. Due to the fact that the model does not reveal all possible income types of a rural entrepreneur, the objective of the diagram is to make a visible demonstration that the structure of a rural entrepreneur's economic activity of consists of two related economic activity blocks that do not overlap.



Source: author's construction after research

Fig. 1. Farm income structure (major sections)

A rural entrepreneur's income can be displayed as follows:

$$\Sigma (( R \times T \times DR ) + ( LDz )) \tag{1}$$

where R – available resources,  
 T – application of contemporary technologies,  
 DR – labour productivity,  
 LDz – rural life style

In turn,  $LDz = M + N$  (2)

where M – tangible income,  
 N – non-tangible benefits.

As seen from the above displayed figure, a rural entrepreneur can gain income both from agricultural production and rural lifestyle. In addition, agricultural income is mostly of tangible nature, whereas the income from rural lifestyle can be both tangible and intangible.

An ability to balance the models of two different value systems (Colin C. W., 2011) depends on the human capital capacity of the rural entrepreneur and competences determined by the rural entrepreneur's education level, access to other capital forms (financial, natural (land), technological) and capabilities to utilise different areas of social capital in one's own interests and those of one's family.

If rural entrepreneurship has only a specific production type and yet meets all the standard prerequisites of successful entrepreneurship (Hoggart K. et al., 1995; Pittaway L., 2005) – effective use of available resources with an objective to gain maximum income by taking into account the need for sustainable development of a farm, then the income from a rural lifestyle is measured by both economic and social parameters such as satisfaction with the chosen life style and an adopted system of value (Berkes F., Folke C., 1993; Carter, 2001; Chell E., Baines S., 2000).

The value system is an open system which is significantly influenced by external factors next to an individual's own subjectively adopted value scale (Sarason Y. et al., 2006; Zhang F. Q., Donaldson A. J., 2010). Under agricultural production, the market is subject to strong regulation by the EU and its influence (damage). Different regulations and conditions significantly impact free choice options of a rural entrepreneur. Consequently, the concept of economic rationality is a priori narrowed, and a rural entrepreneur adopts 'bounded rationality' concept within one's own value system. Herbert Simon (1957, 1991, 1997) introduced the concept of 'bounded rationality' to explain how the optimal choice or solution to a problem may be limited or restricted if the individuals concerned have incomplete information, or a limited capability for processing it and, consequently, for exploring various options before taking the decision. Consequently, arriving at optimal choices is rare. If 'bounded rationality' prevails over economic rationality in the value system, then it is only logical that a rural entrepreneur has to be able to run a farm, taking into consideration challenges of global economy and retaining dimensions of local social affiliation (Jayasinghe et al., 2008), exactly according to the relative rationality of belief.

## RESULTS OF THE STUDY

Empirical research demonstrates a dual nature of the value system among rural entrepreneurs: on the one hand, farmers have an understandable wish to make a bigger income from agricultural production, hence, securing a higher income level. Acquisition of high output technology and purchase of modern equipment serve to attain this objective. On the other hand, the farmer stresses

his 'special' or 'exclusive' circumstances on all possible occasions determined by the variability of the land fertility as the main agricultural resource. However, the basis of the notion of 'special' social definition is provided by a social construction – a desire to fit in the respective social field – by incessantly constructing and defining special differences of rural lifestyle.

The interviews and a following research confirmed that 83% of all respondents tried to construct directly or indirectly their daily lifestyle and adopted value system as 'special', with agricultural production being a 'special' type of entrepreneurship. Such data demonstrate that farmers possess a strong support of 'bounded rationality' value system promoted by the existing social field. When this question is considered from the point of view of the 'rational economics' system, it means that an additional resource is required to sell a new, technologically innovative product to a rural entrepreneur, thus overcoming the system of the 'exception' social value created by the abovementioned social construction. In the meantime, the construction of the rural lifestyle value system has got its other side which stresses benefits brought by rural lifestyle. Stability, a certain prestige within the society, immediate access to such resources as the environment of high ecological quality and food products of known origin raise the social value of such lifestyle. The EU rural support policy promotes, in particular, the importance of rural lifestyle value system by subsidising environmental cleanup and the development of non-agricultural entrepreneurship in a rural environment. Although the survey demonstrates that entrepreneurs highly value advantages delivered by rural lifestyle, it also evident that they are sceptical about gaining additional income from the EU subsidies towards environmental cleanup. Approximately 91% out of total respondents expect EU subsidies towards the modernisation of agricultural production instead of rural lifestyle diversification. Therefore, it confirms once again that by living in a rural environment and engaging in rural entrepreneurship, farmers regard both types of socio-economic activities to be based in different social fields and belonging to different value systems.

In agriculture, the social factor "What will my neighbours say?" plays a crucial role in the selection of production tools and applied technologies compared to other entrepreneurial sectors. The evaluation of respondents' responses to the question whether they would be willing to test new agricultural technologies on their farm demonstrated that a majority did not decline a possibility of applying innovative methods; however, they expressed a wish for applying such innovations collectively, to avoid "being ridiculed by neighbours". The given example once again confirms that the social field has a special role in the rural environment and that the promotion of innovations in agriculture requires the carrying out of economic transactions not only among certain manufacturers but among the majority of the agents involved in a certain social network.

The coexistence of two value systems in the rural environment leads to an objective necessity to possess high-level professional qualifications in order



to be capable of balancing gains provided by the rural lifestyle. Regrettably, rural entrepreneurs being professionals in a certain field of activity (mainly, agronomists or technicians) do not wish to improve their knowledge in entrepreneurship and consider objective elements of entrepreneurship (accounting, economic activity analysis and long-term planning) as an external need and not an integral part of rural entrepreneurship.

It is important to note that agriculture is constructed as a socially popular problem area by rural entrepreneurs who make a public declaration that agricultural production is an extremely tough and complicated national industry sector (Sharp, J., Smith, M., 2003). The subsidy system supports both agricultural production and rural life style.

In turn, the analysis of rural entrepreneur's understanding of the relations between economic categories and global economy and his place in the global job market did not demonstrate significant difference or empiric deviation. The farmers have a relatively good knowledge of grain and meat price fluctuations on the global stock markets, they plan expenditure for the acquisition of the resources they need (prices of fertilizers and seed grain), they are familiar with modern information technologies (online banking, GPRS installation on equipment units). The aforementioned once again confirms the coexistence of two parallel value systems in rural entrepreneurship. The knowledge of global economic development processes coexists with primary local concept when analysing a farm from the aspect of rural lifestyles.

## CONCLUSIONS

1. The analysis of rural entrepreneurship distinguishes two socio-economic fields which are not always related and which are used by farmers in forming their value systems.
2. Rural entrepreneurship is one of the economic activity types whose objective is to gain income and to promote a long-term development of a farm. In its turn, rural lifestyle is the other socio-economic field where rural entrepreneurs operate.
3. The rural lifestyle income can have both tangible and intangible forms.
4. A part of rural lifestyle construction is a formation of a "special" value system. In the context of entrepreneurship, agricultural production is a part of "rational economics", whereas rural lifestyle can be more precisely explained by the "bounded rationality" concept.

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# AUDIT QUALITY ASPECTS OF COOPERATION BETWEEN CERTIFIED AUDITOR AND AUDITED ENTITY

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DAGNIJA DAŅĒVIČA<sup>1</sup>

University of Latvia, Faculty of Economics and Management;

IEVA AIZSILA<sup>2</sup>

University of Latvia, Faculty of Economics and Management;

ROBERTS IKAUNIEKS<sup>3</sup>

University of Latvia, Faculty of Economics and Management

**Abstract.** Due to the recent economic crisis in Latvia, Europe and on the global level there is a considerable uncertainty regarding the future developments and trends of the national and global economy. Increasingly, entrepreneurs and investors have to take important business decisions under conditions of risk and uncertainty. Consequently, the importance of reliable information, including that of financial information, is ever-increasing. One of the ways to enhance the credibility of financial information, such as the reliability of financial reporting in business, is the audit of financial statements.

The International Federation of Accountants (IFAC) has issued the International Quality Control Standard and International Audit Standards that prescribe the requirements the auditors must meet to obtain reasonable assurance about whether financial statements as a whole are free of significant non-compliances caused by mistakes or fraud. The requirements of international auditing standards in general define the measures and procedures an auditor must follow by establishing appropriate internal systems and procedures for the audit practices and in the process of audits. However, an essential part of the issues is left to the competence of the auditor and the solutions are based on each auditor's professional judgment.

Audits in the market conditions when audit clients want to minimize costs, including the cost of the audit services, is a great challenge for audit practices regarding remuneration for audit services so as to meet the expectations of the client, while at the same time allowing to perform appropriate audits in accordance with the International Standards on Auditing, as well as getting profit. This situation makes the existing auditing practices review the current principles of setting fees for the audit services, as well as reviewing the principles of the audit process. To ensure a sustainable development and growth of audit practices, audit firms have to introduce qualitative changes in order to render audits more effective and efficient and improve communication with their

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<sup>1</sup> Corresponding author – e-mail: [danevica@mail.teliatmc.lv](mailto:danevica@mail.teliatmc.lv), telephone +371 29231299

<sup>2</sup> Corresponding author – e-mail: [aizsila@hotmail.com](mailto:aizsila@hotmail.com), telephone +371 29145484

<sup>3</sup> Corresponding author – e-mail: [roberts.ikaunieks@gmail.com](mailto:roberts.ikaunieks@gmail.com), telephone +371 26525227

clients at the same time fully meeting the requirements set by the International Standards on Auditing.

In this paper the authors analyze the most important factors that influence cooperation and mutual communication between auditors and audit clients, the scope and type, as well as the quality of the audit services provided.

Challenges and development of the audit profession in Latvia, alongside with the application of auditing standards, is closely connected with economic development, political changes and legislation in the country.

Being able to see an effective functioning, analysis and return of external audit in small and medium-sized enterprises is the main purpose for an entity currently operating in the Republic of Latvia to enter into future collaboration with a certified auditor.

**Key words:** *external audit; International Standards on Auditing; International Standard on Quality Control; aspects of audit quality; audit market in Latvia*

**JEL code:** M40; M42; M48

## INTRODUCTION

The global economic situation affects economy as the whole, and it also has an impact on materiality in an independent audit. The recent years have been considered a turbulent period for economy both on a local and global level due to the rapid growth of technology and globalization, and even more so due to the crisis in financial markets, when banks worldwide could not serve their loans and had to be supported by governments. Increasingly more often, entrepreneurs and investors have to take important business decisions under the conditions of risk and incertitude. Consequently, an ever-growing role and importance is attached to reliable information, including financial information and information provided by audit reports. One of the ways to increase the credibility of financial information, such as the reliability of financial reporting in business, is the audit of financial statements.

As the global economic development and cooperation among the countries is increasing, it is necessary to apply uniform international rules and criteria for the accounting and auditing system. At present, there is much discussion in the world about the role of independent auditors their training and professional suitability, information provided by audit reports, the conformity of the audited company's financial statements with the truthfulness of the data, and the efficient involvement of investors, creditors, shareholders and society at large, as well as predicting the results of future operations.

The role of a certified auditor is gradually increasing under the spotlight of the recent global financial turbulence. It is vital that the accountancy profession re-examines the role of audit and assurance and comes up with constructive, practical ways which both can improve and continue to benefit businesses, the economy and society in the 21st century (ICAEW, electronic resource).

It is equally important to have a proper view and understanding of the market and surveillance of certified auditors in Latvia and Europe, where statutory regulation of the problems and common standards in the audit industry, and significant risks have been taken into account to reach the common goals of all the EU Member States.

The IFAC has issued the International Quality Control Standard No. 1 and the Clarified International Standards on Auditing that provide the general requirements the auditors must meet to obtain reasonable assurance about whether financial statements as a whole are free of material misstatements due to error or fraud in general. The requirements of international auditing standards in general define the measures and procedures the auditor must follow by establishing appropriate internal systems and procedures for the audit practices and in the process of audits. However, an essential part of the issues is left to the competence of the auditor, and the solutions are based on each auditor's professional judgment.

Audits under market conditions, when the audit clients (entities) want to minimize their costs, including the cost of the audit services, is a great challenge for audit practices regarding remuneration for their services so as to meet the expectations of the client while at the same time allowing them to perform appropriate audits in accordance with the Clarified International Standards on Auditing, as well as getting profit. This situation makes the existing auditing practices review the current principles of setting fees for audit services, as well as reconsidering the existing principles of the audit process.

To ensure sustainable development and growth of the audit practices, audit firms have to introduce qualitative changes in order to make audits more effective and efficient and improve communication with clients at the same time fully meeting the requirements set by the Clarified International Standards on Auditing.

This paper presents general considerations on the study of current developments in the audit market, audit quality related aspects, and cooperation and communication between a certified auditor and an audited entity.

## RESEARCH RESULTS AND DISCUSSION

### FRAMEWORK DEVELOPMENT AND EXPANSION IN THE AUDIT MARKET

The profession of a certified (independent) auditor and audit services have already existed in the Latvian market for 18 years. It is not a long period of time if compared with other countries and the history of the auditing profession, however, during these years the profession of a certified auditor in Latvia has undergone a positive dynamic development alongside with the lack of changes in the audit market of Latvia.

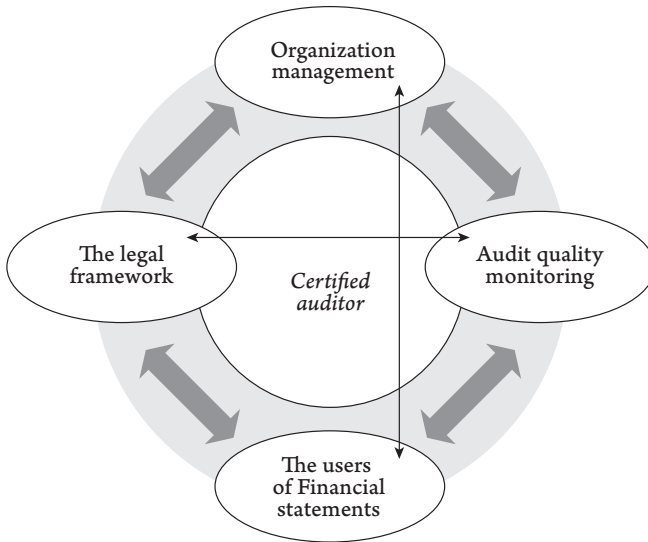
The main purpose of this paper is to describe the audit services market in Latvia and assess the expected impact of changes on the audit market by evaluating the audit quality management, mainly focusing on the situation after Latvia's accession to the EU. The paper will refer in, particular, to the development problems of the local audit firms and challenges for the audit profession, the role of the Latvian Association of Certified Auditors and the Audit Advisory Board in the development of the current situation in the audit market and the quality management of audit firms.

The subject of the paper is the development of regulative requirements for external (independent) audit and of legislation on services by certified auditors and audit firms in the audit market of Latvia.

To demonstrate better the audit market activity in Latvia the authors of the paper present a five-element interaction for reaching a common aim (see Fig. 1), namely, the development of audit and further improvement of regulative requirements on audit. To characterize the audit market, the authors of the paper give explication of cooperation involving five elements with the certified auditor in its centre. This co-operation is a continuous, never-ending process where all its elements affect one another in terms of development, regulation, service quality and professional work of certified auditors (the central, fifth element) and lead to proposals for further improvement.

The interaction process takes place in a negotiation environment not only in Latvia, but also in other countries; it gives understanding and reveals that different interested parties (the fourth element) – organizations, investors, banks, state institutions, creditors, employees, employers, the users of financial statements – are interested in the activities and development of certified auditors and audit quality management. All these parties have a common goal – to increase the reliability of financial statement as the audit process depends on a competent person and the regulatory framework of the country.

It is important for society to have trust in the profession of a certified auditor (the central, fifth element), in the quality of auditing and consulting. The five-element interaction comprises the following elements. The first is an auditor's client or organization that requests an audit. The second element is the regulatory requirements on audit, including elements of judgment in the preparation of financial statement (to show true financial results), as well ISA requirements (on risk-based audit research, audit procedures, use of evidence, audit planning, competence and others) and the existing national legislation. The process, as presented in Figure 1, demonstrates that auditors are responsible for the quality of auditing (the third element). Notwithstanding the lack of generalization of international standards, laws and a national framework, and shortage of experience in Latvia, audit firms and certified auditors give an opinion whether financial statements (information) are prepared in accordance with an identified financial reporting framework.



Source: author's construction based on International Standards on Auditing and Consultation Paper A Framework for Audit Quality

Fig. 1. **Structure of audit: Five element interaction**

Businesses have become more complex and global, and accountant firms have expanded their range of services well beyond traditional assurance and tax advice. This has led to a great deal of re-examination of regulatory and standard-setting structures both nationally and internationally in recent years. (Paper 7, ACCA, 2010, p. 5) The process as revealed in Figure 1 demonstrates that certified auditors engage in close interaction with all the four elements under close scrutiny from the organization management and the users of financial statements (investors, businesses, regulators and others).

Nowadays the independence and service quality of certified auditors, the development and application of ISA and other related standards and understanding of the national legislation reveals the competence and high qualification of certified auditors. Efficiency of external audit depends on:

- the regulated base of legislation and organization,
- compliance with ISA requirements,
- observation of principles formulated in the code of ethics for certified auditors,
- planning and auditing procedures concerning professional services by certified auditors,
- high quality corporate reporting,
- high quality auditing,
- high quality actuarial practice,
- statutory oversight and regulation of certified auditors.

The *Preface* restates the mission of IFAC as set out in its constitution: “The development and enhancement of an accountancy profession with harmonised standards able to provide services of consistently high quality in the public interest”. (Paper 7, ACCA, 2010, p. 6)

The fourth element in Figure 1 is the users of financial statements expect from certified auditors an opinion that the financial statement prepared by the organization gives a true and fair view of the financial position, financial performance and cash flows. The client expects to have high quality service and the auditor’s liability.

Successful development of the audit service market in Latvia depends on the improvement of legislative and regulatory requirements for audit and mutual coordination between all the five elements.

Recently in the Republic of Latvia quantity has been transmuted into quality, leading to and supporting a change in the general tendency of meeting the audit quality requirements of the European Union, the provisions of Latvian laws and increasing cooperation among national and worldwide professional associations.

The Law on Sworn (Certified) Auditors is based on the requirements of the Eighth EU Company Law Directive (1984) (Legal norms arising from directives 84/253/EEC, 89/48/EEC and 95/26/EEC have been included in this Law) in some areas, specifically, the requirement for public oversight of the audit profession. The Law on Sworn Auditors identifies the profession mainly as self-regulated and independent; its oversight on the part of the state is carried out by the Ministry of Finance.

To ensure monitoring over compliance with professional standards and norms of ethics as well as other applicable professional norms and regulations and professional activities of certified auditors in Latvia the certified auditors have founded the Latvian Association of Certified Auditors (LACA).

LACA is an independent professional corporation that was established in 1994 pursuant to the Law on Certified Auditors. Presently LACA incorporates 189 certified auditors and 166 firms of certified auditors.

Section 6 of the Law on Sworn Auditors provides that all certified auditors of Latvia and commercial companies of certified auditors are, on the principle of professional activity, united into LACA.

The aim of LACA is to facilitate the development of the audit profession on the national level and to ensure that the firms of certified auditors operate according to International Standards on Auditing. LACA is a member of the Federation of European Accountants (FEE) and a member of IFAC and its operations are based on the statutes of IFAC that are equally binding for all professional auditors all around the world. LACA has established four standing committees – on examination, ethics, education and quality.

LACA implements the professional self-regulation of certified auditors. In other words, certified auditors have assigned the right to LACA to ensure



the administration of adaptation with ISA and ethical norms, as well as other regulatory enactments applicable to the profession, and of the association members' professional activity by.

In its everyday operations LACA provides translation of International Standards on Auditing, training of certified auditors and quality control of audit engagements and maintains the system for disciplinary processes. LACA represents the interests of its members at the level of national and municipal institutions as well as local and international organizations. Moreover, LACA, together with the Ministry of Finance, shares the ultimate responsibility for the public oversight system and cooperation between certified auditors and entities.

Nevertheless, the current situation in the audit market reveals the need for the public oversight regulation system. In 2008, the Audit Advisory Board (Council) was established in Latvia to support and ensure quality enhancement of the audit service in the country. The Board was established as an independent public institution with the objective to review documents prepared by certified auditor candidates of LACA for examination and certification of auditors for obtaining commercial license, ensure maintenance of professional qualification and control over sworn auditors' professional quality, as well as monitor compliance with the international auditing standards and ethical guidelines recognized in Latvia, provide recommendations for improving LACA activities, and submit to the Ministry of Finance any recommendations or proposals relating to regulatory laws on audit.

Membership of the Audit Advisory Board includes a representative each from the Ministry of Finance, the Ministry of Justice, the Financial and Capital Market Commission, LACA, the Latvian Association of Accountants, NASDAQ OMX Riga Stock Exchange, the Foreign Investors Council in Latvia, and the Employers' Confederation of Latvia and a representative from one of the higher educational institutions.

Within the context of enhancing the audit quality in Latvia the situation has been improved as far as the law on Sworn Auditors provides third parties with the right to see the auditor's working papers. Further enhancement of the audit quality in Latvia is expected due to the increase of the Baltic rates, which is a positive indicator of the market.

The collapse of *Enron* in the US and the demise of Andersen have generally undermined confidence in the world's capital markets. Much of the concern has focused on accounting and auditing practices, and on the independence of auditors in particular. Auditor independence is fundamental to public confidence in the audit process and the reliability of auditors' reports. (Beattie, V., and Fearnley, S. 2002)

Audit is an essential part of the framework which supports our capital markets. The audit report adds value to the financial statements provided by managers (capital seekers) to shareholders (capital providers) through the independent verification it provides (Johnstone, Sutton and Warfield, 2001). The audit is

not just a benefit to investors. It also reduces the cost of information exchange for both sides (Dopuch and Simunic, 1980, 1982) and benefits management by providing a signalling mechanism to the markets that the information which management is providing is reliable. It has been further argued that the auditors' liability insurance serves to indemnify investors against losses. (Beattie, V., and Fearnley, S. 2002)

If the auditor is not seen to act independently of management, then the audit loses its value to all parties. A significant and persistent criticism of auditors that has been raised many times over many years underlines that the joint provision by auditors of other services to management alongside the audit undermines their independence. (Beattie, V., and Fearnley, S. 2002)

It is important to understand the dynamic growth and structure of the audit market and provide an in-depth analysis of the factors that determine the entities' choice of auditors. At present the Big Four audit firms (Deloitte & Touche (Deloitte Latvia), Ernst & Young Baltic, KPMG Baltics and PricewaterhouseCoopers (PwC)) audit around 75% of all audited companies in Latvia. The high degree of concentration of the Big Four audit firms in the market became more pronounced after 2008 in the wake of the economic crisis in the country. From 2008 till 2009 in Latvia, 70% of audit reports were issued by the Big Four audit firms. Moreover, if the situation in the turnover of the companies is compared, the following is revealed: out of TOP 100 companies (starting with the highest turnover; the calculations made by using the information in *Lursoft* data base, 2012) around 68% were audited by the Big Four audit firms and 32% – by other national audit firms. If TOP 500 companies are compared, then around 43% audit report were issued by the Big Four audit firms and 57% – by other national audit firms.

The current situation in the audit market requires higher costs for audit quality framework, and reviewing and surveillance on the part of the government that is mostly due to high risk insurance costs, taking into account historical trends.

Small and medium-sized certified audit companies have their advantages in the audit service market – they are more flexible as to the services provided and offer competitive prices to small and medium-sized entities for audit reports.

A market is a group of buyers and sellers exchanging services that are highly substitutable for one another. Within a larger market there can exist submarkets that define the relevant range of choices for many buyers. Market and submarket boundaries usually are established on the basis of substitutability of services at competitive prices. It is suggested that dividing the audit market into submarkets by seller and/or buyer type could further our understanding of the entire audit market (Yardley et al., 1992, p. 173).

The audit service market is expanding due to audit firms offering different consultancy services, such as risk management, IT system control testing, management of internal audit and other specific services.

Relationship has currently been traced between the size of an audit firm and the audit quality. In Latvia it is the competitive concept, and most significant competition concerns the audit quality, audit fees, service quality, flexibility, audit experience and historical tendencies, and other aspects.

The current economic situation and regulations create uncertainty among small and medium-sized local audit firms about their existence. Moreover, the EU regulations demand enhancement of audit criteria (if a company meets the criteria, external audit is compulsory).

Audit efficiency is becoming progressively more important to firms as audited entities seek to reduce fees. Firms should establish central safeguards to ensure that total audit hours, the determination of materiality and the extent of work performed are maintained at an appropriate level to protect overall audit quality, particularly where significant fee reductions have been agreed. (Audit Quality Inspections Annual Report 2011/12)

Firms have responded in different ways to improve the effectiveness of their engagement quality control reviews. We will continue to focus on whether these initiatives are making a difference in practice. We expect the engagement quality control reviewer to give particular attention to the extent to which appropriate professional scepticism has been exercised in key areas of judgment. (Audit Quality Inspections Annual Report 2011/12)

Niemi L. (2004) has suggested a four segment market model that describes the audit client types and auditors with their main characteristics associated with each of the segment of audit market. A model of the adopted version of the four segments of the audit market in Latvia is presented in Table 1.

Table 1

**The four segments of audit market**

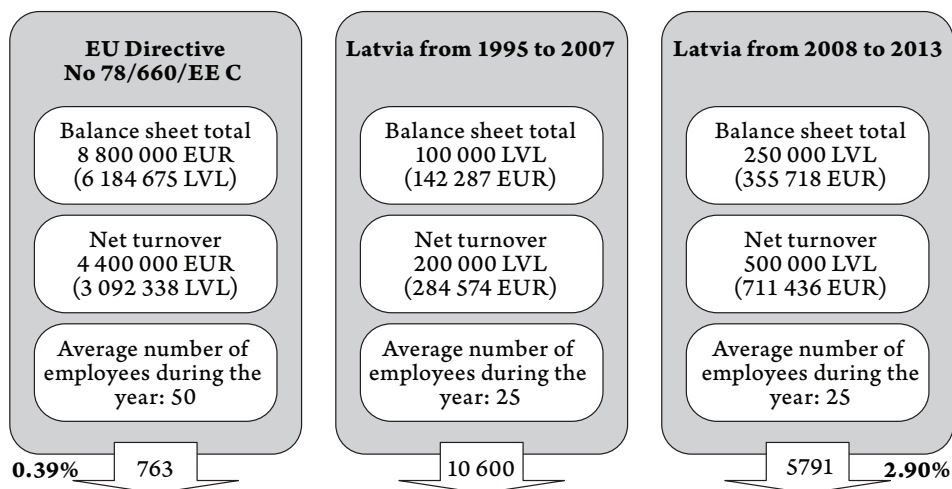
No.	Four types of audit clients	Main suppliers of audit services	Key auditor characteristics of audit credibility
1.	Multinational clients	Big 4 audit practices	Global brand name
2.	Large domestic clients	All certified audit practices excluding sole practitioners and smallest partnerships	Capacity, size of client portfolio (independence)
3.	Small domestic clients with stakeholders to whom auditing is of significance	All certified audit practices	Certification
4.	Small domestic clients with stakeholders to whom auditing is of no significance	All certified audit practices	Credibility is not a critical factor

Source: author's model based on Niemi L., 2004

In accordance with the terminology used by ISA, the objective of an audit of financial statements is to enable the auditor to express an opinion whether the

financial statements are prepared, in all material respect, in accordance with an applicable financial reporting framework.

The criteria under which a legal entity needs an audit (verification) of financial statements performed by certified auditor are given below in Figure 2. A legal entity in Latvia needs an audit if the entity meets two of the three criteria (see Figure 2).



Source: the author's model based on the Annual Accounts Law and EU Directive No 78/660/EEC

Fig. 2. Criteria in Latvia under which an entity needs an external audit of financial statements by certified auditor in comparison with the EU Directive

Since the year 2010 in Latvia the issue of enhancing the criteria of external audit for a legal entity up to the level of EU Directive No 78/660/EEC has gained importance (see Fig. 2.). Changing the existing criteria at this moment without any prior survey and analysis is risky due to many reasons discussed above. As shown in Figure 2, in Latvia the application of EU Directive No 78/660/EEC significantly reduces the number of entities that need an audit of financial statements. According to information in the *Lursoft* data base, certified auditors have issued 5791 reports for 2011, for 2010 – 6653 reports and for 2007 – 9000 reports. So it can be concluded that if Latvia applied the criteria of the EU regulation it would mean that there are only 763 companies (0.39% of all legal entities in Latvia according to the *Lursoft* data base information for 2011) which comply with two of the three criteria and are in need of an external audit.

## AUDIT QUALITY ASPECTS

There is no clear definition given for the term *audit quality* in either International Quality Control Standard No. 1 or International Standards on

Auditing or even in the consultation paper, A Framework for Audit Quality, which was recently published by the International Auditing and Assurance Standards Board (IAASB). In general, the International Standards on Auditing imply that the audit quality is achieved if the auditor meets its key objective – to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework (ISA 200.11(a)). The question remains whether that explanation is sufficient enough.

Francis J. R. (2011) suggests that the audit quality is a complex concept and cannot be reduced to a simple definition. The author suggests evaluating the audit quality from two key aspects:

- legal view of audit quality;
- audit quality as a continuum.

From a legal point of view (binary approach) the audit quality can be seen as an “audit failure” or “no audit failure”. An audit failure occurs when the auditor expresses a wrong opinion that the financial statements are free from material misstatement. Consequently, no audit failure occurs when the auditor expresses opinion that the financial statements are free or are not free from material misstatement according to the actual circumstances. As measures to evaluate audit failures can be used (1) a number of successful civil litigations or criminal prosecutions against auditors or (2) the relation between a going concern audit report and client business failure – when the auditor issues a going concern report and there is no client failure within the next 12 months (Type 1 error) or when the auditor issues a clean opinion and there is a client failure within the next 12 months (Type 2 error). Based on the research by Francis J. R. (2011) made by observing a number of successful civil litigations or criminal prosecutions against auditors and Type 1 and 2 errors made by the auditors over a certain period of time, it was concluded that due to the very low level of litigations and prosecutions against auditors and Type 1 and 2 errors made by the auditors a legal point of view does not sufficiently differentiate low and high quality audits.

When discussing the continuum view of audit quality, Francis J. R. (2011) emphasizes the link between the client earnings quality and the audit quality as higher earnings quality means higher audit quality. The author introduces the equation given below in Figure 3:

$$\text{Earnings quality} = f(\text{audit characteristics} + \text{controls for non-audit factors})$$

Source: Francis J. R., 2011.

Fig. 3. Earnings quality equation

The design in equation above tests if audit-related factors (the units of analysis in Table 2) are systematically associated with the quality of earnings on audit engagements, after controlling other (non-audit) factors that may affect earnings quality. Audit quality is affected by each of the units of analysis in Table 2. Audits are of higher quality at the input level when the people implementing audit tests are competent and independent, and when the testing procedures used are capable of producing reliable and relevant evidence. The quality of audit inputs flow through to the audit process, where audits are of higher quality when the engagement team personnel make good decisions regarding the specific tests to be implemented and appropriately evaluate the evidence from these tests in leading to the audit report. Audit quality is affected by the accounting firm in which the auditors work. Firms develop the testing procedures used on audit engagements, and create incentives that affect the behaviour of engagement team personnel. Lastly, the incentives of accounting firms and individual auditors to produce high-quality audits are affected by the institutions that regulate auditing and punish auditors and accounting firms for misconduct and low-quality audits. (Francis J. R., 2011, p. 126)

Table 2

#### Units of analysis in audit research

No.	Units	Sub-units
1.	Audit inputs	Audit tests
		Engagement team personnel
2.	Audit processes	Implementation audit tests by engagement team personnel
3.	Accounting firms	Engagement teams work in audit practices
		Audit practices hire, train, and compensate auditors, and develop audit guidance
		Audit reports are issued in the name of audit practices
4.	Audit industry and audit markets	Audit practices constitute an industry
		Industry structure affects markets and economic behaviour
5.	Institutions	Institutions affect auditing and incentives for quality, e.g., State boards of accountancy, the AICPA, FASB, SEC and PCAOB as well as the broader legal system
6.	Economics Consequences of Audit Outcomes	Audit outcomes affect clients and users of audited accounting information

Source: Francis J. R., 2011

The audit quality perception in A Framework for Audit Quality is close to the Francis J. R. continuum view of audit quality. A Framework for Audit Quality describes the audit quality as interactions between audit inputs, outputs and context. In addition, A Framework for Audit Quality emphasizes the reasons for the different perspectives of audit quality among the different stakeholders.

The linkage of the earnings quality with the audit quality is also supported by other theories. For example, Beck P. J. and Wu M. G. H. (2006) suggest that the audit quality will increase if the quality of earnings also increases and the increase of the earnings quality is strongly related to the auditor's knowledge about the client's business model. The auditor's knowledge about the client's business is increasing with each year of the audit services provided and, especially, the provided non-audit services. Niemi L. (2004) in his study regarding the auditor size and audit pricing suggests that higher audit fees allow auditors to perform more audit procedures as such, thus increasing the earnings quality and ultimately – the audit quality.

Table 3

### Audit practices quality control system

No.	Components of the control system	Notes
1.	Audit practice level	Defined by International Quality Control Standard No. 1
2.	Audit engagement level	Defined by International Standards on Auditing
3.	Audit work	Relates to audit engagement level
4.	Auditor's objective	To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework (ISA 200.11(a))

Source: author's construction based on research, 2012

De facto audit practices ensure that the appropriate level of the audit quality is maintained by using the internal quality control system. According to the components of the quality control system summarized in Table 3, there are two key levels:

- auditor practice level;
- audit engagement level.

According to International Quality Control Standard No. 1, an audit practice is responsible for establishing quality control policies and procedures that ensure that (a) the audit practice and its personnel comply with professional standards and applicable legal and regulatory requirements; and (b) reports issued by the firm or engagement partners are appropriate in the circumstances.

International Standard on Auditing 220 prescribes that (a) the audit (on engagement level) complies with professional standards and applicable legal and regulatory requirements; and (b) the auditor's report issued is appropriate in the circumstances.

## CONCLUSIONS, PROPOSALS, RECOMMENDATIONS

It is necessary to ensure that the users of financial statements have better understanding of the form and meaning of information contained in financial statements and auditors' report in Latvia. The audit and quality control issues and functioning are to be explained to the users of financial statements. Credible and reliable financial information available to the users is to contribute significantly to the economical and effective functioning of the internal market.

The outlook of Latvian audit industry is subject to legislative regulation and standards in use. When developing new regulations, adopting the provisions of EU legislation and applying them to the Latvian situation, the Cabinet of Ministers, together with the Ministry of Finance and audit supervisors should carefully assess the effectiveness of the legislation in terms of the situation in Latvia.

It is necessary to analyse and compare the experience of other countries concerning determination of the corporate audit threshold in view of the company size and eligibility under criteria.

In order to facilitate negotiations of small and medium-sized audit firms in large projects it is necessary to see the essential earning from mutual cooperation between audit firms and the experience of the certified auditor.

There are different understandings of the term *audit quality*. The audit quality is associated with the quality of earnings, measured from the legal point of view which is based on a number of legal cases against auditors or on a number of overqualified or underqualified going concern opinions issued. However, it is clear that in order to perform a high quality audit it is not sufficient only to produce an auditors' report according to the requirements of auditing standards: other aspects, such as audit effectiveness and efficiency, appropriate client communication, engagement profitability and professional appearance should also be taken into account.

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# COMPARISON OF TRADITIONAL, ENVIRONMENTAL AND SUSTAINABILITY ACCOUNTING SYSTEMS

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GYULA FÜLÖP\*

Institute of Business Sciences, University of Miskolc, Hungary

BETTINA HÓDI HERNÁDI

Institute of Business Sciences, University of Miskolc, Hungary

**Abstract.** Over the past decade the requirements of sustainability were included in strategies of many companies. Besides economic goals, they also determine the exemplary social as well as environmental considerations. However, several empirical studies show that their environmental and social performance has been improving only slowly. Therefore, the application of the appropriate management methods and tools are needed to measure the economic, social and environmental impacts of strategic decisions and activities within the organization.

The aim of this paper is to study the interaction between the sustainability strategy and sustainability accounting as its key success factor. The paper begins with the conceptual definition of sustainability and the process of sustainability strategic management. Next, the article introduces new approaches for the appraisal of strategic performance, beginning with conventional accounting, then followed by environmental accounting, and finally, sustainability accounting.

**Key words:** *corporate sustainability, sustainability strategic management, sustainability accounting*

**JEL code:** M21, M41, Q56

## INTRODUCTION

Sustainability has become a kind of ‘mantra’ in the 21st century. It includes the promise of development towards a more equitable society and a richer world in which the natural environment and cultural artefacts are preserved for future generations. *Sustainable development* is a challenge that today’s companies also have to address as it significantly affects their strategy. While the idea of sustainability is vividly present in the life of many companies, they still cannot maintain about themselves that their operation is based on the principles of

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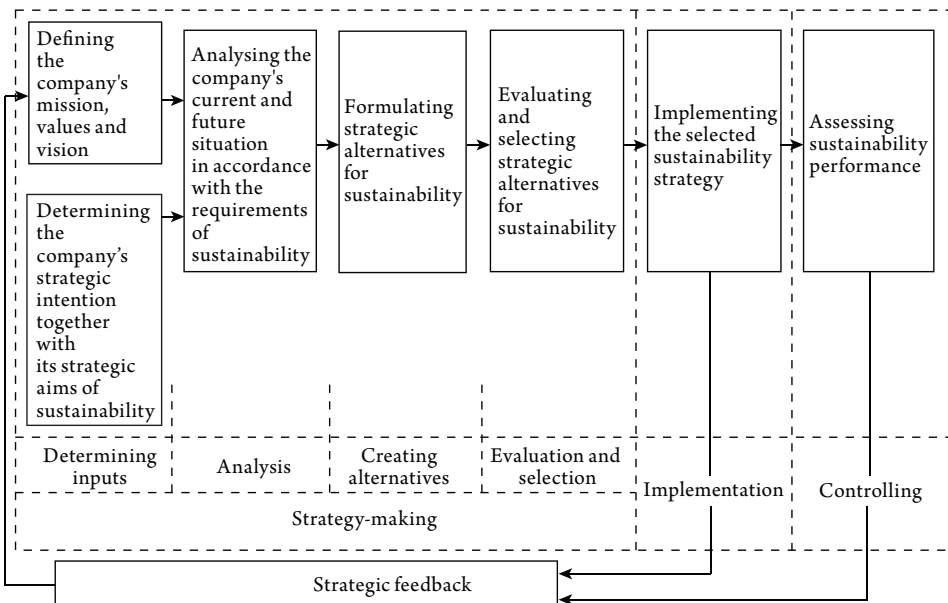
\* Phone: +36-46-565-111/16-94, e-mail: [vgtfulop@uni-miskolc.hu](mailto:vgtfulop@uni-miskolc.hu)

sustainability due to the lack of sustainability-related *strategies* and the knowledge needed to implement sustainability management *processes* and *methods*.

## 1 THE PROCESS OF SUSTAINABILITY STRATEGIC MANAGEMENT

The dimensions and principles of sustainability open an opportunity for a conscious creation of sustainability strategic management processes together with the formulation and implementation of a *sustainability strategy*. According to a wider interpretation by Bieker and his co-authors, it lays particular emphasis on the statement that *corporate strategies have to meet the expectations of the company's present and future stakeholders without making any crucial compromises in terms of skills and capabilities* (Bieker et al, 2002).

*The strategic management of sustainability* enables companies to develop and apply strategic methods and tools by which environmental protection and people's well-being can be ensured. This notion is expressed in Crutzen's (2011, pp. 9) definition as one that "on the one hand, links environmental and social management with the business and competitive strategy and management and, on the other hand, integrates environmental and social information with economic business information and sustainability reporting". On the basis of these definitions the process model of sustainability strategic management is illustrated in Figure 1.



Source: author's construction based on Fülöp, 2008, pp. 44

Fig. 1. The process of strategic management of sustainability

## 1.1 STRATEGY-MAKING

Three major elements have to be simultaneously integrated in the process of sustainability strategic management: *strategy-making*, *strategy implementation*, and *feedback*. The first phase of the *strategy-making process* mainly serves as a better foundation for, and enables an effective implementation of *decisions having strategic importance*. In doing so, *the internal changes in a company* have to be determined *for the sake of sustainability* while more profoundly understanding the nature of social and environmental changes. In order to more easily meet this requirement, it is advisable to divide the complex work of formulating a sustainability strategy into four distinct phases, which are the following: the definition of strategic inputs, strategic analysis, creating strategic alternatives, and evaluating and selecting strategic alternatives.

### 1.1.1 The definition of strategic inputs

The first three elements of *strategic inputs* – the company's mission, values and vision – describe the *internal conditions* of the company. According to Prahalad and Hamel (1990), these are linked to the company's strategic intent together with its strategic target system. The ability of the company to realize its intent and reach its strategic goals of sustainability mainly depends on the influence and the *external changes* of social and environmental expectations.

Determining these strategic inputs in advance often proves to be difficult mainly because a sustainability strategy, at least in an explicit form, is not available.

### 1.1.2 Strategic analysis

The analysis of the company's *current and future situation*, *on the one hand*, means the timely recognition of both social and natural environmental requirements and taking into account the anticipated increasing pressure coming from stakeholders, which requires a continuous analysis of regulations as well as the values of social and natural environment (*external factors*); *on the other hand*, it also assumes that the company is aware of its own internal resources and activities (*internal factors*) and it continuously evaluates their social and environmental impacts.

### 1.1.3 Strategic alternatives

During the strategic analysis mentioned in the previous point, the internal and external factors determining the company's sustainability strategy can be examined along with its capabilities and opportunities. Based on the results of the analysis, it becomes possible to formulate a *deliberate strategy or strategic alternatives*, explicitly expressing the company's basic position on the subject of sustainable development. The five types of competitive sustainability strategies are defined by Bieker et al (2002) as follows:

The aim of the "Safe" Strategy is to reduce, avoid or handle the company's overall operational risk.

The aim of the “*Credible*” Strategy is to preserve and enhance credibility and corporate reputation.

The “*Efficient*” Strategy is designed to improve the social or environmental effectiveness of business processes.

The “*Innovative*” Strategy is aimed at increasing the range of socially and environmentally friendly products and services.

The aim of the “*Transformative*” Strategy is to develop new markets and restructure the already existing markets.

These five strategies are applicable both on corporate and divisional levels; furthermore, they can also be successful with certain products or technologies. However, this classification seems idealistic as these strategic alternatives may overlap in practice, and no clear distinction can be made between them.

#### 1.1.4 *The evaluation and selection of strategic alternatives*

In the above, we summarily followed the way in which a company acquires accurate knowledge on its macro-and microenvironment, its resources and its intentions, and we identified the possible strategic alternatives. For choosing from the range of strategic alternatives, it is not sufficient to define the possible directions of strategic development or strategic options, a system of criteria (Dias-Sardinha, et al., 2007) helping the managers responsible for making strategic decisions has also to be designed.

## 1.2 THE IMPLEMENTATION OF THE STRATEGY

The second main phase of the process of sustainability strategic management is the implementation of the strategy which typically involves such tasks as action planning, defining the necessary resources, organization restructuring, management and leadership (van Kleef and Roome, 2007). Due to the limited space, we set aside the detailed description of these activities and we do not mention the *context* that mainly influences the introduction of strategies either (small-sized companies, multinational and manufacturing companies, public utility companies as well as voluntary organizations).

## 1.3 THE SUSTAINABILITY PERFORMANCE ASSESSMENT, STRATEGIC FEEDBACK

For an organization, an essential part of the implementation of the strategy is “to keep its eye on the target”. It means the *monitoring, evaluation of, and feedback* on the sustainability performance.

*Monitoring and evaluation* are intended to adjust the organization’s sustainability strategy to the ever-changing conditions and to the changing social and environmental demands. The *strategic feedback* is information on the changes in certain subareas or in the whole organization of the company as well as on the

changes of the social and natural environment, and it has the potential to start adapting or redefining the sustainability strategy. This feedback closes the circle of sustainability strategic management and provides *the initial impetus* for starting the redefinition of the necessary strategy. This feedback is the basis for the *motivation* related to the strategy, thus enabling the organization to *continuously improve its performance*. All of this can only be conceivable if the appropriate information is available for the management on the course of the implementation of the strategy, the achieved sustainability performance and the occurring problems. In the modern organization of a company, a *sustainability accounting system* gives the basis for receiving information on monitoring, evaluating and giving feedback, and its development history is briefly described below.

## 2 A NEW APPROACH TO STRATEGIC PERFORMANCE EVALUATION: SUSTAINABILITY ACCOUNTING

In the course of evaluation of the strategic performance of sustainability, companies need to build up and operate an accounting information system that meets the requirements of sustainable development. The development stages of accounting in this direction are described below.

### 2.1 CHANGES IN TRADITIONAL ACCOUNTING

*Traditional accounting systems* are information systems supporting the daily operation of economic organizations, with the purpose of observing, collecting, recording, measuring, classifying the economic events that have an influence of the company's assets, financial and earnings position, together with their impact. Therefore, the aim of accounting for stakeholders (owners, managers, creditors, inspection bodies, etc.) is to provide accurate information for making future decisions.

In the light of corporate sustainability, however, the generally accepted accounting principles, the range of those demanding accounting information and the content of accounting information all have to be reinterpreted.

#### 2.1.1 A new approach to the going concern principle

One of the most fundamental principles in accounting is the going concern principle, which states that "*in the course of book-keeping and preparing the accounts, it must be assumed that the enterprise will maintain its operation in the foreseeable future, will be able to carry on its activities, and a significant decrease or closing down its activities is not expected for any reason*" (Act C on Accounting § 15 (1), 2000). This wording suggests that only a stable external environment allows for the company activities on an unchanged continuation, and assumes what is also emphasized in Aras and Crowther's (2008) work, namely, observing the going concern principle results in keeping the company operations

maintainable. However, a company's external environment should include the business (economic) environment in which it operates, the local and regional social environment in which it is located, and the natural environment, which, in turn, gives a natural limit to the company's operations (Hódi Hernádi, 2012).

### 2.1.2 *Reconsidering the content and the range of those demanding accounting information*

Since the information provided by accounting systems are suitable for preparing and establishing decisions, it is important to make the demanded information available. However, it would be reasonable to give an extended interpretation on the range of stakeholders. Therefore, according to Hódi Hernádi (2012), the population, meaning society itself, the natural environment, especially at local and regional levels, as well as future owners, employees, the next generations, and the future state of the natural environment all have to be taken into account. After all, the general principle of sustainability focuses on stakeholders' needs in order to make all those decision-making opportunities that are currently in place accessible to present-day stakeholders.

The fundamental task of accounting is to provide reliable and real information on the operation of the company for market participants. However, different information is needed by different stakeholders. Therefore, an accounting information system should be established that is capable of collecting and organizing the social and environmental information necessary for making various decisions, and is capable of presenting and interpreting them to both internal and external users in a reliable and accurate way. In response to these changing requirements, traditional accounting systems have to change and improve accordingly. The next step in this improvement is the development and the implementation of environmental accounting systems.

## 2.2 THE CHARACTERISTICS OF ENVIRONMENTAL ACCOUNTING

The concept of *environmental accounting* and reporting appeared in the literature nearly a decade ago. According to Schaltegger and Burritt's (2000, pp. 63) definition, "*environmental accounting is a subset of accounting that deals with activities, methods and systems; recording, analysis and reporting; environmentally induced financial impacts and ecological impacts of a defined economic system*". Environmental accounting systems basically consist of two parts, one of them deals with the environment-induced financial impacts, i.e. environment-related expenditures and savings, while the other part is concerned with the environmental impacts of the company's business, that is, how the natural environment changes as a result of the company's operations (Pál et al, 2006). Environmental accounting systems present the above-mentioned effects both by measuring in natural units and expressing in terms of money, as – opposed to traditional accounting – non-monetary and qualitative factors are also strongly emphasized here.

Thus, basically there are four areas of environmental accounting: *internal ecological accounting*, *environmental management accounting*, *external ecological accounting*, and *environmental financial accounting*. A relatively wide literature base already exists that is dealing with those, and a number of scholars have studied the subject from many perspectives, including the elements which constitute environmental accounting, and the methods and tools used, for example Jasch and Stasiškienė (2005), Comite (2009), Lee (2011), Debnath, Bose and Dhalla (2012).

“So ecological accounting facilitates establishing a connection between environmental and economic performance together with the presentation of the interaction between these two types of performances” (Pál, 2011, pp. 128).

By focusing on the company’s financial and environmental dimensions, environmental accounting systems ignore the impact of corporate activities on society. However, there are approaches (Yakhou and Dorweiler, 2004) that interpret society as part of the natural environment, and the sustainability of the natural environment is the basis for human well-being; therefore, they should not be treated separately. However, according to the conclusions of the present paper, all three dimensions must be taken into account in the development of accounting systems, giving way to sustainability accounting systems.

### 2.3 THE THEORETICAL FRAMEWORK OF SUSTAINABILITY ACCOUNTING

Borrowing the notion proposed by Burritt and Schaltegger (2010), *sustainability accounting* is the peak of accounting. Sustainability accounting, reaching far beyond environmental accounting, examines business operations by putting all three – economic, social and environmental – dimensions into its focus, and most importantly, it emphasizes the interaction of these dimensions in accordance with corporate sustainability.

The most widely accepted definition was presented by Schaltegger and Burritt (2010, pp. 377):

“Sustainability accounting describes a subset of accounting that deals with activities, methods and systems to record, analyse and report:

- First, environmentally and socially induced financial impacts,
- Second, ecological and social impacts of a defined economic system (e.g., the company, production site, nation, etc.), and
- Third, and perhaps most important, the interactions and linkages between social, environmental and economic issues constituting the three dimensions of sustainability.”

The development of a sustainability accounting system includes the following five elements: the aim of operating a sustainability accounting system; the principles and requirements of operating the system; methods and devices for data collection, data recording, measurement and analysis; sustainability



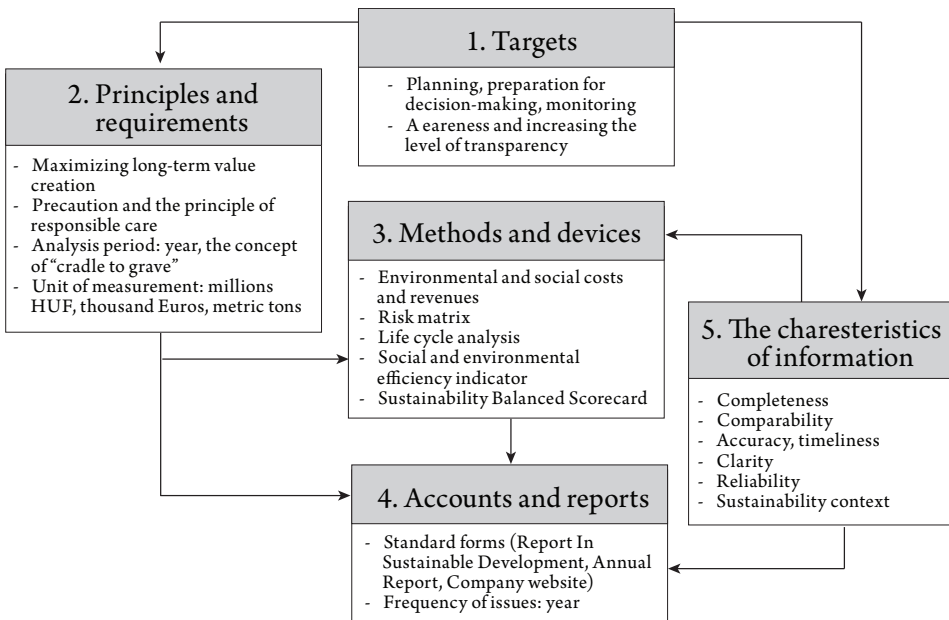
accounts and reports; and the qualitative characteristics of the resulting information (Lamberton, 2005).

The elements and their connections as well of the sustainability accounting system are shown in Figure 2.

### 2.3.1 The aim of sustainability accounting systems

Sustainability accounting information systems are *primarily designed* to evaluate the performance of the economic organization in terms sustainability, namely, paying special attention to its economic, social and environmental aspects. Like traditional accounting, sustainability accounting can also be divided into two areas according to the external or internal users provided with the necessary information.

The external stakeholders' need for information focuses on the accountability of the organization's operations both in social and environmental terms. In addition to this, sustainability accounting information systems provide internal stakeholders, namely, the management, with information relevant to decision-making, and thus play an important part in strengthening the internal management of the organization. As it is possible to determine the effects and consequences of measures taken to achieve sustainability objectives in the course of performance evaluation, a good basis is provided for the preparation of a possible intervention, that is, for controlling and feedback.



Source: author's construction based on Lamberton, 2005

Fig. 2. The logical framework of the sustainability accounting system

### 2.3.2 *The principles and requirements of operating a sustainability accounting system*

During the development of a sustainability accounting system, some important *principles* and *requirements* should be taken into consideration that specify the methods and devices applied in the course of data collection, measurement, and evaluation, as well as the content and the process of reporting.

As mentioned before, with the reinterpretation of the going concern principle, the existing *accounting principles* also gain new meanings both in social and environmental terms.

The following principle is *the interpretation of sustainability at a corporate level*. It is an important issue because it establishes the framework of the whole system. The company's sustainability goals, the complex realization of economic, social and environmental sustainability raise the issue of their integrated measurement and performance evaluation.

Due to the complexity of the company sustainability performance evaluation, *the boundaries of the sustainability accounting system* have to be clearly marked in a way that it still could be managed by the company.

The following essential requirement is the selection of the proper *period for accounting, evaluation and analysis*, that is, the determination of the period in which the company is evaluated in terms of its sustainability.

The evaluation of the social and environmental impacts caused by corporate activities or the entire life cycle of a product requires the application of non-monetary, qualitative *indicators* beside the usual monetary indicators for measuring economic or financial performance.

### 2.3.3 *Methods and devices for data collection, data record, measurement and analysis*

The sources used for *collecting and recording data* are wide-ranging and abundant; however, in the selection process some cost-benefit aspects should be enforced.

Based on the collected economic, social and environmental data, it becomes possible to measure the company's sustainability performance, and it requires *a variety of benchmarks and evaluation methods*. Some of these are the cost estimation of decision alternatives regarding corporate sustainability (Bebbington and Gray, 2001), input-output analyses, life cycle analyses, and the mapping of social and environmental impacts. One of the most complete methods available for the management is the Sustainability Balanced Scorecard (SBSC), an integrated indicator system aimed at evaluating the company's performance (Fülöp and Hódi Hernádi, 2012), which is the basis for decision-making and monitoring the realization of objectives.

Considerable attention should be paid to the evaluation of environmental protection measures, the costs of social and environmental liabilities in order to make the company accountable in terms of sustainability.

#### 2.3.4 *Sustainability accounts and reports*

The fourth part of sustainability accounting focuses on distributing both quantitative and qualitative information to users. Here, there are two key questions to be answered. What is the appropriate form and content of a *sustainability account*? How often should these *reports* be prepared and published?

Sustainability accounting information are presented by the SBSC including a wide variety of performance indicators, and other sustainability reports based on the guidance of the Global Reporting Initiative (GRI).

Such reports should be produced regularly throughout the entire lifetime of a product. The company's sustainability accounting information should be presented and published on the website, thus making regularly updated information on sustainability promptly available to the stakeholders.

#### 2.3.5 *The qualitative characteristics of information on sustainability*

The information provided by sustainability accounting systems have to meet a number of important requirements. These are based on the *characteristics of traditional accounting information*, as well as on the guidelines of GRI sustainability reports. The two highlighted features are transparency and controllability. *Transparency* demands the complete publication of processes, procedures and assumptions (GRI, 2002). *Controllability* requires that the recording, organizing, analysis and publication of the presented data and information should be done in a way that enables auditors to certify data reliability (GRI, 2002).

The further requirements concerning sustainability information are: completeness, credibility, neutrality, clarity, materiality, timeliness, comparability and readiness for interpretation in the context of sustainability.

The main characteristics of the different accounting systems are summarized in Table 1.

Since traditional, environmental and sustainability accounting systems examine the company's sustainability performance through different dimensions, the contents of the obtained information are also different, giving different tasks to the particular accounting systems. The modified range of tasks is noticeable in the areas and the applied methods of the accounting systems. Despite the fact that there have not been compulsory standards for the operation of sustainability accounting systems, these requirements will certainly appear in the long term (Ngwakwe, 2012).

Table 1

**The comparison of the characteristics of traditional, environmental and sustainability accounting systems**

<b>Aspects for comparison</b>	<b>Traditional accounting system</b>	<b>Environmental accounting system</b>	<b>Sustainability accounting system</b>
<b>Dimension</b>	<ul style="list-style-type: none"> <li>• Economic (financial) situation</li> </ul>	<ul style="list-style-type: none"> <li>• Relationship between economy (company) and environment</li> </ul>	<ul style="list-style-type: none"> <li>• Integrating economy (company), society and environment</li> </ul>
<b>Target</b>	<ul style="list-style-type: none"> <li>• Presenting general economic situation</li> <li>• Cost management</li> </ul>	<ul style="list-style-type: none"> <li>• Presenting environmental performance</li> <li>• Presenting environmental liabilities and costs</li> </ul>	<ul style="list-style-type: none"> <li>• Presenting sustainability performance (including economic, social and environmental performances)</li> </ul>
<b>Field of application</b>	<ul style="list-style-type: none"> <li>• Financial accounting</li> <li>• Management accounting</li> </ul>	<ul style="list-style-type: none"> <li>• Environmental financial accounting</li> <li>• External ecological accounting</li> <li>• Environmental management accounting</li> <li>• Internal ecological accounting</li> </ul>	<ul style="list-style-type: none"> <li>• Sustainability financial accounting</li> <li>• Sustainability management accounting</li> </ul>
<b>Method</b>	<ul style="list-style-type: none"> <li>• Evaluation processes</li> <li>• Cost accounting</li> </ul>	<ul style="list-style-type: none"> <li>• Evaluating environmental performance</li> <li>• Life-cycle analysis</li> <li>• Analyses on environmental costs and savings</li> </ul>	<ul style="list-style-type: none"> <li>• Evaluating sustainability performance by applying the methods of other disciplines (biology, sociology)</li> <li>• Sustainability Balanced Scorecard</li> </ul>
<b>Unit of measurement</b>	<ul style="list-style-type: none"> <li>• Money (inventories excluded)</li> </ul>	<ul style="list-style-type: none"> <li>• Money and natural units</li> </ul>	<ul style="list-style-type: none"> <li>• Money and natural units</li> </ul>
<b>Forms of accounts</b>	<ul style="list-style-type: none"> <li>• Financial and accounting reports</li> <li>• Internal reports</li> </ul>	<ul style="list-style-type: none"> <li>• Environmental reports and accounts</li> </ul>	<ul style="list-style-type: none"> <li>• Sustainability reports and accounts</li> <li>• Global Reporting Initiative</li> </ul>
<b>Regulation strictness</b>	<ul style="list-style-type: none"> <li>• Compulsory due to legal regulations (financial accounting)</li> <li>• Voluntary (management accounting)</li> </ul>	<ul style="list-style-type: none"> <li>• As part of the Act on Accounting, some reporting requirements on environmental performance</li> </ul>	<ul style="list-style-type: none"> <li>• Not regulated, voluntary</li> </ul>

Source: Hódi Hernádi, 2012

## 2.4 THE RELATIONS BETWEEN SUSTAINABILITY STRATEGY AND SUSTAINABILITY ACCOUNTING

Sustainability accounting systems must primarily meet the needs of the top management. Accordingly, the function of a sustainability accounting system is to identify, collect, analyse, and communicate feedback on the company's economic, social and environmental performance. In order to achieve this, the following steps should be taken:

- As the first step, the *identification* of those strategic and operational indicators should be carried out that are crucial to the success of the business and the creation values for stakeholders (Schaltegger and Wagner, 2006). In other words, in accordance with its sustainability strategy, the company systematically has to choose the appropriate goals of sustainability performance indicators, their structure and their information needs also should be planned.
- As the second step, the required quantitative and qualitative data *should be collected* that include social and environmental costs, expenses and risks, then the financial benefits and savings of sustainable business operations, and finally, the natural effects on the society and the environment. These can be acquired either directly or indirectly by taking cost-benefit aspects into consideration.
- The third step is *to analyse* the company's sustainability performance, and then to monitor whether the company has met its strategic and operational objectives or not, and whether it has revealed the reasons for achieving or failing them.

Sustainability accounting systems thus support sustainability strategies, where they provide appropriate, reliable and real information on the sustainability results of the company. Apart from supporting managerial decision-making, the information provided by sustainability accounting systems can also be utilised in other areas that give a basis for reports on sustainability. The major corporate as well as micro- and macro-environmental benefits resulting from operating a sustainability accounting system are summarized in Table 2 as important contributing factors to the development and implementation of sustainability strategies.

Table 2

**The benefits of operating sustainability accounting systems**

<b>Corporate benefits</b>	<b>Micro- and macro-environmental benefits</b>
<ul style="list-style-type: none"> <li>• Presents the impact of sustainability performance on balance sheet earnings</li> <li>• Maps cost-saving opportunities, revenues and financial advantages originating from sustainability-oriented operation</li> <li>• Evaluates, handles and reduces social and environmental risks, liabilities, cost and expenses</li> <li>• Creates more favourable conditions in the course of economic or investment negotiations, widens the range of potential investors</li> <li>• Helps to determine the cost of production as well as set the price of a product more accurately</li> <li>• Support establishing cleaner production projects, the evaluation of investments (by mapping the social and environmental effects of investment decisions)</li> <li>• Facilitates the appearance on the list of 'eco' suppliers</li> <li>• Facilitates tracing energy and material flows more accurately, contributing to increased resource efficiency</li> <li>• Helps the management to make responsible decisions</li> <li>• Fosters the social and environmental awareness of employees while performing their tasks and strengthens their commitment and motivation</li> </ul>	<ul style="list-style-type: none"> <li>• Satisfies the information needs of external users</li> <li>• Makes better relationships with the stakeholders</li> <li>• Ensures and improves the legitimacy, credibility and the reputation of the company</li> <li>• The public recognizes corporate accountability, transparency and trustworthiness in social and environmental issues, thus improving the company's general acceptance</li> <li>• Facilitates the comparability of the company's sustainability performance to other companies or industrial sectors</li> <li>• Promotes the application and improvement of sustainability accounting by acquiring knowledge on the best practices</li> <li>• Contributes to sustainable development on a corporate, national and global level</li> </ul>

Source: authors' calculations, 2013

### 3 THE RESULTS OF THE PAPER AND SUGGESTIONS FOR FURTHER RESEARCH

The results of the study could be evaluated from three aspects.

The novelty of the paper from the point of view of strategic management could be summarized as follows:

- The development of the process of sustainability strategic management in accordance with to the principles of sustainability: the formulation of the sustainability strategy (defining the company's mission, values, vision and strategic aims of sustainability; the analysis of the company's current and future situation in terms of sustainability; the formulation, evaluation and selection of alternative strategies for sustainability).
- The identification of the activities and tasks of the different sections of the process with the adequate modern management measures: economic per-

formance assessment (quantification of environmental and social costs and revenues, life-cycle analyses), social performance assessment (stakeholder analyses, social efficiency indicators), environmental performance assessment (eco-efficiency indicators, input-output analyses), integrated evaluation of corporate sustainability performance (Sustainability Balanced Scorecard, Global Reporting Initiative).

In the course of the development of the accounting information system the following measures could be valuable:

- The comprehensive overview of the developing phases of the accounting in the last two decades from the aspect of to what extent the system integrates the principles of the sustainability into itself: traditional accounting (economic factors), environmental accounting (economic and environmental factors), and sustainability accounting (economic, environmental and social factors).
- The comparison of the characteristics of the different accounting information systems (dimensions, target, field of application, method, unit of measurement, forms of accounts, regulation strictness) in order to support the selection of the measures and tools.
- The specification of the logical model of sustainability accounting system (targets, principles and requirements, methods and devices, form and content features of the information).

The next could also be considered as the outcomes of the research:

- The determination of relations between the sustainability strategy and sustainability accounting (the identification of the strategic and operational indicators; the collection of the needed quantitative and qualitative data; assessment and communication of the company's sustainability performance).
- The classification of micro- and macro-environmental benefits of the system for the company.

These unique results, of course, can be regarded as the initial steps of a fresh research project that needs further specification both from theoretical and practical perspective in the future. The following research tasks are needed to achieve these goals:

- The operationalization of the conceptual model of the sustainability accounting system with a special regard to its practical application.
- The clarification of the impact of the sustainability accounting information supply to the company's decision makers on the sustainability strategic performance.
- Producing domestic and international case studies to illustrate the success of operation of the sustainability accounting system.

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# SIMILARITIES AND DIFFERENCES OF CONDUCTING INNOVATION SURVEY – LATVIAN AND ESTONIAN APPROACHES

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SVETLANA JESIĻEVSKA\*

Doctoral student, Faculty of Economics and Management, University of Latvia

**Abstract.** An innovation survey conducted in Latvia addresses one of the major driving forces of sustainable economic growth – innovation. In Latvia, there is still room for improvement in the process of collecting innovation statistics in order to obtain more accurate data. According to the innovation survey results, Latvia has a small number of enterprises involved in product or process development; for comparison, every tenth enterprise in Estonia had completed an innovation project during 2008–2010, and an innovation project was ongoing in every sixth enterprise (Heinlo, 2010), which is the best innovation performance among the Baltic states. This could be explained by the special features of collecting innovation statistics in Estonia.

Estonia began conducting innovation surveys earlier than Latvia, and thus Estonia has a broader experience in the area of producing innovation statistics. That experience could be useful for Latvia, currently looking for ways of improving the method of collecting innovation statistics. Support for, and development of innovation performance is one of the priority tasks for the government of Latvia, and thus high quality statistics on innovation in Latvia will provide a point of reference to entrepreneurs and policy-makers and support decision- making, which would accelerate Latvia's progress towards innovation-based economy.

The *purpose* of this paper is to discuss individual features in the process of collecting innovation statistics in Estonia and Latvia based on the Community Innovation Survey 2010 (CIS 2010) methodology and results in order to identify weaknesses in the process of collecting innovation statistics in Latvia. On the basis of this theoretical background, the paper offers proposals for the improvement of approach to compilation of innovation statistics in Latvia.

*The theoretical and methodological evidence* is based on the following: analysis of economic literature; scientific works published by Latvian and foreign researchers; legal documents of the European Commission; the statistics database of the Central Statistical Bureau of Latvia, Statistics Estonia and Statistics Lithuania; statistical and methodological materials by Eurostat and other international agencies. Research methods mainly used for the paper are bibliography review and the methods of statistical analysis such as grouping, processing and comparative analysis .

**Key words:** *innovation statistics, innovation survey, sample, target population*

**JEL code:** C00, C13, O31

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\* Corresponding author. E-mail address: [svetlana.jesilevska@csb.gov.lv](mailto:svetlana.jesilevska@csb.gov.lv)

## INTRODUCTION

Changes in technology and innovation are major drivers of economic growth and lie at the heart of the competitive process (Christensen & Raynor, 2003).

Enterprises that offer products adapted to the needs and wishes of target customers and market them faster and more efficiently than their competitors are in a better position to create a sustainable competitive advantage (Prahalad & Hamel, 1990; Amit & Schoemaker, 1993; Nonaka & Takeuchi, 1995; Calantone et al., 1995). Competitive advantage is usually obtained from knowledge, technological skills and experience in the creation of new products (Teece et al., 1997; Tidd et al., 1997; Alegre et al., 2006).

According to Alasoini et al. (2007), an enterprise's competitiveness will be even more dependent on its ability to produce innovations in the future. Thus, it can be assumed that an enterprise's performance is more and more dependent on its innovation capability (Alasoini et al., 2007; Saunila & Ukko, 2012).

Innovation can only occur if an enterprise has the capability to innovate (Laforet, 2011). Innovation capability is composed of the main processes within the enterprise (Lawson & Samson, 2001). It cannot be separated from other practices. According to Neely et al. (2001), an enterprise's innovation capability can be thought of as the potential to generate innovative outputs. Innovation capability has several definitions proposed by different researchers. In the authors' opinion, the most complete definition is the following: innovation capability is defined to consist of the elements influencing an enterprise's capability to manage innovation (Saunila & Ukko, 2012). The concept of innovation capability includes three elements:

- Innovation potential consists of factors that affect the present state of innovation capability. The factors reflect the potential that enterprises have to produce innovations.
- Innovation processes are systems and activities that assist enterprises to utilize their innovation potential and therefore enable innovations. They are the way systems and activities are carried out.
- The results of innovation activities are, for instance, product/service innovations, and process innovations (Saunila & Ukko, 2012).

Within this context, special attention needs to be paid to the measurement of innovation performance. Measuring is important for the development of innovation capability, and thus important for the future success of the enterprise. Policy-makers, private businesses, financial investors and researchers wish to have quantitative statistical tools available to learn more about the effectiveness of innovative activities and to provide efficient tools to stimulate innovation capability of enterprises in the future. However, the measurement of innovations is not an easy matter.

## 1 METHODOLOGICAL ASPECTS OF COLLECTING INNOVATION DATA IN LATVIA

In order to have an accurate picture of the innovation situation in Latvia and to plan innovation support activities on its basis, a detailed survey of the innovation performance of the enterprises has been carried out. For statistical purposes in Latvia, the definition of innovative enterprises is based on the Community Innovation Survey (CIS) methodology, which follows the Oslo Manual guidelines (Oslo Manual, 2005).

The majority of European countries rely on the Oslo Manual definitions and guidelines that ensure international comparability of data based on innovation survey inside Europe. A number of non-European countries do not carry out innovation surveys, but if they do, they commonly rely on the definitions and guidelines of the Oslo Manual and do not use the CIS harmonized questionnaire. This limits the international comparability of innovation survey based data outside Europe.

The CIS methodology has several constraints: the CIS is a sample survey which does not cover all enterprises and sectors of the business economy, and the CIS data are not available on an annual basis. Every CIS questionnaire includes an additional module dedicated to some special topic. In CIS 2010, this module was dedicated to the use of skills and the stimulation of the creativity of employed staff and the generation of new ideas.

Since 2002 the CSB participates in the innovation survey. During the last innovation survey carried out in Latvia with the reference year of 2010 (the observation period covered by the survey is 2008–2010), the survey questionnaire *An overview on Research and Innovation performance in Business sector in 2010 (2-Research and Innovation)* was used. The survey questionnaire, *2-Research and Innovation*, consisted of two sections. Section A was dedicated to the information on innovations (based on the CIS 2010 provided by Eurostat), while section B questions were related to R&D data (according to the Commission Regulation (EC) No 753/2004 on statistics on science and technology). The questions covered in section B were the same as in the survey questionnaire, *An overview on Research in Business sector in 2010 (2-Research and Experimental Development)*.

The survey sample was designed for the survey, *2-Research and Innovation*, in accordance with the Commission Regulation (EC) No 1450/2004 statistics on innovation and the Commission Regulation (EC) No 753/2004 on statistics on science and technology. The main statistical unit for CIS 2010 in Latvia was an enterprise, as defined in the Council Regulation (EEC) No 696/93 of 15 March 1993 on the statistical units. Actually, one sample frame was used for two surveys (*innovation and research*). The sample design was a stratified simple random sample. Enterprises were stratified by two variables, namely, the main sphere of economic activity (by NACE Rev. 2) and the size of an enterprise by number of employees (see Table 1). Regional allocation as the third dimension was not

taken into consideration when sampling, as most strata had too small a number of enterprises in them. The survey sample included economically active enterprises of the industry (NACE Rev.2 sections B, C, D, E, excluding Construction) and services sector (NACE sections H and K, and NACE divisions 46, 58, 61, 62, 63 and 71). The size of the sample frame for the survey *2-Research and Innovation* was 29188 units (of which, 15815 units comply with the innovation survey). The number of strata was 350, the sample size – 3547 units (12.15% of the sample frame of 29188 units).

According to the Oslo Manual methodology (Oslo Manual, 2005), enterprises with less than ten employees should be excluded from the innovation survey. The number of respondents for the survey *2-Research and Innovation* was 1,358 while the survey *2-Research and Experimental Development* gathered the opinions of 1865 respondents.

Table 1

**Enterprise groups by size (number of employees)**

Enterprise size	Number of employees
0	0
1	1-9
2	10-49
3	50-249
4	250-499
5	500+

Source: Unpublished materials of CSB

The innovation survey was carried out in the official language of Latvia; therefore, questionnaires and the e-Report interface were available in Latvian only. The CIS 2010 was mainly an online survey: the main data transmitting media were available on the website of the Central Statistical Bureau (CSB), while questionnaires could still be downloaded from the CSB homepage. All indicators included in the innovation survey questionnaire were described in an integrated statistical data management system (ISDAVS) of the CSB. About 130 validation rules were described in ISDAVS and an e-survey system taking into account the possible values of variables, logical and arithmetical rules and relations between the sections of the survey.

According to The Official Statistics Law (The Official Statistics Law, 1997), a respondent has a duty to prepare and submit individual statistical data upon the request of the CSB. During the innovation survey, statisticians contacted respondents to remind them to submit a survey questionnaire. In the case of incorrect data, logical errors or non-response the respondent was contacted by phone or by e-mail to clarify information. The response rate was high. In absolute figures, 1,639 out of 1,865 sampled enterprises or 87.9% responded to the survey, *2-Research and experimental development*, while 1,205 out of 1,358

sampled enterprises or 88.7% responded to the survey, *2-Research and Innovation* (see Table 2). The response rate to the survey *2-Research and Innovation* by size of enterprise is the following: among small-sized enterprises response rate is 89.0%, among medium-sized enterprises – 87.4% and among large enterprises – 97.8%. The highest response rate is seen among large enterprises. The response rates to the survey *2-Research and Innovation* by NACE Rev.2 among industrial enterprises (excluding Construction) – 88.3%, and core service enterprises – 89.2%, do not differ significantly (see Table 2). Main reasons for non-response in the survey *2-Research and Innovation* are as follows: 103 sampled enterprises or 67.3% of non-respondents refused to provide a survey questionnaire; 30 sample enterprises or 19.6% of non-respondents had stopped their operations for a fixed period of time; 19 of the sampled enterprises or 12.4% of non-respondents were impossible to contact; 0.7% had other reasons for non-response.

Table 2

**Un-weighted unit response rate by NACE Rev. 2 and enterprise size  
(survey 2-Research and Innovation)**

NACE	Breakdown	Un-weighted unit response rate
<b>Total NACE</b>		
	Total	88.7
	Small [10-49]	89.0
	Medium-sized [50-249]	87.4
	Large [> 249]	97.8
<b>B_C_D_E</b>	<b>Total industry (excluding construction)</b>	
	Total	88.3
<b>NACE sections H and K, and NACE divisions 46, 58, 61, 62, 63 and 71</b>	<b>Core Services</b>	
	Total	89.2

Source: Unpublished materials of CSB

Table 3

**Innovative enterprises as per cent of total enterprise number**

	Latvia	Lithuania	Estonia
<i>Total</i>	29.9	32.5	56.8
<i>of which with number of the employed:</i>			
10-49	26.7	27.9	51.7
50-249	38.2	43.1	73.3
≥250	62.5	69.6	92.5

Source: authors' construction based on statistical data of CSB, Statistics Estonia and Statistics Lithuania.

The results on the last innovation survey CIS 2010 show that the highest propensities to innovate were recorded in Estonia (56.8 % of total enterprise number are innovative enterprises). The share of innovative enterprises in

Latvia and Lithuania are lower than in Estonia and are approximately at the same level. According to the CIS 2010 results (see Table 3), Estonian innovation performance is better than that in Latvia and Lithuania; moreover, Estonia began to conduct innovation surveys earlier than Latvia and has broader experience in the area of producing innovation statistics, so in order to find the ways of improving innovation statistics in Latvia, the article examines the experience of Estonia in collecting innovation statistics.

## 2 INNOVATION SURVEY IN ESTONIA

The CIS 2010 was the fifth innovation survey in Estonia. The first innovation survey with the reference year 2000 and the observation period of 1998–2000 was not yet obligatory for enterprises, but the CIS has since become a part of the official compulsory statistics in Estonia. The next innovation surveys covered the reference years 2004, 2006, 2008 and the latest was 2010. The regular surveying of innovative enterprises gives a possibility to analyse different facets of innovativeness using time series.

The innovation survey in Estonia covers only the core part, those being enterprises with 10 and more employed persons in the sector of industrial activities (excluding construction) and some service activities according to the Estonian Classification of Economic Activities (EMTAK based on NACE Rev. 2). Micro-enterprises in Estonia were not surveyed during the CIS 2010, as the completion of the questionnaire would be an excessive burden for them. Actually, the enterprises in the sampling frame were stratified by two main variables: by economic activity (the two-digit division level of EMTAK); and by the number of employed persons, according to five size classes (enterprises with over 250, 100–249, 50–99, 20–49 and 10–19 employed persons). In the case of international comparison, combined size-classes are used: large (250+ employed persons), medium (50–249 employed persons) and small (10–49 employed persons) enterprises.

The final sampling frame of the CIS 2010 consisted of 3,234 enterprises, and the sample of 2,083 enterprises divided into 240 strata. Compared to 2008, there were nearly 800 enterprises less in the sampling frame and 400 enterprises less in the sample. The economic crisis had thinned out the number of active enterprises and reduced the number of employed persons in small enterprises below the survey limit. 51 strata were empty and 41 consisted of less than three enterprises, making the data obtained on the respective stratum confidential. Secondary confidentiality added the same number of strata for which data cannot be published. This is a typical phenomenon in a small country (Heinlo, 2010).

Enterprises with 50 or more employed persons were surveyed by the census. In case of enterprises with less than 50 employed persons, 18 of the 96 strata were empty, 60 strata were surveyed by the census, and simple random sampling was used only in the case of 18 strata with the following conditions: the size of

the sample was at least 30 enterprises; in a stratum consisting of less than 225 enterprises, the sample size comprised at least 25% of the frame; and in a stratum consisting of 225 or more enterprises, the sample size comprised at least 20% (Heinlo, 2010).

The main data transmission channel for the CIS 2010 in Estonia was an online survey. In the CIS 2010, 79% of the respondents preferred the online method. To perform data input and processing, the special software for data checking and generation of output tables was introduced in Estonia. In case of incorrect data, logical errors or non-response, the respondent was contacted by phone or e-mail to correct the data. During the CIS 2010 it was necessary to contact over one third of the respondents (i.e. 657 enterprises). The survey CIS 2010 in Estonia was quite successful – it achieved a high response rate of 80.1% (data of Statistics Estonia).

The financial statistics of enterprises published in the database of Statistics Estonia covered over 58,000 enterprises in 2010. This is 18 times more than in the CIS frame, but as most of these were micro-enterprises, the difference in turnover or number of employees is not so drastic at all. As shown in Table 4, the innovation survey covered two thirds of employees and three quarters of turnover in case of industrial enterprises. Among service enterprises, the coverage is more modest, achieving 40% for employment and 50% for turnover. Consequently, there is no doubt about the representability of the CIS. It is worth noting that the CIS also covers financial and insurance activities (85 enterprises in 2010), which are not included in the financial statistics of enterprises – the reason is that their financial statements have a different structure (Heinlo, 2010).

Table 4

**Innovation survey coverage compared to data from financial statistics of enterprises, 2010 (percentages)**

<b>Economic activity</b>	<b>Number of enterprises</b>	<b>Number of employees</b>	<b>Turnover</b>
Industry	12.3	66.1	77.3
Services (excl. financial intermediation)	3.5	25.0	36.9

Source: Heinlo, 2010

In order to ensure quality of innovation statistical data and to promote the use of innovation statistics, Statistics Estonia established co-operation with the government and the following users: Ministry of Economic Affairs and Communications (Economic Development Department – Innovation and Economic Analysis Divisions); Ministry of Education and Research (Research Policy Department); Government Office (Strategy Unit); Research and Development Council (headed by PM); Foundation Enterprise Estonia (Innovation and Development divisions); Tartu University, Tallinn University of Technology; Several private research institutions.



### 3. MAIN PROBLEMS AND POSSIBLE SOLUTIONS

Estonia and Latvia conducts innovation surveys that are actually based on the same Eurostat methodology, although innovative performance in Estonia is much better than in Latvia. Estonia is more experienced in collecting data on innovations as the country participates in the innovation survey for a longer period of time than Latvia.

An approach to data collection, control and interpretation has impact on the quality of statistical data. Estonia and Latvia have different approaches in creating survey samples. According to the Eurostat requirements, a R&D survey should be conducted annually, whereas the CIS should be carried out every two years. In 2011 both R&D and innovation surveys were undertaken. Two different survey samples were created in Estonia in 2011, and two different surveys with different submission deadlines were sent out to the respondents. This approach helps to evenly distribute response burden over respondents and workload for statisticians; thus more time can be devoted by statisticians to the control of statistical data received from the survey and to communication with respondents. A report that contains fewer questions helps enterprises to focus on the question, rethink their possible answers and to provide more accurate data. Latvia created one survey sample and sent one combined survey, *2-Research and Innovation*. The main disadvantage of this approach is that it originates inaccurate financial data, because the survey should be filled in before the deadline of the completion of the audit.

Latvia and Estonia have similar innovation survey problems, which are as follows:

- Respondents have difficulties to distinguish among product, process, organisational and marketing innovations;
- A lack of understanding of the innovation definition;
- Accountants who often fill in the survey questionnaires have limited knowledge about innovation activities in the enterprise; often there are no accounting of financial indicators related to innovation and R&D activities;
- Respondents are not motivated enough to provide accurate data;
- Some respondents refuse to fill in the questionnaire because of the lack of time or the lack of data requested;
- The survey is carried out on a sample basis, and thus an innovatively active enterprise can stay out of the sample.

The following measures should be taken by statisticians to solve the problems mentioned above: the clearness of guidelines and recommendations for innovation surveys must be increased; ambiguous questions or questions hard to understand must be eliminated from the questionnaire; examples and instructions must not focus only on high-tech activities of large firms. Currently in the CSB, reports are distributed among statisticians according to

the geographical location of the surveyed enterprise. It would be more effective to assign statisticians who are directly responsible for the innovation survey and to train them well, so that they are able to provide professional assistance to the respondents. A direct contact with the respondent helps to identify weaknesses of the survey questionnaire, which should be corrected. Experience suggests that the quality of statistical data is highly dependent on the communication with respondents and analysis of alternative data sources. Estonian statisticians make a careful analysis of alternative data sources to obtain information about what kind of innovative activities are conducted in the country and which enterprises are involved in those activities. This extra effort helps statisticians to control information received from the respondents during the survey and avoid non-response from potentially innovative enterprises. Such an approach should also be adopted by the CSB. To improve cooperation between statisticians and respondents and to motivate enterprises to provide correct and accurate data, booklets with main indicators on innovation statistics from the latest survey should be disseminated to respondents who filled in the survey questionnaire, together with the expression of thanks for their collaboration. Such information could be interesting for them.

Statistics Estonia actively cooperates with data users, especially with policy-makers. In order to ensure quality of statistical data on innovation and to promote the use of innovation statistics, the CSB should establish co-operation with the government and the data users, such as the Ministry of Economics, the Ministry of Education and Science, the Investment and Development Agency of Latvia, the University of Latvia, Riga Technical University, private research institutions etc.

Statistics Estonia regularly publishes articles with a detailed description of the methodology used and a wide range of statistical data on innovation. Such an approach facilitates the availability of innovation data, increases the understanding of statistical data on innovation, and promotes the use of innovation statistics for innovation decision-making. Only a few tables of innovation statistics in Latvia are currently published on the CSB website, while all the tables are available on the Eurostat statistics database. The CSB is planning to expand the range of statistical information on innovations available on the CSB Website, so that, in the future, innovation statistics should mostly be available on the CSB portal.

## CONCLUSIONS AND RECOMMENDATIONS

1. The following recommendations can be offered in regard to the contents of the survey questionnaire for Latvia: the clearness of guidelines and recommendations for innovation surveys must be increased; ambiguous questions or questions hard to understand must be eliminated from the questionnaire; examples and instructions should not focus only on high-tech activities in large firms.

2. Several groups of people are involved in creating innovation statistics. Those are policymakers, researchers, statisticians and respondents. All groups have different understandings of innovations. It is only statisticians who have studied the Oslo Manual guidelines in detail; therefore, they should clarify the matter to other groups of people, mainly to the respondents.
3. In order to ensure the quality and promote the use of innovation statistics, the CSB should establish co-operation with the government and the data users, such as the Ministry of Economics, the Investment and Development Agency of Latvia, the University of Latvia, Riga Technical University, private research institutions etc.
4. In Latvia, one survey sample was designed for the survey, *2-Research and Innovation*, while two different samples were designed in Estonia. Estonian approach offers the possibility of evenly distributing the response burden and statisticians' workload. Meanwhile, Latvian approach of creating one survey sample generates inaccurate financial data, because the data are collected before the deadline of the completion of audit. The CSB should consider the approach of creating two different samples.
5. The CSB statisticians should make a careful analysis of alternative data sources to obtain information about innovative activities in the country and enterprises involved in those activities. This extra effort helps to control information received from the respondents during the survey and avoid non-response from potentially innovative enterprises.
6. The CSB should expand the range of statistical information on innovations on its website, so that in the future, most of innovation statistics would be available on the CSB portal.
7. To improve cooperation between the CSB statisticians and respondents and to motivate enterprises to provide correct and accurate data, booklets with main indicators on innovation statistics from the latest survey should be disseminated to respondents who filled-in the survey questionnaire, together with the expression of thanks for their collaboration. Such information could be interesting for respondents.

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# SUBJECTIVE ASSESSMENT BY TEACHERS AND OTHER PROFESSIONALS OF WELL-BEING IN LATVIA IN YEARS 2011/2012

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SILVIJA KRISTAPSONE\*

Faculty of Economics and Management, University of Latvia

**Abstract.** The human aspiration for a better life and higher living standard is a priority for anybody and, consequently, for the society as a whole. However, the consequences of the global economic crisis (decreasing wages, rising unemployment, limited access to medical services etc.) have definitely worsened the quality of life over the recent four to five years.

The sustainable development model for Latvia has been defined as “Putting People First”. The goal of the model is to improve the various aspects of every Latvian resident’s quality of life, including the opportunity to participate in the labour market, education, awareness raising, creativity, electronic communications, social cohesion, participation processes, the stability of growth, culture, leisure time and opportunities, and others. One of the important factors in achieving the goal is education and the development of the sector and its quality, including the teacher as change agent and initiator, while the teacher’s quality of life remains critical.

A popular belief is that, theoretically, teachers’ salaries should be high enough so that they need not work extra hours but could devote their time to extracurricular work and preparation for classes. Only then a teacher can work creatively, use modern technologies to attract students, devote attention to his or her own personal development – to remain motivated. At the same time, a competitive salary is not the only indicator of the quality of life measurement from a monetary aspect and a motivating factor. In addition to wages, there are other equally important aspects of life satisfaction, such as health, education, social life, hobbies, achievements etc.

The aim of this research is to assess the results of the evaluation of various domains of subjective well-being made in two respondent groups over the academic year of 2011/2012 within a research project. The respondent groups represented teachers (N = 630) and other employed persons (N = 560), to find out how teachers assess their quality of life. For the assessment of subjective well-being the *International Well-being Index (IWI)* survey was used, which was supplemented with questions from the research on the quality of life made in Latvia in year 2005 (International Well-being Group, 2006; Bela, 2006). For the purposes of this research the author has used the methods of descriptive and inductive statistics.

The results of the study indicate relatively lower assessments in the domains of the subjective well-being index among teachers in comparison to the

\* Corresponding author. Tel.: +371 67034702; fax: +371 67034788; e-mail: [silvija.kristapsone@lu.lv](mailto:silvija.kristapsone@lu.lv)

representatives of other professions. The teachers assess significantly lower their satisfaction with life as a whole, satisfaction with their health, community connectedness and their future security. Their assessment of national domains is also relatively lower: satisfaction with life in Latvia, its economic situation and business development in the country. When assessing the life quality domains in the places of their residence, teachers are significantly less satisfied with their living environment; they rate lower their opportunities of spending their leisure time according to their liking, society integration and equal opportunities in their place of residence. The presented results suggest a higher risk for teachers as a professional group to face psychological disorders, such as depression, the professional burn-out syndrome etc. Moreover, these results substantiate the need for actively addressing the encountered problems at various levels.

**Key words:** *quality of life, satisfaction with life, subjective well-being.*

**JEL code:** I20, I30, E21

## INTRODUCTION

Quality of life is an interdisciplinary concept, and there are many quality of life measurements used in the assessment of quality of life; some of them are based on objective indicators, but the other part relies on subjective indicators. One example is the Legatum Prosperity Index. It is the first global index to provide an empirical framework for prosperity as a complex blend of both income and wellbeing. It includes social capital, effective governance, human rights and liberties, health, opportunity, security, and overall quality of life. The ranking of Latvia in 2011 is as follows: the summary rank – 51st, Entrepreneurship and Opportunity – 33th, Education – 32nd, Social Capital – 96th, Economy – 90th, Personal Freedom – 81st, Health – 42nd, Safety and Security – 43rd, and Governance – 40th place in the world. (The Legatum Institute, 2012)

Subjective quality of life indicators are measurements that reflect people's perception of their family, community or quality of nation's life. For example, an individual's quality of life reflects his satisfaction with life. It has been found that the conditions for satisfaction with life reflect in a family (marriage), leisure activities, work, finances, home, residence, and friends.

Research has revealed that people who are well-off financially are happier than poor people (Diener & Biwas-Diener, 2002; Diener & Seligman, 2004). Happy people are successful in many areas of life that require motivation and persistence, including domains such as work and income (Lyubomirsky et al., 2005). Striving for material goods can have a negative impact on social relationships, thus lowering the level of happiness. Relativistic judgment theories suggest that a person's satisfaction with his or her income is based on social comparison. People make comparisons to multiple standards – they compare what they had in the past to what they have now, what they have and what they want, and to what relevant others have. According to Multiple Discrepancies

Theory, these comparisons explain the level of life satisfaction (Michalos, 1985). Meta-analysis of studies on materialism reveals an overall negative link between well-being and materialism (Wright & Larsen, 1993). However, the nature of this relationship has generated considerable controversy. It has been established that money does increase well-being in very poor people. Once basic needs are met, the relationship between money and well-being is not so clear.

Some studies show that income contributes to subjective well-being (SWB) (Diener & Biswas-Diener, 2002).

The gap between the achieved and the desired financial status is smaller in wealthier than in poor people.

Contrary to that, other studies showed that materialism has a detrimental effect on well-being and that people striving for financial success have a diminished quality of life (Kasser et al., 2004). Above the poverty level, increases in income contribute only to a minimal increase in subjective well-being (Oishi et al., 1999). It has been found that people with materialistic orientation have lower well-being in later life (Nickerson et al., 2003).

Various studies have shown the monetary aspect of a relatively small impact. According to the third European Quality of Life Survey (2012), one might be led to think that people living in countries with a higher GDP per capita appear to report higher levels of both life satisfaction and happiness. However, there is only a weak positive correlation between GDP and subjective well-being (Eurofound (2012)). In transitional European countries financial success means opportunity and possibilities of self-expression and self-growth (Frost & Frost, 2000).

However, better circumstances also enjoy greater subjective well-being and that ongoing rises in living standards have delivered higher subjective well-being. (Stevenson B., Wolfers J., 2008)

However, a competitive pay as the monetary domain of the quality of life is not the only motivating factor. Along with the pay, other domains in the satisfaction with life are equally important, for example, health, education, community-connectedness, leisure time, achievements etc.

The quality of life is a complex social, economic and political concept which comprises a wide spectrum of the living conditions of the country population. No universal definition of (subjective) well-being exists. However, some of the most well-known researchers in the field offer the following definition: "Well-being, which we define as people's positive evaluations of their lives, includes positive emotions, engagement, satisfaction and meaning." (Diener and Seligman, 2004) "Subjective well-being is a broad category of phenomena that includes people's emotional responses, domain satisfactions, and global judgments of life satisfaction. Each of the specific constructs needs to be understood in their own rights, yet the components often correlate substantially [...]." (Diener, Suh, Luca and Smith, 1999)

Kahnemann et Riis (2005) consider subjective well-being as being a hybrid concept with two components, which can be labelled “experienced well-being” and “evaluated well-being”. Both components are subjective and refer to a time of reference. The first component is the time series data on momentary affective states. The second component includes global subjective evaluations of one’s life. In many instances, these two components can be expected to be highly correlated with each other. However, not always they are. The determinants and consequences of happiness are often treated as unitary but they should be measured separately. (Kahneman D., & Riis J., 2005)

Other authors note that life satisfaction may reflect an individual’s scores on specific areas of their lives, for instance, family, environment, friends and one’s “I” assessment (Suldo & Huebner, 2006). Life satisfaction scores have very many other processes. For example, it affects an individual’s social contacts and intimate partner relationship quality, success at work, general physical health, positive psychological health and so on. (Pavot & Diener, 2008).

Sociologist T. Tisenkopfs (Latvia) has it defined as follows: the quality of life is a concept which involves both objective and subjective indicators and “the set of their mutual interaction which is reflected by a certain level of well-being which depends on an individual’s resources and knowledge”. (Tisenkopfs T., 2006). Subjective welfare is a complicated construct with very many domains. Subjective well-being refers to self-satisfaction about life and other factors such as personal relationships, health, and work (White, 2007). Stevenson and Wolfers (2008) concluded that happiness was principally related to six demographic factors – age, education, gender, marital status, geographic region, and race – and that educated men and women were happier than individuals with less education. It comprises the emotional reaction of persons, various domains of satisfaction and general judgements about the satisfaction with life. A wide range of factors have been identified as factors that influence well-being or happiness including leisure, retirement, physical appearance, and location of residence (Diener, 2009). The following factors, however, have also received considerable attention from researchers: age, activities, education, employment, gender, income, personality, race, religion, life events, social contacts, and marriage and family. Margitits and Paulwlik (2009) described subjective well-being as satisfaction with life in general, a positive affect and emotions, and the relative absence of negative emotions (e.g., depression, fear, sadness, stress). Subjective well-being and similar concepts such as life satisfaction and psychological well-being are associated with cognitive and affective factors that influence maintaining a balanced, healthy life. Factors such as attrition, stress, and burnout have increasingly affected teachers and their wellbeing (Pillay, Goddard, & Wilss, 2005). Teacher attrition has been predicted to increase during the 21st century (Mihans, 2008), a factor related to teachers’ wellbeing and job satisfaction (Pillay, et al.).

The aim of the article is to assess the results of the subjective well-being survey made within a scientific research project in two respondent groups – teachers (N = 630) and people of other professions (N = 560). The public administration



reform comprises the merging or dividing of various state sector organizations, including the reorganization or closing of educational institutions. As a result of the structural reform of educational institutions in the academic year 2011/2012, compared to the year 2008/2009, the number of general education schools in Latvia has decreased by 153, the number of teachers employed at general education schools – by 2.7 thousand, while the overall number of teachers has decreased by 4.2 thousand. (Ministry of Education and Science of the Republic of Latvia, 2012). The reduction was first determined by the decrease in the number of pupils; secondly, there was a need for a fast optimization of the use of financial resources upon the beginning of the economic recession in Latvia.

The economic and social situation of teachers significantly deteriorated in 2009 as a result of the salary reduction. In 2011, compared to 2008, the average gross salary of persons employed in education had decreased by 17.3% reaching 401 LVL (while the average gross salary in the country was 464 LVL LR CSB, 2012, b)). The survey was made in the Internet in the period from October, 2011 to May, 2012.

The teachers' group: women – 82% men – 18%, broadly in line with the gender breakdown ratio of teachers working in the profession; the majority of them, 54.6% were at the age of 41 to 61 years. In the teachers group, 89.7% of the respondents had higher education.

The other professions' group: women – 78.8%, men – 21.2%, 72% of them at the age of 40 years; the higher education rate among the respondents in the other professions group was 59.1% .

As regards the homogeneity of the groups, it appears that women and men are similarly represented in both ( $U = 112197.5$ ,  $p = 0.202$ ), but the groups were statistically significantly different by age ( $U = 77099.5$ ,  $p = 0.000$ ), level of education ( $U = 76140.5$ ,  $p = 0.000$ ) and employment status ( $U = 106,455.0$ ,  $p = 0.002$ ), which only means that the teacher group is relatively “older” and better educated.

When characterizing the quality of life, most commonly the objective listing and assessment of indicators is used which comprises living conditions, the standard of living, income, living environment, education, health and employment, however there is less attention paid to the subjective evaluation of life by people themselves. The International Well-being Index (IWI) survey (Cummins R. A., Eckersley R., Pallant J., 2003) has been developed for measuring the well-being assessment in a particular nation, and it envisages the possibility of implementing cross-cultural comparison. The application of the International Well-being Index survey provides an additional opportunity to test the survey and adapt it for Latvia. The survey consists of 13 statements and comprises the measurements of both the Personal Well-being Index with 7 statements and National Well-being Index with 6 statements. The respondents are asked to answer questions regarding their satisfaction with various domains of life and asked to provide their answers in the scale from 0 to 10 where “0” means that he/she is completely dissatisfied and “10” stands for full satisfaction. (International

Well-being Group, 2006). In addition, the above mentioned International Well-being Index statements have been supplemented with questions from the quality of life survey conducted in Latvia in 2005. (Bela B., 2006)

The data were processed by using the methods of descriptive and inductive statistics: creation of graphical images, calculation of statistical indicators and Mann–Whitney U test as the method of proving hypothesis.

## RESEARCH RESULTS AND DISCUSSION

Among the subjective well-being domains included in the International Subjective Well-being survey (table 1) the highest estimation both in the teacher and other professionals' group has been given to personal relationships (respectively 7.2 and 7.2), followed by satisfaction with personal safety (respectively 6.4 and 6.5) and satisfaction with personal achievements in life (6.4 and 6.4 points). The highest rating of these domains is to be attributed to the fact that both in the teacher and other professionals' group people with higher education represented respectively 91% and 63%.

The research results indicate comparatively lower personal well-being assessments of the subjective well-being index in the teachers' group than in the other professionals' group in the following domains: the teachers evaluate statistically lower their satisfaction with life as a whole, including their living standard, their health, community connectedness and their future security ( $p < 0.05$ )<sup>1</sup>. The assessment of satisfaction with the living standard must certainly be associated with the reduction of teachers' salaries along with the adjustment to the economic recession and demographic situation in Latvia as a whole. The low assessment of the satisfaction with health is to be attributed to the age distribution of teachers: 58.6% of the respondent teachers were more than 40 years old, and the age ratio is characteristic to the teacher population in Latvia as a whole (the average age of teachers in Latvia's schools was 45.4 years in 2011), which differs significantly from people working in other professions. Moreover, there is a distinctly different gender distribution in favour of women among teachers: the research participants included 82.3% women and 17.7% men, which certainly affects the assessment of specific domains; however, this kind of gender distribution is characteristic to the general set of teachers. Thus, for example, in the academic year 2011/2012 women constituted 88.2 % of the general education school teachers and 81.3% of teachers in all Latvian schools. (LR CSB, 2012a)

The teachers assess relatively lower such national domains as satisfaction with life in Latvia ( $p < 0.10$ ) and satisfaction with business development in Latvia ( $p < 0.10$ ). The differences in the assessment of the national domains are

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<sup>1</sup> The significance level of the Mann–Whitney U test results (differences among groups are statistically relevant if  $p \leq 0.05$ )

also observed among genders. Thus, for example, in one of the previous articles analysing the research results the author found that women were less satisfied with all domains of national well-being and with life in Latvia than men. (Kristapšone S., 2012) All respondents together provided a negative assessment (< 5.0) of the following domains of the national well-being: satisfaction with the work of the government, with the economic situation in Latvia, the condition of business in Latvia, the situation in Latvian society.

Table 1

**Assessments of the subjective well-being index domains in the respondent groups of teachers and other professionals**

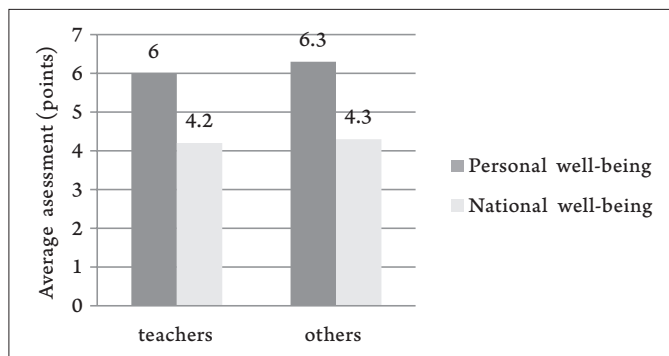
Questions of the International Well-being Survey	Teachers (n=630)		Others (n=560)		Mann-Whitney U test value	p
	M	SD	M	SD		
<b>Personal well-being assessment questions:</b>						
How satisfied are you with life as a whole?	<b>6.1</b>	2.0	<b>6.4</b>	1.9	160266.5	<b>.006</b>
... your living standard?	<b>5.5</b>	2.1	<b>6.0</b>	2.0	153886.5	<b>.000</b>
... your health?	5.9	2.2	<b>6.4</b>	2.1	152961.0	<b>.000</b>
... what you are achieving in life?	6.4	2.0	6.4	1.9	174198.0	.706
... your personal relationships?	7.2	1.9	7.2	2.0	175646.5	.897
... how safe you feel?	6.4	2.0	6.5	2.1	171033.0	.358
... feeling part of the community?	<b>6.2</b>	2.1	<b>6.5</b>	2.0	160778.5	<b>.008</b>
... your future security?	4.4	2.2	<b>5.0</b>	2.2	150760.0	<b>.000</b>
Average personal well-being assessment	<b>6.0</b>	1.5	<b>6.3</b>	1.5	156783.00	<b>.001</b>
<b>Questions of the national well-being assessment:</b>						
How satisfied are you with the life in Latvia?	<b>5.0</b>	2.3	<b>5.2</b>	2.2	165643.0	<b>.067</b>
... economic situation in Latvia?	3.4	1.9	3.6	2.0	167985.5	.150
... environment condition in Latvia?	5.4	1.9	5.5	2.0	172259.5	.479
... situation in Latvian society?	4.1	1.7	4.3	1.9	168135.0	.157
... work of the government?	3.2	1.8	3.3	2.0	174767.5	.779
... condition of business in Latvia?	<b>3.9</b>	1.7	<b>4.1</b>	1.8	165638.5	<b>.065</b>
... level of national security in Latvia?	5.1	2.0	5.1	2.0	174063.0	.688
Average national well-being assessment	<b>4.2</b>	1.4	<b>4.3</b>	1.5	168573.0	.186

Source: author's construction based on study data

Overall, the assessment of the national domains does not significantly differ statistically ( $p > 0.05$ ) between teachers (4.2) and other professionals (4.3), however, the assessments of personal and national well-being do differ significantly ( $p < 0.05$ ) within each of the groups (Figure 1).

Personal well-being is rated comparatively higher than national well-being. Such an assessment has developed as a result of the negative consequences of the recent three-four years of economic recession and internal political problems in the country. The population often find the ways and speed of solving various

economic, political and social problems unacceptable, which is also reflected in the low assessments provided by the groups.



Source: author's construction based on study data

**Fig. 1. Assessment of the personal and national well-being in the groups of teachers and other professionals**

When evaluating domains of the quality of life in the respondents' places of residence (table 2), the teachers are substantially or statistically significantly less satisfied with their living environment ( $p < 0.05$ ), the teachers assess lower their opportunities of spending leisure time as they would like to ( $p < 0.05$ ) and also society integration and equal opportunities in their place of residence ( $p < 0.10$ ).

The domain which is estimated the highest both in the teacher and other professionals' group is satisfaction with ecological situation, followed by satisfaction with society integration and equal opportunities in the place of residence.

The respondents have relatively highly (in a small range around six points) assessed the opportunities to spend their leisure time according to their wishes and their safety in their place of residence, although the teachers' and other professionals' opinion is substantially or statistically significantly different. The teachers might have higher requirements towards the organized culture events than other professionals, and the assessment might be connected with the specific features of the teacher profession.

Both groups provided a negative assessment to the work opportunities in their place of residence (4.4 points in the teachers' group and 4.2 points in the group of other professionals) and business opportunities in the place of residence (4.3 points in the teachers' group and 4.3 points in the group of other professionals) which indicates the stagnation of economic life and difficulties in finding a job or starting one's own business.

The research results reveal that the current ratings of the domains of the quality of life in the society have been induced by the economic recession. The results substantiate the need for actively dealing with the problems at the

Table 2

**Assessment of satisfaction with various domains of life in the teacher and other professionals' groups**

Satisfaction with various domains of life - Questions	Teachers (N=630)		Other professionals (N=560)		Mann- Whitney U test value	p
	M	SD	M	SD		
How satisfied are you with the living environment in your place of residence (city, parish, village)?	5.7	2.0	6.2	2.1	4394.50	.032
How satisfied are you with the opportunities to implement your intentions and aims in your place of residence?	5.5	2.3	5.6	2.2	5250.50	.864
How satisfied are you with the opportunities to spend your leisure time according to your wishes in your place of residence?	5.3	2.5	6.3	2.3	4072.50	.004
How satisfied are you with the society integration and equal opportunities in your place of residence?	6.0	2.5	6.6	2.2	4545.50	.073
How satisfied are you with the work opportunities in your place of residence?	4.4	2.6	4.2	2.6	5030.00	.499
How satisfied are you with business opportunities in your place of residence?	4.2	2.4	4.3	2.2	5095.00	.598
How satisfied are you with the ecological situation in your place of residence?	6.2	2.2	6.6	2.0	4701.00	.150
How satisfied are you with the safety in your place of residence?	5.9	2.2	6.3	2.1	4643.50	.115

Source: author's construction based on study data

different levels of the society as well as the government, the most significant of the problems being the development of business opportunities, the creation of new jobs in all settlements thus improving the economic situation in Latvia, which serves as the foundation for a better quality of life for each of the country's citizens.

The following measures should be taken to improve the teachers' quality of life and their assessment:

- 1) to enable the raise in teachers' salaries in the country, for example, by reviewing the salary formation mechanism,
- 2) to provide free opportunities for teachers to get teacher qualifications in other subjects,
- 3) to provide teachers with mandatory health insurance.

These measures will both ensure material prosperity and create a sense of security for the future.

## CONCLUSIONS

1. The research results demonstrate relatively lower assessments of the subjective well-being index domains in the teachers' group (N = 630) compared to the representatives of other professions (N = 560). The teachers presented a statistically significantly lower assessment of their satisfaction with the life as a whole, and also of such domains as satisfaction with the living standard, their health, their social life and future security.
2. The teachers also provided a relatively lower assessment of the national domains: satisfaction with life in Latvia, the economic situation in Latvia and business development in Latvia.
3. The assessment of the domains of the quality of life in the places of residence indicates that the teachers' group has a significantly lower satisfaction with their living environment, with opportunities to spend their leisure time according to their wishes, society integration and equal opportunities in the place of their residence.
4. The given results indicate that teachers as a professional group face a bigger risk of becoming victims of psychological disorders, e.g., depression, professional burn-out syndrome etc. which can induce other diseases or facilitate their appearance as well as aggravating the symptoms and course of already existing diseases.
5. The undeniably lower health assessment in the teachers' group compared to other professionals can be explained by the teachers' age distribution both in the research group and in the population as a whole – the majority of teachers are more than 40 years old.
6. The living environment, societal integration, ecological situation and the assessment of safety in the respondents' places of residence are rated the highest in both respondent groups, which suggests a positive attitude towards the place of residence; however, respondents demonstrated dissatisfaction with business and employment opportunities in their places of residence.
7. Overall, the respondents rated negatively the work of the government, the economic situation in Latvia and the conditions for doing business in the country.
8. The results of the research convey the current opinions on domains in the quality of life formed in the society as a result of economic recession and, consequently, prove the need for dealing with the problems related to unemployment and increasing labour mobility by the following means: an increase in remuneration, the development of various offers that improve the motivation to work and provide for personal development thus improving the economic situation of Latvia, which underlies the quality of life of each person living in this country.
9. The following measures should be taken to improve teachers' quality of life and their assessment of it:
  - 1) enable an increase in teachers' salaries in the country, for example, by reviewing the salary formation mechanism;

- 2) provide free opportunities for teachers to receive their qualifications in other subjects;
- 3) provide teachers with mandatory health insurance.

These measures will both ensure material prosperity and create a sense of security for the future.

10. Since the IWI method has been adapted for Latvia, the international prosperity index survey could be used in future for other quality of life research groups, such as occupational, social, and others.

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# PENSION STATISTICS IN LATVIA: RESOURCES AND WEAKNESSES

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OLGA RAJEVSKA\*

University of Latvia

**Abstract.** The author provides a directory to Latvian publicly available resources on pension statistics; presents a review of the responsible authorities and their areas of competence; critically analyses the indicators published; reveals the discrepancies between data from different sources and the underlying reasons for those discrepancies; and warns fellow researchers of eventual ‘pitfalls’. The author has analysed publicly available databases and statistical reports, conducted an in-depth personal interview with the State Social Security Agency specialists and performed a simulation analysis of the raw data in order to ‘reconstruct’ the logic of statisticians.

Two major groups of statistical indicators are examined: first, those characterising the performance of Latvian pension system in the recent decade – the absolute and the relative number of pensioners, the average size and distribution of pension benefits; and second, those characterising the performance of Latvian second-pillar mandatory private pension funds – average profitability, geographical distribution of investments, and others. Useful links to web resources are provided with detailed guidelines on what kind of indicators can be found, and where, and the differences in methodology are described. Potential bottle-necks of Latvian pension statistics have been detected in view of an increasing diversity of benefit providers.

**Key words:** *pensions, statistics, research*

**JEL code:** C46; H55; H75

## INTRODUCTION

Reliable statistical data is a fundamental prerequisite of a credible research. A researcher with academic interest in pension policies and economics of pensions cannot do without pension statistics. There are numerous indicators that can be found in variety of sources, both national and international (e.g., Eurostat).

Latvian pension system is a unique object for study: Latvia was the first country in the world to implement NDC (non-financial defined contribution) system with individual notional accounts for first pillar pensions, and was one of the leaders in Eastern Europe to privatise second pillar pensions. Therefore, it is not surprising that it is being explored not only by national scholars – one

\* Corresponding author – e-mail address: [olga@livoniaship.lv](mailto:olga@livoniaship.lv), telephone +371 29110545

can mention, for instance, a recent study by Māris Pūķis and Ināra Dundure (Pūķis M. & Dundure I, 2012), but also by colleagues from other Baltic States (Aidukaite I., 2003), as well as researchers from other European countries – like Anna Zalewska from Poland, who compares pension reform in her home country with the experience of other states, including Latvia (Zalewska A., 2006), or Georges de Menil who investigates regulation of II pillar mandatory private pension funds in Latin America and Eastern Europe (de Menil G., 2005), and even authors from the USA studying pension privatisation: Latvia is included into the panel of 42 countries (Reece C. & Sam, A.G., 2011)

Several public bodies in Latvia are gathering statistics on pensions:

- 1) Overall pension management, including gathering and processing of statistical data, is a core business of the State Social Security Agency (*Valsts sociālās apdrošināšanas aģentūra, VSAA*) and its Department of Statistics. The agency is an institution within and subordinate to the Welfare Ministry.
- 2) Central Depository of Latvia (*Latvijas Centrālais depozitārijs, LCD*) is a subsidiary of NASDAQ OMX Riga Stock Exchange, it holds the registry of individual second-pillar pension accounts and runs the web-portal devoted to mandatory pension funds – <http://www.manapensija.lv>
- 3) Financial Capital and Market Commission (*Finanšu kapitāla un tirgus komisija, FKTK*), an autonomous public institution which, inter alia, is supervising the performance of private second- and third-pillar pension funds and the activities of the Central Depository;
- 4) Central Statistical Bureau of Latvia – CSB (*Centrālā statistikas pārvalde, CSP*) is a body subordinate to the Ministry of Economics; it is the main performer and coordinator of the official statistical work in the country and also provides the data to Eurostat in accordance with EU regulations.

It might seem that the abundance of national resources is impressive compared to other Baltic States: Estonian and, especially, Lithuanian publicly available sources are much less detailed. However, the overlapping functions of the above listed institutions sometimes lead to discrepancies in the figures that can be found in their reports. In the absence of methodology descriptions a researcher may be confused by mismatching indicators. This could be a particular problem when the aim of research is comparative analysis of two or more countries.

The aim of this study was to review the sources of pension statistics in Latvia and to assess their advantages and vulnerabilities, to provide a sort of directory – where to look for what kind of information, to reveal the discrepancies between the figures provided by different institutions, and, where possible, explain these discrepancies; to detect the areas not sufficiently covered by existing statistics. Regrettably, researchers quite seldom question the reliability of statistical data sources and the author was unable to find any example of critical assessment of pension statistics in journals and databases. The only exclusion are the reports

of UK Statistical Authority (e.g., 2010, 2012). The author has limited herself to old-age pension statistics, not considering disability pensions, survivors' pensions and other minor types of pension benefits.

The methods used are as follows: the analysis of publicly available databases and statistical reports; simulation analysis; and in-depth personal interview with VSAA specialists. The author is grateful to the Head of Statistical Department Evita Česka, senior statistician Sabīna Rauhmane and financial statistician Ruta Avotiņa for explanations as to difficulties and offering useful comments.

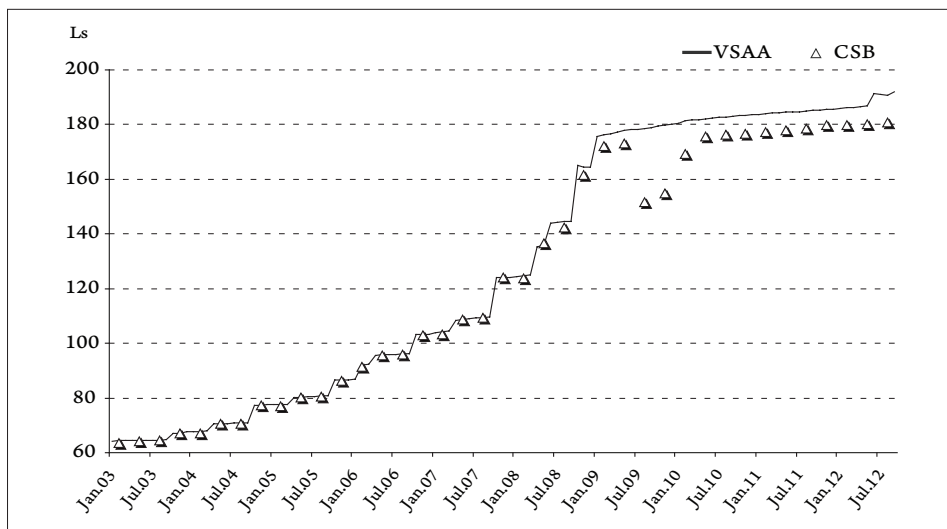
## RESEARCH RESULTS AND DISCUSSION

### 1 STATISTICS ON CURRENT PENSIONERS

The first group of indicators refers to existing pensioners: the total number of old-age pensioners, average monthly pension benefits, average newly-awarded monthly pension benefits, distribution of pension recipients by average size of pension granted. These figures can be found both on the VSAA web-site: <http://www.vsaa.gov.lv/lv/budzets-un-statistika/statistika> and in the CSB online database: <http://www.csb.gov.lv/statistikas-temas/sociala-drosiba-datubaze-30403.html>. However, while VSAA offers only monthly data, the CSB database contains only quarterly and yearly figures, and they do not perfectly correspond to each other.

To start with the absolute *numbers of old-age pensioners*: until the 2nd quarter of 2008, the quarterly figures provided by the CSB were matching the respective monthly indicators given by VSAA. However, starting from April 2008 the situation has changed: quarterly data are always slightly higher. The difference is relatively small, and on average is less than 1,000 (the maximum observed difference was 1,564). The Central Statistical Bureau does not calculate quarterly figures, they take them 'ready-made' from the VSAA quarterly reports (VSAA itself does not publish these reports for the wider public). The difference roots in the fact that a person who had reached retirement age in month X may come to claim his/her pension later: in month  $Y = X+1$  or  $X+2$ , or so on. Respectively, the person has to appear as a pensioner not only in month Y, but also in preceding months Y-1, Y-2 and so on. Monthly reports, once published, are not updated, but quarterly reports are open for such backward amendments while the quarter still lasts.

The next indicator is the *average monthly old-age pension benefit*. Again, since mid-2008 the monthly VSAA figures differ from the quarterly CSB ones, but here the direction is opposite: the CSB figures are lower (see Fig. 1). The most significant difference was observed in the 3rd quarter of 2009: 178.62 Ls according to VSAA, and 151.76 Ls according to CSB – that is, more than 15%. The reason for the difference is that while VSAA reports gross pensions, CSB quotes net pensions, after tax and other deductions.



Source: author's construction based on the VSAA and CSB statistical data.

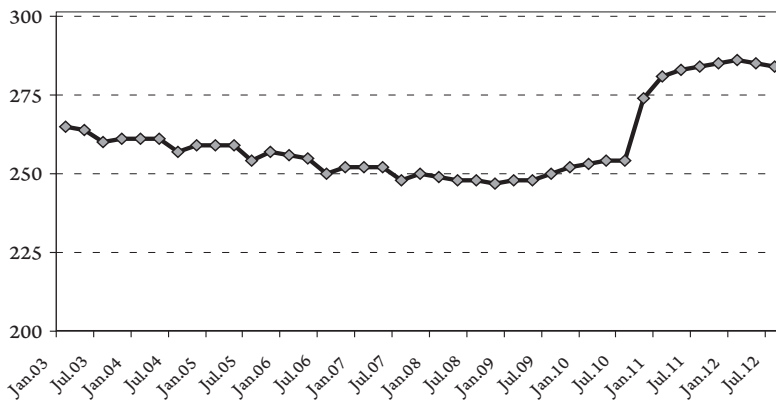
Fig. 1. Average old-age pension benefit in Latvia in 2003 - 2012

Another interesting indicator found in the VSAA/CSB monthly/quarterly reports and also demonstrating discrepancies is the *average newly-awarded monthly pension benefit*. Till 2008, CSB used cumulative indicators – for the first quarter of the year, the data for the three first months were included into calculation, for the second quarter – the average of the first 6 months was calculated, for the third quarter – the average of 9 months, and for the last quarter – the whole year was taken into account. Starting from 2008, CSB simply uses the average quarterly data. The VSAA experts also noted that starting from May 2012 methodology for calculating the average newly-awarded pension has been changed: anticipatory pensions are now taken into account in full 100% as imputed, but not for 50% as actually paid

It is well known that average values do not adequately represent the situation when the distribution does not follow a Gaussian one. There are very interesting tables characterising *distribution of pension benefits by size*. Again, such tables can be found both on the VSAA and CSB web-sites, but the layout of the tables varies significantly. The Statistical Bureau offers annual figures (for the end of each year), the lowest interval is 30–40 Ls, then follow six intervals with an increment by 10 Ls (40–50, 50–60, 60–70, 70–80, 80–90 and 90–100), two intervals with an increment of 50 Ls (100–150 and 150–200), followed by a 200–400 Ls interval and the very last one: 400+. The breakdown by VSAA differs and is much more detailed (except for the lower part): the lowest interval is “below 50 Ls”; the range between 50 and 1000 Ls has been split into 5 Ls intervals, and the highest interval is for pensions above 1,000 Ls. However, regular statistics is not available on the VSAA website: at the time of composing this paper, on 15 January 2013,

distribution tables were available only for two time points: June 2012 and September 2012. Six months before that there were six other tables: for January 2012, January and July 2011, January and July 2010, and July 2009. Now these tables have been removed from public access.

In any case, these data show the increasing amount of persons receiving very low pensions. CSB comments in this regard that this is partially due to the growing number of persons to whom pensions are granted in accordance with international regulatory enactments, i.e., when each country where a person had acquired pension rights during his/her working life grants the pension on the insurance periods accumulated in the respective country. Meanwhile, the senior statistician of the VSAA Statistical Department believes that the number of persons receiving their pensions from two or more countries is small and cannot influence statistics significantly. The author wished to find out whether there were plans to separate this group of pensioners off in regular reports, as the group may artificially decrease average values of indicators making the picture worse than it actually is, but the answer was negative.



Source: author's construction based on CSB statistical data.

Fig. 2. Number of pensioners per 1,000 of inhabitants in Latvia in 2003–2012

The author will mention one more indicator in this group – a relative one: *number of pensioners per one thousand of inhabitants* (see Fig. 2). This ratio can be found in the CSB online database (VSAA does not provide that information), but should be considered with caution. Although the number of pensioners is quite an accurately measured variable, the figures of total population of Latvia for 2001-2010 are less reliable, due to insufficiently accurate data on migration. Starting with the 4th quarter of 2010, the data (pensioners per 1000 population) have been recalculated in accordance with the results of the Population Census 2011, but earlier data have not been adjusted. Thus, a rapid increase in the ratio by almost 8% is just a computation artefact.

## 2. PERFORMANCE OF 2ND PILLAR PENSION PLANS

The second large group of indicators is dealing with the 2nd pillar pensions. Presently, there are very few pensioners whose pension benefit includes the 2nd pillar component. Thus, the vast majority of pension funds participants are in their accumulation stage. The registry of individual second-pillar pension accounts is held by the Central Depository of Latvia in cooperation with VSAA. This registry keeps and updates records for almost 1.2 mln persons who participate in mandatory private pension funds: 41% of them are voluntary participants, and 59% were obliged to join the pillar. Presently there are 8 asset managers offering 26 pension plans divided into three groups in accordance with the chosen investment strategy: conservative, balanced and active. The Central Depository of Latvia maintains a topical web-portal <http://www.manapensija.lv> where the most recent data on pension plans are available – each *pension plan unit value*, *yield* (from the beginning of the year, from the commencement date of the plan activities, as well as cumulative yields for various periods – 3, 6, 12, 24 and 36 months), *net assets value* and the *number of participants*. The information is updated daily, and the archive data is available only for the last day of each month. More detailed information, including *distribution of participants by age, gender, voluntary or mandatory joining*, etc., is available on the VSAA web-site at <http://www.vsaa.lv/lv/pakalpojumi/stradajosajiem/2-pensiju-limenis/statistika2limenis> as downloadable Excel files. And again, the figures provided by CSD and VSAA do not coincide. According to information provided by VSAA financial statistician Ruta Avotiņa, LCD statistics is less precise; it is of operative character, while the figures published by VSAA are better verified and more ‘final’. The data are fully reconciled only once a year – as at the end of the year, on 31 December. Quarterly reports are produced also by FKTK, and Excel files can be downloaded from [http://www.fktk.lv/lv/statistika/pensiju\\_fondi/ceturksna\\_parskati/](http://www.fktk.lv/lv/statistika/pensiju_fondi/ceturksna_parskati/). These reports also provide quite interesting information on *geographical distribution of pension funds investments, proportions of different types of securities in investment portfolios, and average weighted yield* of all the 2nd pillar pension plans taken together.

The most reliable and full data can be found in annual reports. Once again, there are two official authorities producing those reports, and once again one can find discrepancies between the figures. Firstly, VSAA publishes a comprehensive report devoted exclusively to mandatory pension fund activities (“Pārskats par valsts fondēto pensiju shēmas darbību”), the 2011 year report is 62 pages long, while the report for the year 2010 contains 59 pages. These reports can be downloaded as \*pdf or \*doc files from <http://www.vsaa.lv/lv/pakalpojumi/stradajosajiem/2-pensiju-limenis/parskati-par-valsts-fondeto-pensiju-shemas-darbibu>. FKTK annual reports are downloadable from [http://www.fktk.lv/lv/publikacijas/gada\\_parskati/](http://www.fktk.lv/lv/publikacijas/gada_parskati/), but only one out of 55 pages of the 2011 report deals with the 2nd pillar pension fund activities. Surprisingly, almost none of the indicators specified on this single page coincide with the VSAA figures. The only congruent indicator is the total number of the second pillar plan participants,

and FKTK merely borrows the number from VSAA without performing any calculations of its own. The other three indicators differ notably.

Firstly, the *structure of investment portfolio of pension plans*. For example, for the year-end of 2011, FKTK reports that 25% of the portfolio comprised investments in credit institutions. The VSAA report attributes only 17.7% of total portfolio to such investments.

Secondly, FKTK had recorded that 52.4% of total investments had been invested into domestic economy of Latvia at the end of the same 2011, while according to VSAA investments into domestic instruments accounted for only 44.2% of total investments. The difference between these two sources did exist since the very first reports, but was not so significant in earlier years (see Table 1 below).

Table 1

**Mandatory pension funds investments into domestic instruments in Latvia, 2003-2011**

	2003	2004	2005	2006	2007	2008	2009	2010	2011
<b>FKTK</b>	88.6%	85.1%	71.6%	69.4%	59.4%	65.2%	65.6%	61.1%	52.4%
<b>VSAA</b>	88.49%	84.9%	71.3%	69.56%	55.5%	62.2%	64.23%	57.5%	44.2%

Source: FKTK and VSAA reports 2003-2011

Both VSAA and FKTK receive the same raw information (audited reports) from pension fund asset managers. However, they differently treat the data, especially the figures related to “investments in credit institutions”. While VSAA takes into account only time deposits, FKTK considers all money on bank accounts. Both techniques are logical, but when a researcher seeks to compare two or more countries s/he should be aware of the methodology used by statisticians in other countries in order to choose the correct Latvian figures (either from FKTK or from VSAA) for an accurate comparison.

Thirdly, FKTK and VSAA reports return different figures on average *weighted annual yields* produced by second pillar private pension schemes. Table 2 demonstrates average profitability indices as calculated by VSAA and FKTK.

Table 2

**Annual yields of mandatory funded pension plans in Latvia in 2004-2011 (%)**

	2004	2005	2006	2007	2008	2009	2010	2011
<b>VSAA</b>	5.25	7.88	3.50	3.48	-9.83	13.31	8.28	-2.31
<b>FKTK</b>	3.76	6.74	2.82	2.50	-11.5	12.33	7.59	-1.96

Source: FKTK and VSAA reports 2004-2011

Both institutions provide also separate indices for active, balanced and conservative investment plans, and these indices are not congruent either. For example, according to VSAA average weighted profitability of balanced plans in 2011 was negative: 1.56 %, but according to FKTK it was positive: +0.6 %.

The reasons root in the methodologies used by the two institutions. The author used the simulation method to try to receive the same results as VSAA and FKTK from the available raw data and succeeded. The difference lies in which variable is being “weighted” for obtaining the sought-for weighted average. VSAA is weighting the yields demonstrated by separate pension plans, but FKTK is weighting unit values and then calculating the yield that such an average unit has brought by comparing it to last year’s average unit value.

Again, both methods have their justification. However, in my opinion, the logic of FKTK is sounder. It is worth mentioning that Estonian pension statistics is operating with the so called ‘pension index’, to be more exact, with a set of such indices: one common index for all pension plans and 4 sub-indices for conservative, balanced, active and aggressive plans respectively. These indices are intended for assessing the overall performance of mandatory pension funds, namely, their average profitability, and the formula used for computation of the indices is practically the same as the one used by FKTK for obtaining average weighted profitability. Therefore, if one wishes to compare the average performance of Latvian and Estonian pension plans s/he should use the figures from FKTK reports, and not VSAA indicators.

Another problem related to the second pillar pension statistics will declare itself within several years, when a significant number of pension plan participants have reached pensionable age. The legislator provides a pensioner with two possibilities for dealing with his/her second pillar pension capital: upon retirement, the insured can purchase an annuity or have the accumulated funds credited to his/her NDC account, adding them to the first-pillar pension capital. In the first case a pensioner would further receive his pension from two sources: the first pillar benefit from VSAA and the second pillar supplement from an insurer; in the latter case the general pension formula shall be applied to both the parts of the capital and the retiree will receive monthly pension payments from VSAA only. By now, the second pillar pension capital accumulated on individual accounts is too small, and no insurer offers annuities (since administrative costs would be too high), so all the pensioners are choosing the second option, and VSAA has full information on the total amount of benefits. But if a part of future pensioners received pension benefits both from the state and from insurance companies, while the rest of future pensioners – from the state only, the statistical data on average amounts and distributions would become confusing.

### 3. EU STATISTICAL DATA

The growing importance of relative figures rather than absolute ones is visibly demonstrated by the set of indicators chosen by Eurostat for its so called “Pension Portfolio”. The author will list the indicators included into this portfolio and refer all those interested to the following website: [http://epp.eurostat.ec.europa.eu/portal/page/portal/employment\\_social\\_policy\\_equality/omc\\_social\\_inclusion\\_and\\_social\\_protection/pension\\_strand](http://epp.eurostat.ec.europa.eu/portal/page/portal/employment_social_policy_equality/omc_social_inclusion_and_social_protection/pension_strand).



- At-risk-of-poverty rate of elderly people (60+, 65+, 75+)
- Dispersion around the at-risk-of-poverty threshold of elderly people (60+, 65+, 75+)
- Gender differences in the at-risk-of-poverty rate of elderly people (65+)
- At-risk-of-poverty rate for pensioners
- Median relative income ratio of elderly people (60+, 65+)
- Gender differences in the relative median income ratio of elderly people (65+, 75+)
- Inequality of income distribution – S80/S20 income quintile share ratio, elderly people (65+)
- Employment rate of older workers
- Effective labour market exit age (average exit age from the labour force)
- Total Current Pension expenditure (% of GDP)
- Total expenditure on social protection (% of GDP)
- Housing cost overburden rate by age group (65+).

Some more indicators are under preparation at this stage. The indices are annual ones, the earliest available data is for 2005 (2000 for some indicators); the data are submitted to Eurostat by national statistical institutions, and data processing is quite time consuming. Thus, at the moment of writing this paper, in the middle of January 2013, the latest available data for some countries refer to 2010. The undisputable advantage of Eurostat data is their comparability, as the uniformity of methodology used in different countries is granted.

## CONCLUSIONS, PROPOSALS, RECOMMENDATIONS

1. Latvian pension statistics is abundant and diversified. However, the partially overlapping functions of the State Social Security Agency, the Central Statistical Bureau of Latvia, the Central Depository of Latvia and the Financial Capital and Market Commission result in an incongruent approach to calculation of a number of statistical indicators.
2. In order to understand the discrepancies between the statistical data one has to be aware of the methodology used, which is not explicitly explained in publicly available sources.
3. An in-depth interview with the statisticians of the State Social Security Agency, as well as a simulation analysis allowed the author to reveal the nature of the discrepancies and provide guidelines for fellow-professionals.
4. The following statistical indicators have been critically reviewed:
  - First group: total number of old-age pensioners; number of pensioners per 1,000 of population; average monthly pension benefit; average monthly newly-awarded pension benefit; distribution of pensions by size;

- Second group: structure and geographical distribution of pension plan investment portfolio; weighted average yields of second-pillar pension plans.
5. Potential bottlenecks of Latvian pension statistics revealed are as follows: while nowadays almost all Latvian pensioners receive their state pension benefit only from one source – VSAA, which is also administering pension statistics, – the anticipated increase in the number of persons who receive their pensions from different countries and/or from insurance companies will make it difficult to obtain accurate information on the average size and distribution of pension benefits.
  6. The importance and usability of relative indicators is increasing. These indicators published by Eurostat within the framework of ‘pension portfolio’ are intended to assist EU member states to identify and promote their most effective social protection and social inclusion policies and learn from each other’s experience.

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# CURRENT DEVELOPMENTS IN RISK CULTURE IN FINANCIAL ORGANIZATIONS IN GERMANY

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CHRISTIN RICHTER\*

University of Latvia, Heidelberg, Germany

**Abstract.** Fifty per cent of companies covered by the Economist Intelligence Unit study believe that a strong risk culture including risk-awareness throughout the organization is the most important factor for the success of risk management in their organizations. The paper will use the organizational theory approach to examine the current developments in risk culture in the financial sector in Germany via a qualitative content analysis of the annual financial statements of 20 top financial institutions in Germany for 2008, 2009, 2010, and 2011. The comparison shows a clear trend towards a more detailed analysis and management of risk. The number of risks, artifacts and organizational functions has increased. Moreover, the comparison shows that the companies concentrate their business activities and risk focus on their core competencies. Although these additional processes and organization functions require more financial resources, financial results have increased whereas the average risk costs have decreased. This supports the hypothesis that a resource-based risk management approach is the most adequate approach to manage risk.

**Key words:** *Risk culture, resource-based risk culture approach, financial organization*

**JEL code:** L22

## INTRODUCTION

As financial companies accelerate their investments in new markets, extend their trade relations and are confronted with increasing pressure from stakeholders to enhance transparency and disclosure, risk management becomes a board-level concern of companies. Moreover, the financial trade policies have changed. Financial markets deal with the expectation of possible financial streams and monetarised relationships. Financial transactions are no longer linked to material counterparts and production life cycles (Kessler 2011, p. 198). In addition, emerging risks like globalization, demographic change, regulatory requirements or innovative technology developments have altered the focus of risk management from the loss avoidance approach to a key contributor to market advantage via improved corporate reputation and better recognition

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\* Corresponding author – e-mail: [richterchristin@gmx.de](mailto:richterchristin@gmx.de), telephone +491 7624472251

in the financial market. Fifty per cent of the companies believe that a strong risk culture including risk awareness throughout the organization is the most important factor for the success of risk management in their organizations. In recent years, the commitment of the board of directors was the strongest driver for strengthening risk management processes (Economist Intelligence Unit 2007, p. 12 et seqq).

These findings raise the following research questions:

- How is an “adequate” risk culture defined?
- How to implement an “adequate” risk culture?
- Which are the current trends regarding risk culture in financial organizations?

## 1 RELEVANCE

Especially globalization causes new challenges in risk management. The internationalization increases due to improving information technology, opening-up of markets, decreasing transportation and communication costs. On the one hand, globalization provides companies with the opportunity to enter new markets. On the other hand, the competitive pressure intensifies. Foreign competitors try to enter new markets and to gain market access. Complexity, diversity of cultures, and rapidity of change accelerate in the economic sector (Klaffke 2009, p. 12 et seqq.). Thus, financial organizations need to implement a dynamic risk management system to detect the diverse risks. Focusing on the financial sector, some financial catastrophes in the recent years were caused by unidentified risks (e.g. Barings Bank (1995) USD 1.2 billion loss; Allied Irish Bank (2002) USD 750 Mio. loss; National Australia Bank (2004) AUD 360 Mio. loss). Ironically, when the Basel II Accord was set in place, the financial crisis emerged. The financial crisis started with a sub-prime crisis in the U.S. But the sub-prime crisis did not only have an impact on a small segment of sub-prime mortgages, it extended to the entire financial system. The implications of the sub-prime crisis have been liquidity crunch, a dramatic impairment of credit notes, and finally an economic downturn with the risk of a strong economic recession (Bessis 2010, p. 3 et seqq.). Thus, the financial crisis, which is originated in the excessive risk-taking in the financial market, has straightened the debate of risk management (cf. Van Gisteren 2002, p. 418; Hudson / Maioli 2010, p. 53 et seqq.). This risk forced the regulators to pass several laws and policies to regulate the risk management of the companies. In the financial sector the regulatory requirements imposed by KonTraG (control and transparency law) and Basel III result in tightened measures to manage risks. Moreover, risk culture is a new subject in applied science. As stated by several authors, there is a need for further research (cf. Van Gisteren 2002, p. 423; Bungartz 2006, p. 170 et seqq.).

## 2 STATE OF RESEARCH OVERVIEW

Different approaches are applied in the research of risk culture. Some theoretical models of risk culture are based on the relevant findings of organizational culture, especially on the approach of Schein (Schein 2004, p. 5 et seqq.). Researchers such as Bungartz (Bungartz 2006, p. 170 et seqq.) or Führung (Führung 2006, p. 1 et seqq.) apply Schein's findings for their theoretical models regarding risk culture. On the other hand researchers such as Tansey & O'Riordan (Tansey / O'Riordan 1999, p. 71 et seqq.), Dake (Dake 1992, p. 21 et seqq.), Mars (Mars 1996, p. 4 et seqq.) or Mainelli (Mainelli 2004, p. 340 et seqq.) apply cultural theory to develop diverse approaches of risk culture. Their researches are based on Douglas, Wildavsky and Ostrander findings. The researcher Verano-Tacoronte and Melián-González analyse the relationship between human resource control systems and organizational results introducing two major moderating variables, uncertainty and risk behaviour (Verano-Tacoronte / Melián-González, 2008, p. 161 et seqq.). An empirical research is applied by Ermer, Cosmides and Tooby. The research is based on the dominance theory (Ermer / Cosmides / Toby 2008, p. 106 et seqq.). Bozeman and Kingsley focus on a multivariate measure of 'risk culture. They try to examine the correlation between risk and the independent variables: sector, formalism, control, promotion, goal clarity and trust. Their research result shows a positive correlation between the willingness of the leader to trust his co-workers and the willingness of the co-workers to take calculated risk and to act more risk aware (Bozeman / Kingsley 1998, p. 109 et seqq.). The research of Borgelt and Falk focuses on the role of leadership and management regarding risk-management in an innovative environment by building a leadership and management intervention model (Borgelt / Falk 2007 p. 122 et seqq.). Hammond's approach is based on a behaviour-based risk management system and focuses on the appropriate leadership style to manage risk (Hammond 2002, p. 26 et seqq.). Another study concentrating on risk and culture has been accomplished by van Vurren (van Vurren 2000, pp. 31 et seqq.). He analysed the cultural influence on risk and risk management. The focus on this study is on safety culture in the steel and medicine industry. His conclusion is that the traditional focus in human error and technical failure needs to be substitute by a method that focus on the organizational and cultural aspects of failure.

## 3 THEORETICAL FRAMEWORK AND HYPOTHESIS

### 3.1 RISK DEFINITION

In accordance with IDW (Institute of Public Auditors in Germany) and GASB (German accounting standard board) the following definition will be applied in the paper: Risk is the possibility of a future negative impact on the economic position of a group. It is the negative discrepancy between the

achieved and the expected result. Risk can but not necessarily has to result in a potential loss. Risks can occur in each organizational unit and are related to all activities of an entity (cf. Denk/Exner-Merkelt 2005, p. 28 et seqq.). The financial sector differentiates between credit risk, market risk, operational risk and other risks including liquidity risk (Bank for International Settlement 2005, p. 144; International Accounting Standards Board, IFRS 7, App. A.).

### 3.2 RISK CULTURE

Bungartz's theoretical concept of risk culture is based on the cultural concept of Schein. He states that risk culture can be described at three levels. The first level contains the basic assumptions including fundamental perception and attitudes regarding risks. This level is invisible and unconscious. The second level implies the cultural norms and the value system. This level is expressed in unwritten guidelines. The norm and value system is partly visible and partly unconscious. The third level can be described as the symbolic system. It contains visible elements of the risk culture like a risk handbook, existence of a Chief Risk Officer or a risk reporting system. Other risk artifacts are the risk management report in the annual report, risk management workshops such as self assessments, or risk management polices and principles. An adequate risk culture is described by Bungartz as a risk-aware culture which has a coordinating, integrating and motivating function. Influencing factors regarding the risk culture are strategy and philosophy, leadership, human resources, communication, organization and the risk management process as well as the external environment. It is the middle course between a "careless culture" and an "anxious culture" (cf. Bungartz, 2006, p. 171 et seqq.; Preston 1993, p. 18 et seqq.).

According to Führung, a risk management consists of the risk strategy formulated by the board, the closed-loop risk management control process, the statutory control by internal and external auditors. This risk management system is embedded in the risk culture of the company. The risk culture is determined by the degree of risk-appropriate behaviour and the risk conviction. The risk-appropriate behaviour depends on the task. It should not be unidirectional – only risk averse or risk affine. Prerequisites to appropriate risk behaviour are competencies, motivation, and organization. Führung differentiates between two kinds of risk conviction. The first risk conviction he describes is internal risk conviction based on proactive behaviour. The second risk conviction he describes is external risk conviction which observes risk as not influenceable. Thus, Führung developed four risk typologies (Führung 2006, p. 9 et seqq.).

Degree of appropriate risk behavior	high	Resource-based risk management	Market-oriented risk management
	low	Bureaucratic ignorance	Reactive fatalism
		internal	external

Risk conviction

Fig. 1. According to Führung 2004, p. 7: Typology of risk culture

Companies showing “bureaucratic ignorance” have an internal risk conviction, but do not focus on potential risks. They occupy themselves with their internal processes and are not able to adapt to changing market conditions. Companies possessing reactive fatalism have an external risk conviction and a low degree of appropriate behaviour. These companies only have reactive business continuity plans but do not develop a long-term risk management strategy. The third risk typology is described as market-oriented risk management culture. Adequate exposure to risk is in the spotlight of the company. The risk conviction is external and focuses on external influencing variables. Such a risk culture can be observed in risk management reporting focusing on market or exchange risks. A resource-based risk management is defined as the entirety of organizational measures for risk identification and dealing with risk of business activities. Risks of business activities comprise a possible loss of core competencies and impossibility to assemble the respective entity’s resources. Führung applies Schein’s approach to detect the risk management culture.

Cultural theory states, that the view and behaviour of an individual is shaped by the social group to which each individual belongs. Thus, attitudes and judgments about risk are formed in accordance with cultural relationships. Risk-related views and behaviour of individuals is shaped by the expectation and value systems of the cultural group to which they belong (Tansey / O’Riodran 1999, p. 71 et seq.). Mainelli applies Adam’s approach to classify the views and behaviour of people regarding risk into four groups. On the horizontal axis, the researcher juxtaposes people who look at collective risk versus people who look at themselves. The vertical axis represents the view of people regarding equality. On the top of the vertical axis there are people following rules, even if unfair, and people whose life is dominated by a strict hierarchy. On the other end of the vertical axis there are people who establish the rules themselves. Thus, four different risk culture types can be identified: Individualist, Egalitarian, Fatalist, Hierarchist.

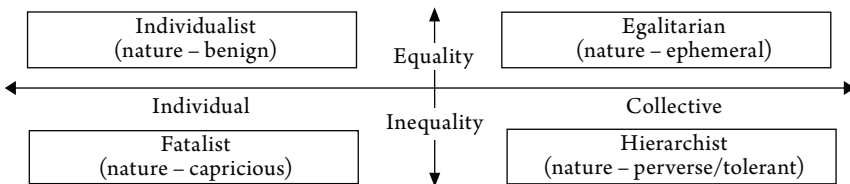


Fig. 2. Author’s construction based on Mainelli 2004, p. 346: Risk/reward personalities

Fatalists view nature as unpredictable. They believe that they cannot influence nature. Thus, they take whatever happens. According to Mainelli, most of the people belong to this group. In contrast to the other three groups, they can be easily moved to another quadrant. Moving this group is the easiest way to gain support for change. According to Dake, fatalists are those who cannot compete successfully in the market due to lack of resources or those who observe life as a lottery where no particular risk management might help to master the challenges of the market. In contrast, Individualists observe nature as innocent. They do not care about risk. Only major catastrophes influence their world. They do not care about the consequences of their decisions except for the return on their investments. Typical marketing professionals belong to this group. According to Dake, deregulation is the favoured risk management approach of the Individualists. The term 'deregulation' means that they prefer self-regulated networks with little external impact. Egalitarians view nature as transient. They are afraid that their world can be destroyed. They are the most active group. They want to establish rules and regulations. They want to know who bears the risks if anything goes wrong. This group demands risk strategies that foster equality of outcomes. Egalitarians risk management issues are related to social and political dimensions. The fourth group contains Hierarchists. They regard nature as stubborn. Their goal is to manage nature. Their system is stable under normal conditions. But extreme situations due to catastrophes destroy their designed world. Hierarchists are seen as power brokers. They are natural bureaucrats and prefer decisions based on sound thinking. According to Mainelli, they are the only group who values a cost/benefit analysis. Moreover, Mainelli believes that most of the finance directors belong to this group. In accordance to Dake, the risk strategy of hierarchical groups is formed by experts. Only they have the knowledge to develop strategies in accordance to the given boundaries. The commands of the experts are followed by the others of the group. There is a high compliance to regulations in this group (cf. Mainelli 2004, p. 340 et seqq; Dake 1992, p. 21 et seqq.).

The risk management approach based on cultural theory and the "resource-based" risk management approach analyse risk management and risk groups from different points of view. The cultural norms are in the focus of cultural theory, which form the risk perception of the group. This risk perception leads to diverse risk behaviour and risk management strategies. In contrast, the behaviour of the organizations is in the focus of the resource-based risk management approach. From this behaviour, Führung deduces different risk management strategies and risk perceptions. Thus, these theories have opposite points of origin.

Both theories define four groups. Whereas the theories have different points of origin, some of the groups are identical regarding their risk perception and behaviour. Thus, both theories have identified a group called the 'Fatalist'. In both theories, this group is reactive and its members do not believe that they can influence the group's environment. Thus, they do not establish a risk management system. In addition, 'Individualists' possess a very similar behaviour as the



organizations applying a 'Bureaucratic Ignorance' style of risk culture. In both theories, this group does not care about external risk. The group is occupied with its own rules and regulations. From these findings, it can be reasoned that groups with an individual orientation possess a less risk-aware behaviour. A reason for this behaviour might be that individual-oriented groups do not look at the whole picture. They just focus on themselves.

In contrast to the groups mentioned before, a clear mapping of the two other groups is not possible. 'Egalitarians' do not fit into the concept of Führung. 'Egalitarians' is not a company competing in the market. Institutions that possibly fit into this role are organizations which want to apply rules to protect a fair market and to establish equilibrium in the market, such as banking supervision or shareholder organizations.

The group of 'Hierarchists' wants to manage risk. Like market-oriented and resource-based institutions they possess high risk awareness. According to Ostrander, organizations based on a hierarchical system can be identified by five tendencies:

- 1) They view society as part of nature;
- 2) Hierarchical relationships are valued positively;
- 3) Routine symbolic actions are embedded in the company;
- 4) Group-oriented goals of symbolic action are deeply rooted;
- 5) The company possesses a high elaborated symbolic system (Ostrander 1982, p. 14 et seqq.).

Thus, Hierarchists, such as organizations with a market-oriented or resource-based approach, have implemented many artifacts in their organizations. A differentiation between external or internal risk convictions is not applied in the risk management approach of cultural theory. According to Mainelli, most of the finance directors belong to this group. Therefore, it can be assumed that hierarchical risk/reward personalities dominate in resource-based organizations. These assumptions need to be examined in primary research. To conclude, the risk management approach in cultural theory and the approach of Führung complement each other.

Although risk management becomes increasingly a focus of applied science, an approved approach to examine an adequate risk culture in financial organizations hardly exists. The research shall disclose the following hypothesis: The 'resource-based risk management culture' described by Führung is the most adequate risk culture approach.

#### 4 RESEARCH DESIGN AND LIMITATION

The aim of the research design is to reproduce the social reality by applying scientific methods based on theoretical approaches. In accordance to the state of research and theoretical concept, the study can be categorized as basic

research. The hypothesis of the paper is of a medium complexity. Besides, the theoretical problem is a relatively new research topic. Thus, an explorative stage has to be included in the research design. In the comparison of companies, only financial institutions are taken into account because they are subject to the same regulatory requirements. A quantitative method is applied. Based on theoretical findings, 20 financial reports of German financial institutions from 2008-2011 are analysed regarding the risk cultural artifacts, risk management approach and organizational risk management functions. This analysis gives an overview of the trends of risk culture in financial institutions in Germany. Moreover, it will be analysed whether a correlation between the risk culture and the risk operating figures in the financial institutions exists.

## 5 CURRENT FINDINGS

Based on the concepts of Führung and Bungartz, 20 financial reports of German financial institutions from 2008 to 2011 have already been analysed regarding the following components:

1. The amount of risk costs compared to the financial result before tax deduction. This shows how much risk cost influenced the financial result.
2. Pages describing the risk concept as a percentage of the entire pages of the financial report. The figure describes the degree of risk adherence in the financial report.
3. Description of the risk management systems. The description is categorized in three types: very explicit description, explicit description, superficial description. The more differentiated the description the higher the possibility of an appropriate risk management system and adequate risk behaviour. The description is explicit, if the risk management system, risk management instruments, risk functions and risk controlling process are described in detail.
4. Number of risks – the more differentiated is the company's risk subdivision, the higher is the degree of risk awareness. Therefore, three categories have been defined: 0–6 risks = low, 7–12 risks = medium, > 12 risks = high.
5. Number of artifacts – the higher the number of artifacts the higher the risk management is embedded in the corporate culture and a highly appropriate behaviour can be assumed. Therefore, three categories have been defined: 1–6 artifacts = low, 7–12 artifacts = medium, > 12 artifacts = high. Risk artifacts are: risk reporting, processes, policies, risk manuals, guidelines, special risk management qualification programs, risk management projects, risk instruments.
6. Number of organizational areas or functions taking care of risk in the risk controlling process – the higher the number of organizational areas taking care of risk, the higher the risk management is embedded in the corporate organization and a high adequate risk behaviour can be assumed. Therefore,

three categorizes have been defined: 1–6 organizational areas = low, 7–12 organizational areas = medium, > 12 organizational areas = high.

A resource-based view (RB) will be assumed if the risk awareness is internal, the risk management description is at least explicit (a description of at least ten pages and 5% of the financial report) and the number of artifacts, organizational functions and diverse risks are in average higher than medium. A market-oriented (MO) risk management is assumed if the risk awareness is external. Bureaucratic ignorance (BI) through an internal risk awareness or reactive fatalism (RF) through external risk awareness will be assumed if the average result of the risk typology components is not high.

<p><b>Resource-based risk management (RB)</b>            Risk awareness: internal            Risk management description <math>\geq</math> explicit            No. of risks / risk functions / artifacts:  <math>\bar{\emptyset} &gt;</math> medium</p>	<p><b>Market-oriented risk management (MO)</b>            Risk awareness: external            Risk management description <math>\geq</math> explicit            No. of risks / risk functions / artifacts:  <math>\bar{\emptyset} &gt;</math> medium</p>
<p><b>Bureaucratic ignorance (BI)</b>            Risk awareness: internal            Risk management description <math>\leq</math> explicit            No. of risks / risk functions / artifacts:  <math>\bar{\emptyset} \leq</math> medium</p>	<p><b>Reactive fatalism (RF)</b>            Risk awareness: external            Risk management description <math>\leq</math> explicit            No. of risks / risk functions / artifacts:  <math>\bar{\emptyset} \leq</math> medium</p>

Fig. 3. Author's own illustration 2012: Research design

Table 1

	Average 2008	Average 2009	Average 2010	Average 2011
Financial Result	-571 Mio €	415 Mio €	603 Mio €	557 Mio €
Risk cost	388 Mio €	573 Mio €	240 Mio €	291 Mio €
Number of risks	13	14	15	19
No. of organizational functions	9	10	11	12
No. of artifacts	12	13	14	18
No. of companies applying BI	7	5	4	3
No. of companies applying RF	5	5	3	1
No. of companies applying RB	6	9	13	15
No. of companies applying MO	2	1	0	1
	<b>Delta 2008-2009</b>	<b>Delta 2009-2010</b>	<b>Delta 2010-2011</b>	<b>Delta 2008-2011</b>

Financial Result	985 Mio €	189 Mio €	-46 Mio€	1228 Mio €
Risk cost	184 Mio €	-333 Mio €	51 Mio €	-97 Mio €
Number of risks	1	1	3	5
No. of organizational functions	1	1	2	3
No. of artifacts	1	1	4	6
No. of companies applying BI	-2	-1	-1	-4
No. of companies applying RF	0	-2	-1	-3
No. of companies applying RB	3	4	1	8
No. of companies applying MO	-1	-1	1	-1

*Comparison of risk artifacts of 20 financial institutions in Germany between 2008 and 2011*

The table above shows the findings of the comparison of financial statements by twenty financial institutions between 2008 and 2011. The comparison shows a clear trend towards a more detailed analysis and management of risk. Whereas in 2008 financial institutions in average have thirteen risks in focus of their risk management process, in 2011 the companies enlarged their focus to nineteen risks. In addition, the number of artifacts and number of organizational functions has increased. These findings are supported by the financial results. The financial results increased by 1228 Mio € whereas the average risk cost decreased by 97 Mio €.

Moreover, the comparison shows that the companies concentrate their business activities and risk focus on their core competencies. In 2011, fourteen companies applied a resource-based risk management approach. These are eight institutions more than in 2008.

## APPENDIX

### Financial institutions analysed:

Wüstenrot Bausparkasse AG
Deutsche Bank AG
KfW Bankengruppe
Unicredit Bank AG
WestLB AG
DZ Bank AG
HSH Nordbank AG
Landesbank Hessen-Thüringen Girozentrale
NRW.Bank
Landwirtschaftliche Rentenbank
Deutsche Genossenschafts-Hypothekenbank AG
Dexia Kommunalbank Deutschland AG
Münchener Hypothekenbank eG
Hamburger Sparkasse
Frankfurter Sparkasse
Volkswagen Bank GmbH
Aareal Bank AG
Schwäbisch Hall Bausparkasse AG
SEB
Bayerische Landesbank

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# EVALUATION OF CITIZEN PARTICIPATION IN LOCAL GOVERNMENTS OF LATVIA

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LILITA SEIMUSKANE<sup>1</sup>

Department of Public Administration, Faculty of Economics and Management,  
University of Latvia

INGA VILKA<sup>2</sup>

Department of Management, Faculty of Economics and Management,  
University of Latvia,

BIRUTA SLOKA<sup>3</sup>

Department of Theory and Methods of Economic System Management,  
Faculty of Economics and Management, University of Latvia

**Abstract.** The level of local democracy and the quality of governance at local level are characterized by citizen participation in solving important local issues. One of the fundamental principles of local democracy is citizens' rights and possibilities to participate in, and to influence decisions that affect their lives and their communities.

No detailed studies have been undertaken yet to analyse and evaluate the process of citizen participation in Latvia. Besides, the development of participatory mechanisms by amendments to the law has also had a great effect on participation at the level of central government. The empirical part of the current research offers some aspects of a survey conducted in 2012.

**Key words:** *citizen participation, local governments, local democracy, participatory democracy*

**JEL code:** H83

## INTRODUCTION

The mechanisms of participatory democracy and its practice at the local level are no less important than those in national politics. Firstly, because local governments decide upon issues that directly affect the quality of people's lives; secondly, because the proximity of local government and directness of contacts between local government and citizens allow for closer cooperation; thirdly –

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<sup>1</sup> E-mail: *lilitase@inbox.lv*, telephone: +371 29287088

<sup>2</sup> E-mail: *inga.vilka@lu.lv*, telephone: +371 29489079

<sup>3</sup> E-mail: *biruta.sloka@lu.lv*, telephone: +371 29244966

residents' trust in local governments is comparatively higher if compared to their trust in national scale institutions, for example, the parliament and the government institutions, which ensures longer-lasting preconditions for mutual cooperation (Eurobarometer 78, 2012).

However, there is no reason to be fully satisfied with the advantages of local democracy, because the results of citizen activity in local elections in many countries show that despite residents' high trust in local authorities, people are less active to take part in local elections than they are in parliamentary elections. Besides, quite often people perceive the role of local government in a very narrow sense – only as a provider of social services rather than the executor of local political authority.

The emergence of the participatory democracy issue is largely determined by the weak activity of the existing representative institutions and inhabitants' low trust in them. According to the data of the European Commission's Eurobarometer survey carried out in autumn 2012 in 34 countries or territories – the 27 European Union (EU) Member States, the 6 candidate states and the Turkish Cypriot Community – citizen trust in the national governments is 27% (-1, compared to previous research in spring 2012) and parliaments – 28% (unchanged) (Eurobarometer 78, 2012).

Moreover, trust in public authority institutions at both levels has been decreasing over several years in the countries where the research was carried out. Local municipalities are trusted by 43% respondents (Eurobarometer 78, 2012).

Residents' trust in the parliament and the government is also low in Latvia. According to the Eurobarometer data depicted in Figure 1, 13% respondents trust Latvian parliament of, and 17% trust the government. The indicators of trust in these institutions in Latvia are lower than the average for the EU member states and candidate states, and also lower than the indicators of trust in particular institutions in the Baltic States (Eurobarometer 78, 2012). Latvia's local municipalities are trusted by 45% inhabitants, which is above the average figures for the EU member states and candidate states, but citizens' activity in local elections (53.8%)<sup>1</sup> in comparison with the turnout in the national parliamentary elections (59.4%)<sup>2</sup> has been lower in all the elections that had taken place in the independent Latvia (see Figure 1).

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<sup>1</sup> Voter turnout in the last elections of the local self-governments of Latvia in 2009

<sup>2</sup> Voter turnout in the early elections of the parliament of Latvia in 2011



	Latvia		Lithuania		Estonia		EU 27
	Tend to trust	Tend not to trust	Tend to trust	Tend not to trust	Tend to trust	Tend not to trust	Tend to trust
Government	17	77	21	73	35	60	27
National parliament	13	82	13	81	29	65	28
Regional or local public authorities	45	46	33	58	56	36	43
Political parties	6	88	13	82	16	78	15

Source: European Commission Standart Eurobarometer 78 (Autumn, 2012)

Fig. 1. Residents' trust in public authority institutions and political parties in the Baltic States

The authors consider that the context of the grounds for participation has changed. Some time ago participation was regarded as a generally accepted thesis of good management and polite political culture, and its actual manifestation was dependent on particular public administrators' political will, attitude and skills to apply it in daily activities. But currently, when the majority of traditional management forms become weaker, people more often seek and find new forms of communication and direct participation, and quite frequently find them outside official frames of participation. Expressions such as "management without government" become more and more popular. Avoiding overstatements, the above clearly shows the tendency of contemporary public management – neither central government nor local authorities are able to operate autonomously without close cooperation with local residents (Vanags, 2007).

Does a higher level of citizen participation mean more democracy? When does a low level of participation signal contentment and when does it reflect discontent – a poorly organized participatory democracy; is there a connection between participation indicators and citizens' satisfaction with policies implemented by the authorities; which factors contribute to participation activity and which create dissatisfaction? It's not easy to provide answers to the previous questions. Besides, there exists quite a popular set of beliefs which acknowledges a contradiction between democracy and efficiency, arguing that decisions made by qualified, highly professional personnel are more effective, and the use of participation procedures is only a waste of time with little result.

**The purpose of this paper** is to evaluate the degree of citizen participation at the local level in Latvia; to identify the factors that influence the degree of citizen participation and the attitudes associated with it and to find a causal relationship between the level of citizens' satisfaction with their lives, the performance of the municipality and the degree of participation.

## RESEARCH METHODOLOGY

From 13 July till 24 July 2012, one of the authors of the paper in cooperation with the Marketing and Public Opinion Research Centre (SKDS) conducted a survey among the residents of Latvia, using the method of direct interview at the respondent's home (Seimuskane, SKDS, 2012). Using stratified random sampling, 1050 permanent residents of Latvia aged 15-74 were surveyed, which is a representative sample of the general population. The polling covered all regions of Latvia. The aim of the poll was to study the following: which forms of citizen participation are used by the residents; which factors determine and influence citizen participation; are there any connections between participation and trust in representative bodies. The survey data were analysed using descriptive statistics (mean, moda, median, indicators of variability, as well as proportions), and the SPSS statistics program was used for data processing.

The research is also based on the monographic method and the document analysis method – a study and evaluation of legislation and pieces of scientific research.

## THEORETICAL FRAMEWORK OF THE RESEARCH

Citizen participation has long been a subject in the field of political sciences. In political sciences participation has been understood as a process by which members of a society share power with public officials in making or influencing substantive decisions. In political sciences, participation is mostly considered as a possibility for citizens of influencing or seeking policy decisions, such as voting in elections or getting involved in political proceeding (Suh, 2005).

Researchers Buss, Redburn and Guo (2006) mention that citizen participation brings out following benefits:

- making democracy more democratic;
- redefining power structures;
- enhancing credibility and legitimacy;
- managing conflict and building consensus;
- eliciting feedback and consultations;
- promoting accountability and transparency (ed. Buss, Redburn, Guo, 2006).

Citizen participation in local politics involves taking part in local municipality elections and electing authorities, as well as direct participation in shaping local politics beside elections. Such forms of participation are practised within direct democracy: referenda, citizen initiatives, residents' polls, forums, counter proposals and others. The mechanisms of deliberative democracy, which emphasize the advantages of individual approach to clarify opinions, are becoming increasingly popular.

Researchers of participatory principles discuss the role of participation and the form it might take in future. If the mechanisms of direct democracy are intensified, will they actually influence the process of decision making? Are institutions of representative democracy going to diminish its role in decision making process by gradually increasing the number of those issues that can be delegated to citizens to decide upon, or nevertheless – “elections are essential to maximize democracy”? (Dahl, 1956)

Researcher Deborah Stevens argues that voting determines control of the government, but the policy content of voting is limited because an election involves many issues. Voting is also a reasonably simple act that does not require much initiative or co-operation with others. Taking part in the voting process at regular intervals defines a minimum level of citizen participation. Direct democracy demonstrates total participation by citizens in the formulation of public policy and law (Stevens, 2008). Other researchers express similar viewpoint, for instance, Buss, Redburn and Guo; they emphasize that expanding and deepening citizen participation is a way to make democracy more democratic – that is direct, deliberative and participatory as opposed to simply representative (ed. Buss, Redburn, Guo, 2006). Juri Russ admits that one of the most important preconditions to create more positive attitude toward political elite would be the combination of elements of both democracies – representative and direct democracy (Russ, 2011). However, the expert in state administration issues E. Levits thinks that the elements of direct democracy are more appropriate for smaller ‘units’, i.e. the level of local government, and its strengthening at local level is even more crucial than at the national government level (Levits, 2003). According to the expert, at national governance level, the elements of direct democracy are not a particularly effective means of control over politicians’ activities, whereas at local government level the elements of direct democracy may successfully carry out this function of control (Levits, 2003).

However, direct participation is not a simple process, and it is necessary to take account of several dilemmas when applying direct participation in practice. Nancy Roberts (2003) mentions the following dilemmas:

- The dilemma of size. Direct citizen involvement will have to accommodate numerous groups and individuals. Direct democracy was formulated for small groups meeting face-to-face and operating in relatively constrained public spaces;
- The dilemma of time. Direct citizen participation takes too much time, but the public administration institutions have to take decisions rapidly, especially during crises when ‘split-second’ decisions have to be made. The more people are involved in some decisions process, the harder it is to act with dispatch. It is more difficult to make decisions as the number of people increases;
- The dilemma of the common good. The issue of the common good is not just about direct citizen participation. It is about direct, deliberative

citizen participation – the ability of citizens to reason together and to come to public judgments with their peers in face-to-face meetings about issues of public concern. A number of trends are threatening this ability. Although citizen access and personal involvement may be on the rise with the growing use of public initiatives, referenda, public opinion polls, and tele-democracy, these techniques aggregate individual interests, they do not enable direct contact and interaction (Roberts, 2003).

The so-called new democracies feature their own problematic issues in the practice of direct democracy. The authors of the paper believe that the implementation of direct democracy mechanisms require not only political will, but also certain political maturity and profound comprehension of eventual benefits. To agree with N. Roberts, the benefits of practising direct democracy are not only the result of voting, but also the interaction process itself between local government and citizens, where both parties learn to cooperate.

Dutch political scientist Michels (2011), summing up the theories of participatory democracy, deliberative democracy and social capital, asserts that citizen involvement has positive effects on democracy (Michels, 2011). Namely, citizen participation:

- gives citizens a say in decision-making (influence);
- contributes to the inclusion of individual citizens in the policy process (inclusion);
- encourages civic skills and virtues (skills and virtues);
- leads to rational decisions based on public reasoning (deliberation);
- increases the legitimacy of decisions (legitimacy) (Michels, 2011).

As regards innovations in democratic management, researcher Michels (2011) emphasizes that beside electoral process there also exist two crucial distinctions between the practised forms of citizen participation. The first distinction, between individual and collective participation, refers to whether citizens are approached as individuals and asked for individual opinions or votes, or collectively as a group. The second distinction, between outcome and process, refers to the focus of citizen participation. Some types of democratic innovations focus on the outcome and guarantee that decisions will be taken seriously, whereas others focus on the process itself. In the latter type, opinion formation is more important: there is no guarantee that decisions will be taken seriously. Combining these two distinctions, Michels distinguishes among four types of democratic innovation: referenda, participatory policy making, deliberative surveys and deliberative fora (Michels, 2011). With every year more and more attention is also devoted to the above mentioned issues in other fields of academic research and to different aspects of citizen participation, such as the efficiency of internet portals for collaboration among municipalities (Sandoval – Almazan, 2012), and also reflections on gender and participatory development (Cornwall, 2003). Researchers in many countries also direct their attention to issues of the

incorporation of citizens' views into local policy decision-making processes where different complex methods, for instance, Problem Structuring Methods (PSMs), are applied (Lourenco, Costa, 2007) to reduce uncertainty and improve the democratic legitimacy in those processes with e-participation. French legislators have introduced participation instruments which allow French citizens be actively involved in the life of their society beside the periodic elections: – research on those issues has been performed by Claudia Gilia (Gilia, 2013). Each of those scholars points to a number of positive effects of democracy and shows that the contribution of participation to democracy differs according to the type of democratic innovations.

## LEGAL FRAMEWORK FOR PARTICIPATION AT LOCAL GOVERNMENT LEVEL IN LATVIA

Legislation of the Republic of Latvia provides different options for residents to get involved in the work of the local government, its policy-making and decision-making process.

The Constitution of the Republic of Latvia guarantees that every citizen of Latvia has the right, as provided for by law, to participate in the work of the State and of local government, and to hold a position in the civil service (Constitution, Art.101). Although the society in general perceives the participation in the work of the State and local government as the right to participate in the selection of the legislature – whether the parliament (Saeima) or a local council – by voting and by standing as candidates, yet it is only one possible way of participation. This particular article gives the right to every citizen of Latvia not only to participate in elections and referenda, as provided for by law, but also to participate in exercising the legislative, executive and judicial powers in other ways laid down in the law (Kusiņš, 2011). Participation in state affairs may be direct and indirect, and Article 101 of the Constitution covers both of these forms of participation (Kusiņš, 2011).

Forms of participation may not be purely formal; they should be effective, because only effective participation corresponds to the principle of democracy. The respective rights protection mechanisms should also be effective. The state has not only the obligation to provide the citizen with the formal right to participate, but also the responsibility to create the circumstances (an opportunity) for the citizen to be able to participate in the work of the state and of local government, by consciously exercising this responsibility and comprehending the essence of participation (Kusiņš, 2011).

In accordance with the legislation, citizens of the Republic of Latvia and citizens of the European Union countries with permanent residency in Latvia are entitled to vote and to stand for election to the parliament (Saeima) and local government. All the residents of the country are entitled to form and join associations and political parties, to make complaints and submissions,

to have a fair trial, to challenging local administrative provisions, etc. (Vanags, Vilka, 2005).

To reach out to citizens and to enable citizen participation in the local government, the legislation in the Republic of Latvia provides for the following:

- local council elections;
- open council and committee meetings;
- availability of the council meeting minutes;
- council members' office hours;
- reviewing complaints and submissions;
- public consultations;
- producing annual public reports (Vanags, Vilka, 2005).

In 2008, the *Law on Local Governments* (1994) was amended by adding a section on a right to organize local referenda, and the Cabinet of Ministers was instructed to draft a bill on local referenda and submit it to the parliament (Saeima). Since 2008, the ministry in charge of local governments (till 2011, the Ministry of Regional Development and Local Governments, and since 2011 – the Ministry of Environmental Protection and Regional Development) has produced several drafts of the law on local referenda. The clause containing transitional provisions has been amended four times, and the deadline for the preparation of the draft law and its submission to the parliament is being constantly postponed.

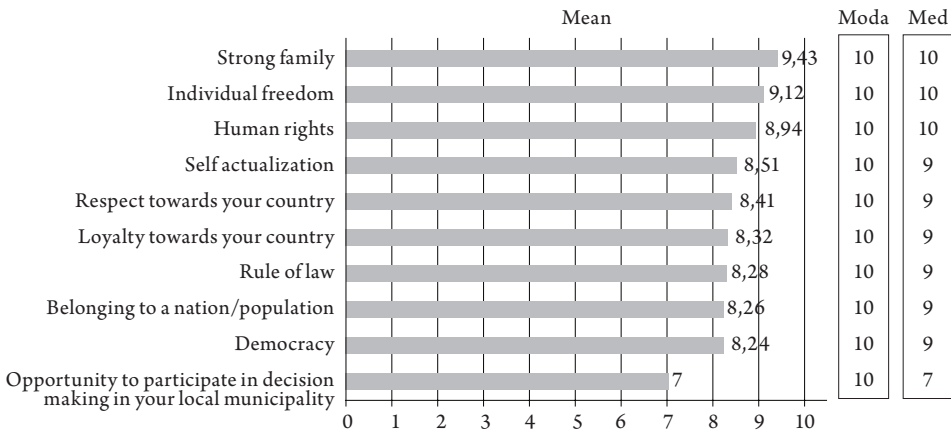
In January 2013 the draft law was accepted at the government level and was to be submitted to the parliament afterwards. In accordance with the most recent draft, its coming into effect was scheduled as of 1st July, 2013 (Draft Law on Local Referenda, 2013).

In order to cooperate with residents, local governments may also use other forms of participation, because Section 12 of the *Law on Local Governments* (1994) allows them, in the interests of residents of the relevant administrative territory, to voluntarily carry out their initiatives with respect to any matter if it is not within the competence of the *Saeima*, the Cabinet of Ministers, ministries, other State administrative institutions, the courts or other self-governments, or if such an activity is not prohibited by law. In Latvia, local governments may conduct opinion polls, resident meetings and forums, include representatives from NGOs or advocacy groups in committees and working groups, and the like. Legal framework in Latvia does not forbid a local government council, acting by a majority, from calling consultative referendum in its administrative territory.

## SURVEY RESULTS

Although the legislation of Latvia envisages various ways of resident participation, the results of the survey indicate several issues to be taken into account when transforming or improving the organization of the participation process in local municipalities.

In the survey, the respondents were asked to evaluate their attitude towards individual values against the rating scale of 10 points. They included “the opportunity to participate in decision making in their local municipality”. The respondents’ choice is shown in Fig. 2.



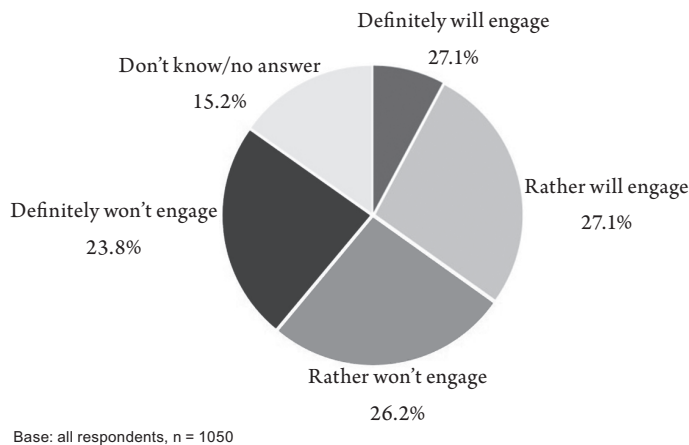
Source: Author's calculations on a survey conducted by Lilita Seimuskane and SKDS, 2012 (n=1050), Evaluation scale 1 – 10, where 1 – not important; 10 – very important

Fig. 2. Mean values of Latvia's inhabitants attitudes towards individual values

Most of the inhabitants of Latvia gave the highest possible ratings to all the statements (characterised by mode 10), but still the evaluations were different: averages were from 7 for a possibility to participate in decision making in a municipality to 9.43 for a strong family.

Although most values named in the survey were rated by respondents at 10 (moda), yet, as regards the option to participate in the decision making process, the respondents' estimation was of the widest range in comparison with other named values. If we view those values from the point of view of the median, it is revealed that the median for the values such as strong 'family', 'individual freedom' and 'human rights' is 10, and for the other named values – 9, while the median for 'participation' is 7, which shows that a half of the respondents rate 'participation' even lower than 7, but the other half of the respondents – higher than 7.

During a survey on different aspects of citizen participation in local governments, when asked what would be the respondent's reaction in case the local government council made a decision in conflict with the interests of the residents of the local government, half (50%) of the respondents said they wouldn't engage in any activity, even if the local government council made a decision which interferes with their interests. Only one third or 35% of the respondents stated that they would actively respond to such doings of the local government (Fig. 3).



Source: *The public opinion survey (Seimuskane, SKDS, 2012)*

Fig. 3. Respondents' opinion about necessity to introduce local referenda in Latvia

Comparing the answers of various socialdemographic groups about their determination to act in a situation where a local government adopts a decision which is in contradiction with their interests, the respondents in the age group of 45–54 (39%) expressed the most readiness to get involved in public activities, followed by the age groups of 25–34 years (37%) and 35–44 years (36%). The elderly respondents in the age group of 55–74 years (30%) and the youngest ones, 15–24 years old (33%) are more passively minded. However, there is a difference between the oldest and the youngest group – if the elderly respondents are negative about their involvement in any public activities (54%) more often than average, then the youngest audience is not so categorical and more seldom (42%) than other age groups express a downright denial of participation. Nevertheless, almost every fourth respondent in this age group hesitated on a particular answer. In the authors' opinion, this is very understandable as the young people of this age group have different priorities, and young adults very seldom associate the influence of local governments' decisions with their lives. Besides, local governments in their offer of participation rarely address the younger audience.

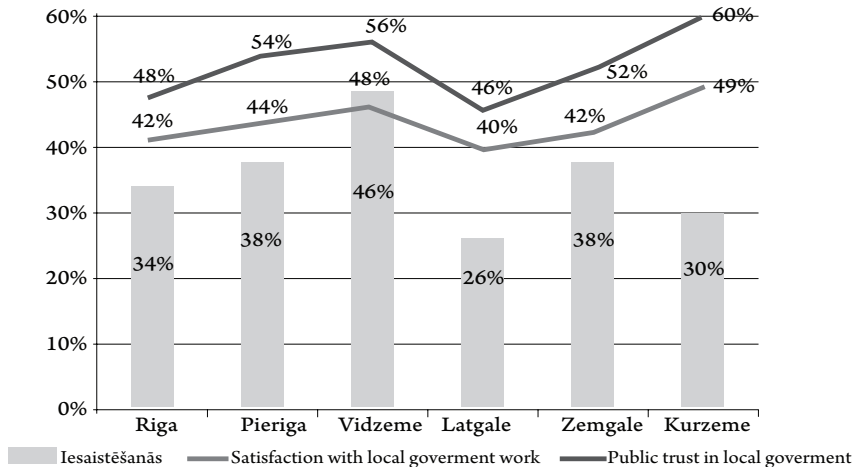
If we examine the distribution of answers to this question among men and women, the authors of the paper are not surprised by the results of the survey: women would undertake more initiative (37%) and tend to be less passive than men (32%).

By viewing the survey data as to the territorial distribution among statistical regions, it has been determined that the most active respondents live in Vidzeme: almost 48% of them would be ready to take part in activities, if the local government adopts decisions that interfere with their interests. Zemgale follows with 38%, then Pierīga (37%) and Rīga (34%). The least active were the respondents in Latgale (26%) and also Kurzeme (30%). The lowest activity is in Latgale region, characterized by the lowest social-economic indicators. However,



in other regions no coherence was observed between the level of residents' activity and the level of socio-economic development of the respective region.

By comparing correlation between the answers on active measures and the indicators of residents' trust in local government, it was discovered that the most passively inclined people live in the regions which trust their local governments the most – in Kurzeme (60%), or the least – in Latgale (46%). The correlation between residents' readiness to take part in any activities in case the local government adopts a decision that interferes with the residents' interests, people's trust indicators and satisfaction with the self-government work is given in Fig.4. Looking at the distribution of respondents' answers to a similar question on residents' contentment with the local government's work, the results correspond to the evaluation regarding the question about public trust – those most satisfied with the work of their municipality are the residents of Kurzeme, but the least satisfied – the residents of Latgale.



Source: Source: Author's calculations on survey conducted by Lilita Seimuskane and SKDS, 2012 (n=1050).

Fig. 4. **The correlation between residents' readiness to act in situation if local government adopts decision that interferes with residents' interests, peoples trust indicators and satisfaction with local government work**

The obtained research data obviate a necessity to pay closer attention to this aspect, when comparing the motivation of citizen participation – whether a low level of citizen participation always means only discontent, namely, distrust in public authority institutions, disbelief that it is possible to change anything by taking part, disinterest and seeing no reason for participation. Or the other way round – the reason for a low level of participation is due to the perception that daily life and welfare is not in danger, and residents are confident that their interests are well represented by the local government.

The comparison of the results of residents' survey and the results of local authority self-evaluation after an inquiry among local government leaders has also proved interesting.

The inquiry among local municipality leaders carried out in 2012 shows that 58% of them rate citizen participation in municipality activities and decision making as average, 14.3% – as active, only 0.8% – as very active, but 26.9% – as passive (Krastiņš, Vanags, 2012). Local government leaders evaluate citizen participation as comparatively the most passive in Zemgale region (50%) and Vidzeme region (38.5%), less so – in Kurzeme (10%). Local government chairmen consider that, in general, the citizen activity in the country is increasing (27.7% believe that it on the rise, 69.7% think that it has remained the same, 2.5% – that the activity has diminished in comparison with the past year.) Local government leaders evaluate the increase of activity in Kurzeme region as the highest (40% think that activity has increased), but the lowest – in Latgale region, where only 19% residents think that citizen activity has increased (Krastiņš, Vanags, 2012).

Considering the options of advocating for residents' interests in the local government and its institutions, the respondents were offered to assess several forms of participation. Summarizing research data by their mean value, it was revealed that the majority of respondents found the following forms of advocacy and influencing a self-government's decisions effective:

- local elections – 6.35;
- use of mass media in advancing a particular agenda – 6.29;
- use of social media in advancing a particular agenda – 6.28;
- personal contacts with members and officials of the local government – 5.94;
- local referenda – 5.81;
- collection of signatures, petitions – 5.78;
- resident polls – 5.69;
- resident meetings – 5.67;
- protests, demonstrations, strikes – 5.51;
- public consultations – 5.45;
- taking part in municipal committees, working groups – 5.09;
- round table discussions – 4.91;
- participation in non-governmental organizations – 4.55;
- using trade union influence – 4.54;
- joining a political party – 4.33;
- moving elsewhere – 3.56

*(Author's calculation based on a survey conducted by Seimuskane and SKDS, 2012 (n=1050), Evaluation scale 1-10, where 1 – not important; 10 – very important).*

When the forms of participation chosen by the respondents are compared to a survey conducted about ten years ago, there emerges a similarity among

the top three forms of advocacy. Also a 2001 survey, “Democracy and local self-governments”, conducted by the Department of Public Administration, University of Latvia, had shown that most often the respondents pointed to elections and referendua (67%), the use of public mass media (52%) and personal contacts with decision-makers (31%) (Vanags, Seimuskane, Vilka, 2006).

The results show that, for advocacy, the residents rely more on the influence of the media and direct contacts with decision-makers, rather than on political parties, NGOs and trade unions. Respondents being quite reserved about joining political parties can be explained by a very high level of distrust in them. The most recent poll from autumn 2012, conducted by Eurobarometer, the centre of public opinion analysis of the European Commission, reveals that only 6% of the residents of Latvia tend to trust political parties, while 88% do not (Eurobarometer 78, 2012). It is one of the lowest trust indicators for political parties in the European Union. Even more skeptical about their political parties are only the residents of Greece, with 5% trust. Also data from the survey conducted by the authors confirm the tendencies seen in the Eurobarometer (2012) survey. Yet, in the authors’ opinion, the respondents have ranked the influence potential of NGOs and trade unions surprisingly low.

## THE FOLLOWING CONCLUSIONS CAN BE DRAWN FROM THE RESEARCH RESULTS

1. Although residents’ trust in local governments in Latvia is higher than in the parliament and the government, the survey results indicate rather high public inactivity in the area of participation. A half of the respondents replied that they would not undertake any activities even if the local government adopted a decision that interfered with community interests.
2. The results of the research do not confirm any correlation between residents’ satisfaction with the work of their municipality and the factor of residents’ participation. The most passively disposed are the residents of those regions where people are the most satisfied with the work of their local governments (Kurzeme) and the least satisfied (Latgale). It leads us to think about diverse causes in the formulation of opinion. In the context of the research data it is not possible to assert that the more satisfied a person is with the work of a municipality, the more actively he/she will take part in public activities, express opinions and, vice versa, the less satisfied a resident is with the work of his or her municipality the more actively he or she will take part in defending his or her interests.
3. The comparison, in a regional aspect, of the results of residents’ survey and local government self-evaluation on resident participation activity testify that local government leaders’ opinions and residents’ opinions do not match, and thus it can be concluded that their understanding of participation is rather different.

4. Upon comparing the possibilities provided for in the legislation of the Republic of Latvia to participate in municipality work and decision making, it can be stated that people rate those participation mechanisms as less effective. More optimistic is their valuation of their possibilities in local government elections, the use of mass media and social media to highlight an issue, as well as personal contacts with municipal deputies, local government referenda, collecting signatures, submitting petitions. This means that local municipalities and departments that render services to residents should consider possibilities to develop the practices of participation mechanisms that match the residents' communication networks, for instance, registering with social media networks.
5. Ineffective activities by representative institutions and residents' low trust in them at the national level stimulate the use of direct participatory democracy mechanisms at the level of local communities. The practice of residents' polls, citizen initiatives, alternative proposals, referenda and other forms of participation should be considered.
6. Local government referenda should be a supported form of participation in local democracy; however, if the mechanisms of cooperation between residents and local authorities are ineffective and formal, it will not improve the quality of participation. Local government referenda is only one form of participation in a complex system of participatory activities.
7. Local municipalities are advised to carry out self-evaluation of the participation process in order to evaluate the weak and strong sides, to conduct a revision of managerial and decision making procedures and to evaluate compliance with the residents' needs and forms of communication. Already now the situation in Latvia shows that in order to express their opinion, people use cooperation and communication forms outside the official frame of participation.

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# RENAISSANCE OF A SOCIAL RELATIONSHIP BETWEEN ORGANIZATIONS AND CUSTOMERS: A CRITICAL REFLECTION ON SOCIAL CAPITAL THEORY AND MEASURES IN THE LIGHT OF A GROWING CONVERGENCE OF SOCIAL AND TECHNOLOGICAL NETWORKS

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MARION TENGE\*

Dipl.-Betriebsw. (FH)

University of Latvia, Latvia

University of Applied Sciences Kufstein, Austria

**Abstract.** The emergence of public Social Software Platforms (SSP) is not only enforcing a renaissance of the social relationship between organizations and their customers, but also challenges social capital theory. Based on a literature review the paper discusses dimensions and measures of social capital in the light of a growing convergence of social and technological networks. The purpose of the paper is to identify implications for theory and measures caused by the advent of SSP with regard to the focal actors 'customer' and 'organization'. The paper concludes that existing social capital measures need to be rethought and suggests an initial starting point for a revised measurement approach.

**Key words:** *social capital, social networks, social software platforms*

**JEL code:** O33

## INTRODUCTION

The advent of public Social Software Platforms (SSP), such as online social networks or micro-blogging services, has led to a renaissance of social relationship between organizations and their customers. The era of the passive customer and the old top-down-view of the internet, where the few published and the many consumed information, has come to an end (Poynter and Lawrence, 2007). SSP are "digital environments that support human communication and collaboration. Contributions and interactions are globally visible and persistent over time" (McAfee, 2006, n.p.). SSP embrace customer participation, while drawing on the

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\* Corresponding author – e-mail: [marion.tenge@gmx.net](mailto:marion.tenge@gmx.net), telephone: +049 511 / 9771596

ideological and technological advances of 'Web 2.0'. One of the main principles of Web 2.0 is the definition of the internet as a platform for facilitated collaboration, idea sharing and joint value creation in a democratic manner (O'Reilly, 2007). Facebook, the globally most adopted SSP, has more than 1 billion active users worldwide (Zuckerberg, 2012). The SSP "emerge as a major source of social capital" (Lin, 1999, p. 48) for individuals and organizations. A general definition of social capital consistent with the renditions of other scholars has been posited as "investments in social relations with expected return" (ibid, p. 30). Put in other words, investing time in maintaining relationships is beneficial, as often the support of others is needed with regard to human need satisfaction or economic goal attainment. It is those others, who are the source of advantage (Bourdieu, 1986; Portes, 1998). The overall notion of an organizational social capital theory is that relationship networks and other aspects "unrelated to money can help organizations succeed economically" (Cohen and Prusak, 2001, p. 10). Social capital plays an important role in the creation of intellectual capital as antecedents of organizational performance (Nahapiet and Goshal, 1998, p. 245), as organizational innovation derives from knowledge exchange and learning from network connections that cross organizational boundaries (Wasko and Faraj, 2005). SSP are a relatively recent phenomenon. Hence, new aspects and implications for social capital theory arise that may not yet be considered in the existing body of literature:

- a) **Level of analysis:** SSP enable the formation of network ties between 'customers' and 'organizations'. Though social capital research also bridges the micro and macro level (e.g. individual and community level) these two focal actors are novel to social capital research.
- b) **Network size:** The number of network ties of an actor may be able to grow substantially, because connections can be cheaply and easily maintained on SSP (Donath and Boyd, 2004).
- c) **Network structure:** Customers are able to connect to organizations on SSP without explicit permission of the organization. Thus, structural holes within a network structure may decrease substantially, as they can be easily spanned with a mouse-click.
- d) **Network interactions:** The interactions (dialogue) between organizations and customers on SSP are publicly visible.

The first purpose of the paper is to identify arising inconsistencies in social capital theory and existing measures of social capital caused by the emergence of SSP with regard to the focal actors 'customer' and 'organization'. The second purpose of the paper is to suggest a starting point for the development of a revised measurement approach of social capital tailored at SSP. The paper is based on an interdisciplinary literature review, while focusing on the work of scholars who have made major contributions to the advancement of social capital theory and who are therefore frequently cited in literature (including Bourdieu, 1986; Burt, 1995; Burt, 2000; Coleman, 1988; Fukuyama, 2002; Lin, 1999; Portes,

1998; Granovetter, 1973; Granovetter, 1992; Nahapiet and Goshal, 1998; Putnam, 2000; Woolcock, 1998; Woolcock and Narayan, 2000). The views of the scholars are arranged into three different theoretical perspectives of social capital by the author: structural, relational and cognitive (Nahapiet and Goshal, 1998). The paper discusses each theoretical perspective of social capital and corresponding measurement models of social capital in the light of a growing convergence of social and technological networks. The paper highlights implications for social capital theory caused by the advent of SSP (level of analysis, network size, network structure, network interactions) and suggests an initial starting point for the adaptation of existing measurement approaches.

## RESEARCH RESULTS AND DISCUSSIONS

While scholars commonly agree that social relations act as a mediator for needs satisfaction, they often focus on different aspects of social capital. Nahapiet and Goshal (1998) integrated the different approaches into three dimensions: structural, relational and cognitive. Notwithstanding the limitation that these dimensions are “highly interrelated” (*ibid*, p. 243), the author shares the view that a distinction in dimensions is beneficial for analytical reasons. Hence, the implications of SSP for social capital theory and measures of social capital are analysed separately for each of the three dimensions.

### 1 IMPLICATIONS OF SSP FOR THE STRUCTURAL DIMENSION OF SOCIAL CAPITAL AND RESPECTIVE MEASUREMENT APPROACHES

The structural dimension of social capital focuses on the existence or absence of network connections between focal actors within a social network, i.e. the impersonal network configuration (Nahapiet and Goshal, 1998, p. 244). It also comprises the “the sum of the resources, actual or virtual, that accrue to an individual or a group by virtue of possessing a durable network of more or less institutionalized relationships of mutual acquaintance and recognition” (Bourdieu and Wacquant, 1992, p. 119). Thus, the structural dimension of social capital comprises both the network *per se* and the actual or potential resources that may be mobilized through that network (Nahapiet and Goshal, 1998). In the structural perspective social capital is most commonly divided into bridging and bonding social capital touching on the seminal work of sociologist Granovetter (1973): “The Strength of Weak Ties”. Bonding social capital is referred to as reflecting strong ties with family and close friends, who might be in the position to provide emotional support or access to limited resources (Putnam, 2000). Bridging social capital defines loose connections, that is, weak ties, between focal actors governed by norms of reciprocity. Granovetter describes a weak tie as a bridge that spans parts of a social network and connects otherwise disconnected social groups (Granovetter, 1973). For information diffusion across a network, bridging ties are the most valuable (Putnam, 2000). Burt (1995) refers to the weaker network



connections between non-redundant relations in a social network as structural holes. If an actors' network is rich in structural holes, entrepreneurial opportunity, information and control benefits increase. Structural holes can be compared to buffers acting like insulators in an electric circuit. People on either side of the structural hole circulate in different flows of information. If the structural hole can be spanned, the individual gets access to non-redundant sources of information and is able to control the projects that bring individuals from both sides of the structural hole together (Burt, 2000). In the view of Burt and Granovetter economic outcomes are influenced by overall network configuration. Accordingly, network location is considered as a measure of social capital in literature. The network location approach focuses on the best infrastructure that must be present for accessing social capital, but does not predict access to resources (Lin, 1999). The author argues that in the light of a growing adoption of SSP the importance of network configuration will decrease. With customers being able to connect to organizations on SSP without explicit permission of organizations, structural holes can be easily spanned with a mouse-click. Also control benefits based on network configuration diminish. As the dialogue between customers

Table 1

**Review of existing measurement approaches of social capital (structural dimension)**

Focus	Measurement	Criticism of measurement approach	Implications of SSP for measurement approach regarding the focal actors 'organization' / 'customer'
Network location	<ul style="list-style-type: none"> <li>• Access to bridges that span structural holes (Burt, 1995)</li> <li>• Bridging network ties and strength of tie (Granovetter, 1973)</li> </ul>	<ul style="list-style-type: none"> <li>• Network location per se does not predict existence of and access to network resources valued by the actor (Lin, 1999)</li> </ul>	Importance of network location will decrease: <ul style="list-style-type: none"> <li>• Structural hole that separates customers and organizations can be spanned with a mouse-click</li> <li>• Customer requires no permission of organization for establishing a connection on SSP</li> <li>• Organizations lose control over information flow, as conversation on SSP is publicly visible</li> </ul>
Embedded network resources	<ul style="list-style-type: none"> <li>• Valued resources of others, e.g. wealth, power, status (Lin, 1999)</li> </ul>	<ul style="list-style-type: none"> <li>• Existence of valued network resource per se does not predict that the actor is able to mobilize the resource</li> </ul>	<ul style="list-style-type: none"> <li>• Measurement approach difficult to apply for large scale online social networks</li> <li>• Focal actor 'organization' is an impersonal legal entity</li> </ul>

Source: information compiled by author

and organizations is publicly visible on SSP, it is no longer possible for organizations to filter information or to control the flow of information (McAfee, 2009). Therefore, network location must not be treated as a measure of social capital when analysing the relationship between customers and organizations on SSP. A second measurement approach focuses on the embedded resources in social networks (Lin, 1999). Existing measures concentrate on valued resources of others, such as wealth, power or status. Measurement instruments include for example 'name generator', 'position generator' or 'resource generator' (see van der Gaag, 2005, for a detailed description). However, the existence of valued network resources per se does not predict that the actor is able to mobilize the resource to attain his goals. Complexity is added by the fact that the measurement approach is difficult to apply to large scale online social networks. Furthermore, it cannot be applied to the focal actor 'organization', as it is an impersonal legal entity.

## 2. IMPLICATIONS OF SSP FOR THE RELATIONAL DIMENSION OF SOCIAL CAPITAL AND RESPECTIVE MEASUREMENT APPROACHES

While the structural dimension of social capital focuses on impersonal network structure and embedded resources, the relational dimension of social capital reflects the quality of network ties, i.e. the type of "personal relationships people have developed with each other through a history of interactions" (Nahapiet and Goshal, 1998, p. 244). Components of the relational dimension, such as trust, facilitate exchange and lower transaction costs (Coleman, 1988; Fukuyama 2002; Woolcock and Narayan, 2000). The relational dimension of social capital has been given much less empirical attention, as scholars have been careful to avoid tautological reasoning. As trust can be considered as both cause and effect of durable social relations (Cohen and Prusak, 2001), trust must not be equated with an indicator for the existence of social capital (Adam and Roncevic, 2003; Portes, 1998; Woolcock and Narayan, 2000).

Granovetter describes relational embeddedness as the degree to which focal actors reciprocally consider one another's needs and goals (Granovetter, 1992). Hence, it can be postulated that a mutually beneficial relationship between organizations and customers on SSP is only possible, if the relationship is valued by both actors, i.e. if the needs of the customer are satisfied by the organization and the needs of the organization are satisfied by the customer. Otherwise the relationship has a discount rate (Flap, 2001). The expected future value of the relationship will decrease and so will the investment of effort in maintaining the relationship (Lindenberg, 1990).

SSP make the 'investments' in social relations visible. In addition to the frequency of interactions, researchers are also able to analyse the content of interactions, as contributions on SSP are persistent. The author argues that the content which is exchanged on SSP contributes to the need satisfaction of the focal actors. Need satisfaction can therefore be considered as the 'return of

investment' in social relations. This approach might offer a fruitful new avenue for the development of a rigorous measurement model of social capital.

Table 2

**Review of existing measurement approaches of social capital (relational dimension)**

Focus	Measurement	Criticism of measurement approach	Implications of SSP for measurement approach regarding the focal actors 'organization' / 'customer'
Trust, norms of reciprocity	<ul style="list-style-type: none"> <li>Latent constructs</li> </ul>	<ul style="list-style-type: none"> <li>Tautological reasoning (Adam and Roncevic, 2003; Portes, 1998; Woolcock and Narayan, 2000)</li> </ul>	<ul style="list-style-type: none"> <li>Dialogue on SSP is publicly visible and enables a clear cut distinction between cause and effect</li> </ul>

Source: information compiled by author

### 3 IMPLICATIONS OF SSP FOR THE COGNITIVE DIMENSION OF SOCIAL CAPITAL AND RESPECTIVE MEASUREMENT APPROACHES

The cognitive dimension of social capital focuses on a shared meaning or understanding between actors (Nahapiet and Goshal, 1998; Fukuyama, 2002). In terms of organizational strategy Kaplan and Norton (2004a) equal

Table 3

**Review of existing measurement approaches for social capital (cognitive dimension)**

Focus	Measurement	Criticism of measurement approach	Implications of SSP for measurement approach regarding the focal actors 'organization' / 'customer'
Shared goals	<ul style="list-style-type: none"> <li>Latent construct</li> </ul>	<ul style="list-style-type: none"> <li>No explicit criticism mentioned in literature; shared goals need to be defined context-specific</li> </ul>	<ul style="list-style-type: none"> <li>Shared goal: customer satisfaction</li> <li>Motivational pull of SSP demands for a holistic approach for achieving customer satisfaction (Tenge, 2012b). Organizations must take fundamental human needs into account. Focusing only on customer needs reduces the human being into a "into a category of restricted existence" (Max-Neef, 1992, p. 201).</li> </ul>

Source: information compiled by author

the cognitive perspective with the motivation to work towards a common goal. If this reasoning is applied to the focal actors 'customer' and 'organization', a shared goal is the achievement of customer satisfaction as a basis for a mutually beneficial relationship on SSP. For organizations, customer satisfaction can be seen as a driver of profitability. Satisfied customers are likely to establish a strong relationship to an organization resulting in customer loyalty (Storbacka *et al.*, 1994). The author further argues that the convergence of social and technological networks demands for a holistic approach to achieve customer satisfaction on SSP, as "people in virtual communities do just about everything people do in real life, but we leave our bodies behind" (Rheingold 2000, p. 3). In real life individuals maintain network ties to leverage social support to satisfy their fundamental human needs. In line with this reasoning, organizations must not only consider the customer as a *customer*, but first of all as a *human being* (Tenge, 2012b). Focusing only on customer needs reduces the human being into a "into a category of restricted existence" (Max-Neef, 1992, p. 201).

#### 4 TOWARDS A MEASUREMENT APPROACH OF SOCIAL CAPITAL ON SSP WITH FOCUS ON THE CUSTOMER-ORGANIZATION-RELATIONSHIP

Fukuyama (2002) postulates that "one of the greatest weaknesses of the social capital concept is the absence of consensus on how to measure it" (p. 12). In the author's opinion the development of a commonly agreed upon measure of social capital is a noble goal that due to the heterogeneous purposes of research and different levels of investigation cannot be accomplished.

Levels of analysis range from the individual and small groups (Burt, 1995) to organizations (Tsai and Goshal, 1998) and even communities and nations (Putnam, 2000). Narayan and Cassidy (2001) support this view by stating that social capital is a latent construct that requires subjective interpretation with regard to its translation into operational measures.

In this respect, the author follows the general definition of social capital as "investment in social relations with expected return" (Lin, 1999, p. 30) and suggests that for each study, the 'investment' and the 'return' needs to be carefully specified in order to be able to subject hypothesized cause-effect relationships to empirical scrutiny. The author further argues that 'investment' and 'return' must be measured at the level of an individual actor, as the benefits of social interaction accrue for the actor. Customers and organization can both be considered as actors, while SSP bridge the micro and the macro level. SSP offer researchers unobtrusive new ways of measuring social capital, as the dialogue between actors is publicly visible and persistent over time. The author believes that the 'investment' in social relations can be determined by calculating the ratio of reciprocal interactions on SSP. It must be noted that the calculation is context-specific and needs to be adapted depending on the SSP that is analysed. As for the online social network Facebook the interaction ratio is termed 'engagement rate'

and commonly calculated as the average number of customer interactions (i.e. 'likes', 'comments' and 'shares') per post of the organization on a given day divided by the total number of persons who are connected to the page (Facebook 'fans' of the organization). Other platforms might require a different operationalisation of the interaction ratio.

The content that is exchanged on SSP contributes to individual need satisfaction of customers and organizations. Therefore, need satisfaction must be considered as the 'return of investment'. In the social capital definition of Lin (1999), the emphasis is further placed on the *expected* return. For organizations, the expected return is straight forward: economic need satisfaction, in terms of subsistence in the market place. By including the customer into the value creation process, the customer generates satisfiers for the economic needs of an organization. The author suggests the adoption of a Balanced Scorecard (BSC)/strategy map perspective (Kaplan and Norton, 2004a; Kaplan and Norton, 2004b) for deducing measures for economic need satisfaction. A BSC/strategy map is a visual representation of a corporate strategy and therefore must not be considered as "a strait jacket" (Kaplan and Norton, 1996, p. 34). Each industry and organization needs to develop their own BSC/strategy map depending on the selected strategy.

Figure 1 shows an example of a BSC/strategy map of an airport operating organization pursuing a growth and productivity strategy, while aiming to be viewed as "The most passenger-centric airport". This involves a clear focus on the operational passenger service process in terms of service quality as well as on continuous innovation processes, as innovative airport services quickly become the minimum expectations of tomorrow.

Generally, SSP can be considered as part of the information capital of an organization in the 'learning and growth perspective'. SSP leverage network connections to customers (information benefits) in order to enrich the organizations' 'human capital' (tacit knowledge of employees) and foster value generation in the 'process', 'customer' and 'financial' dimension of the BSC/strategy map.

Based on the customized BSC/strategy map, each organization is able to develop measures with regard to their expected return of investment in the customer relationship on SSP. For example 'deeper insights into customer needs, requirements and attitudes', 'increased efficiency of distinct operational processes due to real-time communication with the customer, a 'reduced time-to-market for product or service innovations' or an 'increase of positive-word-of mouth (referrals)'.

The expected return of the customer can be operationalised as socio-psychological need satisfaction (well-being), as individuals maintain network ties on SSP to leverage the social support of others to satisfy their fundamental human needs (Rheingold, 2000). Hence, it is no longer sufficient for organizations to concentrate on meeting only the customer needs. Human nature remains relatively stable through time and place, meaning that all human beings have

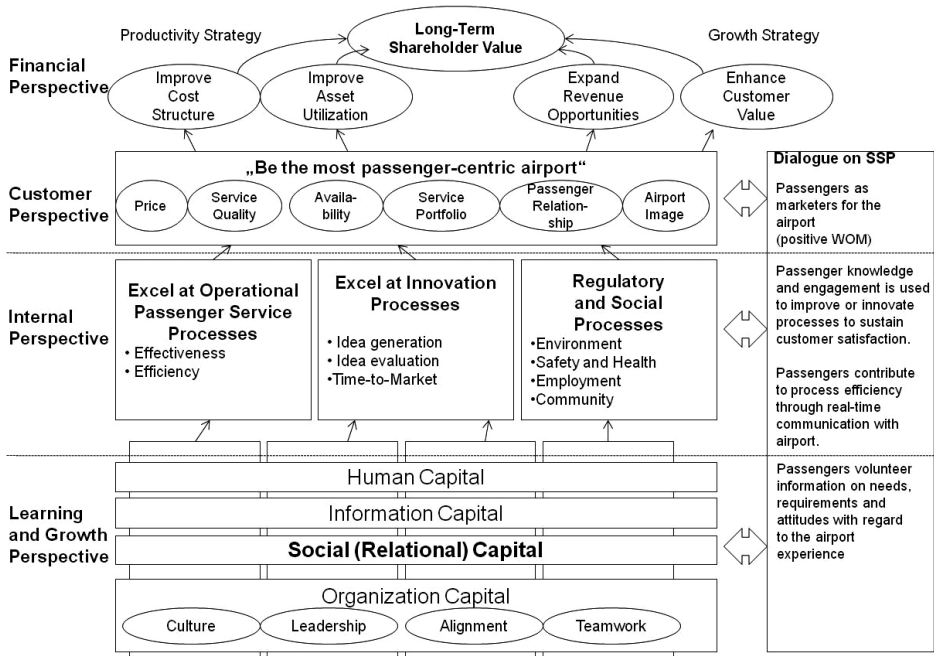


Fig. 1. Generic airport strategy map based on (Kaplan and Norton, 2004, p. 12 with extended social capital dimension (Tenge, 2012a, forthcoming)

the same fundamental needs and strive to achieve the same universal goals (Flap, 2001). What changes during evolution are the options for needs satisfaction. Fundamental human needs can be divided into the physiological need for subsistence and socio-psychological needs. There are different approaches in literature on how detailed the classifications of socio-psychological needs should be. The author supports the view of the *self-determination theory* (Deci and Ryan, 1987), focusing on the basic needs for self-determination, competence and relatedness, for those can be considered as a resource of human motivation. In addition, individuals need values and norms to guide their activities and provide for orientation and meaning (Dambmann, 2004)<sup>1</sup>.

*Self-determination* refers to the feeling of autonomy and choicefulness. Individuals experience themselves as initiators of their behavior when being allowed to choose both their goals and the way how to attain them. In an autonomy-supportive social context a self-determined activity is characterized by integration and the absence of conflict or pressure to cooperate or achieve expected outcomes. Events that control the behavior of individuals have been found to negatively influence self-esteem and well-being (Deci and Ryan, 1987,

<sup>1</sup> For a more detailed discussion on how SSP support the socio-psychological need satisfaction of customers see Tenge (2012b)

p. 1025). Organizations that create an autonomy-supportive communication context on SSP and share actual and valuable information that support decision-making processes of customers, generate satisfiers for the human need for self-determination.

*Competence* can be described as the motivation to succeed at optimally challenging tasks and being able to achieve expected outcomes. The need to feel competent and challenged is often linked to human actions that are targeted at fostering progress and is associated with feelings of curiosity and interest (Dambmann, 2004). SSP are environments that facilitate customer contributions and recognition. Due recognition of the customer requires organizations to be willing to see the world through the eyes of the customer and be responsive to customer needs. Customers believe that “there would be a positive impact from companies taking more time to find out about their needs and interests” (Hulme, 2010, p. 3).

*Relatedness* can be described as a need for being connected to others. Human beings need affectionate care and a sense of belonging from infancy onwards. Relatedness is not concerned with outcomes, but rather with a need to belong and to feel cared for (Deci and Ryan, 2000). Research on customer service expectations suggests that there is a growing demand for a “more personalized and closer relationship” with service providers (Parasuraman *et al.*, 1991, p. 43).

Human beings also need norms to guide their activities and provide for orientation and *meaning*. Values and norms can be regarded as “a foundation for stable expectations that are efficient, because individuals act with greater assurance of the outcome” (Hetcher, 2004, p. 82). SSP support orientation with regard to customer buying decisions, as they facilitate access to peer evaluations and recommendations. Both convey a public understanding of the superiority of a product or service relative to its asserted value propositions.

When developing measurements for the degree of the socio-psychological need satisfaction of customers as they interact with organizations on SSP, a study, *Basic Psychological Need Scales* developed by Deci and Ryan (1987) might be a useful first point of reference. However, so far these scales have been developed to measure ‘basic need satisfaction at work’, ‘basic need satisfaction in human relationships’ and ‘basic need satisfaction in life’. Thus, it is necessary to adapt the existing scales.

According to the *self-determination theory* (Deci and Ryan, 1987), the motivation of individuals to engage in activities increases if their socio-psychological human needs are satisfied. On SSP this might translate into an increased volunteering of information about customer needs, requirements and attitudes or the dissemination of a positive word-of-mouth with regard to the organization and their products and services.

## CONCLUSIONS, PROPOSALS, RECOMMENDATIONS

The paper has contributed to an understanding that the advent of SSP causes implications for social capital theory that have not yet been considered in the existing body of literature and that measures of social capital need to be rethought. The following starting points for the development of a measurement concept for social capital with regard to the focal actors 'customer' and 'organization' have been suggested by the author:

1. The development of a commonly agreed upon measure of social capital is a noble goal that due to the heterogeneous purposes of research and different levels of investigation cannot be accomplished. Each research study carefully needs to specify the 'investment' in social relations and the 'expected return of investment' in social relations for each focal actor in order to be able to subject hypothesised cause-effect relationships to empirical scrutiny.
2. 'Investment' and 'return' must be measured at the level of an individual actor, as the benefits of social interaction accrue for the actor.
3. On SSP the 'investment' in social relations is publicly visible and persistent. It can be determined by calculating the ratio of reciprocal interactions of the focal actors. It must be noted that the calculation is context-specific and needs to be adapted depending on the SSP that is analysed.
4. The content exchanged on SSP, namely, the dialogue between customers and organizations, contributes to the human need satisfaction of customers and economic need satisfaction of organizations. Therefore, need satisfaction must be considered as the 'return of investment' in social relations.
5. The expected economic needs satisfaction of organizations can be operationalised by adopting a BSC/strategy map approach (Kaplan and Norton, 2004c; Kaplan and Norton, 2004b) to determine appropriate measures with regard to the customer relationship on SSP (for example, increase of customer insights volunteered on SSP, positive word-of-mouth generated on SSP or improved process efficiency achieved by real-time communication with the customer).
6. The expected return of the customer can be operationalised as socio-psychological need satisfaction (well-being), as individuals maintain network ties on SSP to leverage the social support of others to satisfy their fundamental human needs for self-determination, competence, relatedness and meaning.
7. When developing measurements for the degree of the socio-psychological need satisfaction of customers in their interaction with organizations on SSP, the *Basic Psychological Need Scales* developed by Deci and Ryan (1987) might act as a useful first point of reference. These scales have been developed to measure 'basic need satisfaction at work', 'basic need satisfaction in human relationships' and 'basic need satisfaction in life'. Hence, it is necessary to adapt the scales.



The matrix of the paper being qualitative, it is proposed to subject the suggested theoretical concept and measurement approach to empirical scrutiny. This implies the development of detailed measurement scales. These scales need to be context-specific, namely, they must be tailored to the industry and SSP under investigation. As SSP are a relatively recent phenomenon the paper must be regarded as only a modest contribution to the advancement of social capital measurement. Other scholars are invited to refine, correct or expand on it in future.

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# BENEFITS AND RISKS OF THE EUROZONE: LATVIAN CASE OF EURO ADOPTION

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Prof. Dr. oec. INESE VAIDERE\*

Faculty of Economics and Management,  
University of Latvi

**Abstract.** The paper aims to analyse the main factors leading to the present eurozone crisis, evaluates the measures taken to overcome the crisis, and weights the benefits and risks of the euro adoption in Latvia on 1st January 2014. By applying the analytical research method, the author scrutinises the solutions to the crisis proposed by the EU institutions, including European Stability Mechanism, the Treaty on Stability, Coordination and Governance, the proposals for a banking union, and the European Central Bank's intervention in the secondary bond markets to evaluate them and to conclude whether these decisions and proposed steps have been adequate crisis solutions. The article concludes that among other conditions for restoring the confidence to the eurozone, its member states have to comply with a strict budget discipline and rational public sector financing which must be the lesson learned for the future.

The paper illustrates that it is difficult to establish a clear causal link between the euro adoption and the changes of the main economic indicators. The economic indicators are linked to the macroeconomic conjuncture and therefore it is hard to distinguish the impact of the euro on the economy from cyclical changes of the economy itself.

After looking at the possible risks and costs associated with the euro adoption in Latvia, the author concludes that joining the eurozone will have, in general, a positive impact; yet the exact extent of the impact will depend on the eurozone's capacity to manage the present risks and future challenges. However, in the case of Latvia, the key advantage of euro adoption is the geopolitical aspect, that is, integration within the eurozone will limit Russia's ability to increase its economic and political influence and to bring Latvia back to the core of the European integration processes.

**Key words:** *Eurozone, Crisis, Growth and Stability Pact, Latvia*

**JEL code:** E42; E62; F33; F34; F36; G01

## INTRODUCTION

Numerous studies have examined the causes and consequences of the eurozone crisis. One of the theoretical approaches – most often used to analyse the current eurozone problems – is the optimum currency area (OCA), a theory

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\* Corresponding author – e-mail: [inese.vaidere@europarl.europa.eu](mailto:inese.vaidere@europarl.europa.eu), telephone: +371 67814199

initially formulated by Nobel Laureate Robert Mundell (1961). The criteria for an optimum currency area include a high degree of labour mobility, the openness of the economies involved, product diversification, and flexibility of markets, prices and wages. Moreover, countries within the currency union should have similar economic development levels and economic structure (e.g. similar GDP per capita levels, economic growth rates, interest rate levels, budget deficit, public debt to GDP ratios, and legal systems) (Bukowski, 2011). If these criteria are not fulfilled, significant asymmetric shocks that affect individual countries appear and are very difficult to solve (Bird, 2012). The optimum currency area theory not only can provide an explanation to the current eurozone crisis but can also assist in finding concrete solutions.

While there are many advantages of a single currency and economic integration within a trading block like the eurozone, the financial crisis discovered structural gaps in the eurozone which deepened the crisis in the currency area. Various responses to the crisis were adopted and a number of other is still a subject of discussions. What were the main reasons that lead the eurozone towards crisis so deep? Have the proposed crisis resolution mechanisms been successful and sufficient? While it is too early to fully assess the effectiveness of the proposed measures, yet they provide hope that the eurozone countries will have sounder fiscal policies.

Meanwhile Latvia has fulfilled the Maastricht Criteria and is paving its road to the monetary union. The 1 of January 2014 has been set as its target for the euro adoption. On 4 March 2013, Latvian authorities requested the extraordinary Convergence Report to the European Commission (EC) and the European Central Bank (ECB) that will assess Latvia's readiness to join the eurozone. Still struggling with recovery, is the eurozone the club for Latvia to join? What are the financial risks the Latvian economy should be prepared for after joining the eurozone? What will the impact be of the eurozone's capacity or incapacity to carry out structural reforms on Latvia's economic benefits from the accession to the currency union?

This paper investigates the current and potential risks of the eurozone, analyses the proposed crisis mechanisms and seeks an answer to whether it is in Latvia's interests to join the eurozone in 2014. By using the OCA theory, the paper addresses the problem of economic heterogeneity within the eurozone and the consequences for Latvia. The author also analyses how the joining to the eurozone corresponds to Latvia's geopolitical interests.

## 1 PROBLEMS LEADING TO THE EUROZONE CRISIS

### 1.1 BREACHES OF THE GROWTH AND STABILITY PACT

The Growth and Stability Pact (GSP) was supposed to guide eurozone member states towards “\“sound government finances as a means of strengthening

the conditions for price stability and for strong sustainable growth conducive to employment creation” (Council Regulation (EC) No 1466/97, 7 July 1997). However, in reality, the member states never achieved the necessary degree of fiscal coordination and the GSP was never properly implemented. From 2001 to 2006, i.e. before the beginning of the global economic crisis, almost one third of eurozone countries did not respect the criteria put forward by the GSP: the ceilings of 3% of GDP for government deficit and 60% of GDP for overall public debt (Darvas, 2012). Even worse, Greek government misreported its budgetary data in order to join the eurozone. Although sanctions were foreseen, they were never properly implemented. Eurostat had only very limited options to check and ensure the quality of data (e.g. no rights to conduct thorough audits). It was only in 2010 that the EU decided to enable Eurostat to directly audit government data – as a result of frequently corrected Greek statistics (Rauch, et al., 2011).

Numerous authors argue that the concept of the eurozone economic governance was expected to be unsuccessful from the beginning, because it was a union based on political motives rather than a monetary union based on strict accession criteria. A number of countries which formed the monetary union in 1999 did not meet the criteria of the optimum currency area (Alexiou and Nellis, 2002; Bukowski, 2011). On the other hand, some scholars predicted that countries would improve their economic performance after the establishment of the eurozone (Wihlborg, et al., 2010). The so-called endogenous OCA analysis implied that potential members of a monetary union would meet the criteria better *ex post* than *ex ante* (Willett, et al., 2010). For instance, in the case of Belgium and Italy, before the introduction of the euro, they did not satisfy the debt criteria set by the GSP (Allen and Ngai, 2012). Yet the hypothesis that countries would better meet the criteria after joining the currency union was not confirmed, because in absence of strong supervision and effective sanctions countries’ debt levels continued to rise.

There have been many proposals to reform the GSP (Jonung, et al., 2008); however no significant political decisions were made prior the crisis. Only in 2008, when the financial situation in the world was worsening, it was acknowledged that there were significant financial problems in several eurozone countries, with situation in Greece representing one of the most serious challenges.

A significant unresolved problem is the absence of a mechanism for leaving the eurozone or expulsing a particular member state. Each system that regulates the entry process has to also establish an exit procedure. The author considers that it is necessary to establish a mechanism that could be applied in case if a country would systematically breach the rules like Greece. Since 2010, the EU and IMF has already provided financial support of 240 bn euro – an expensive price to pay for Greek excessive spending. At the end of the third quarter of 2012, Greek government debt was 152.6% to GDP (Eurostat, 23 January 2013). The IMF confirms that further debt relief will be needed to achieve sustainable reduction of Greek debt-to-GDP ratio to 124% by 2020 and to substantially below 110% by

2022 (International Monetary Fund, 26 January 2013). In the author's opinion, when evaluating future policy options, the eurozone leaders should not only take into account the political considerations, but should also provide estimates about which of the two options would be less costly to the eurozone economies: to continue supporting Greece by injecting more resources into Greek economy or to support the banks in other eurozone countries that have been exposed to Greek debt.

## 1.2 EXCESSIVE CURRENT ACCOUNT IMBALANCES AND INSUFFICIENT STRUCTURAL CONVERGENCE

The euro was a crucial factor in promoting financial integration that led to excessive current account imbalances. The most important factor leading to an increase in cross-border capital flows was lending by German and French banks to non-core countries' banks. From 2002 till 2007, Portugal, Greece, and Spain were all running very large external deficits (-9.2%, -9.1%, and -7.0% respectively) (Lane, 2012; Lin and Theichel, 2012).

In Ireland and Spain, the foreign capital was mainly used to support an unjustified growth in the real estate and housing sector. From 1997 to 2007, housing prices increased at an average annual rate of 12.5% in Ireland and 8% in Spain (compared to 4.6% in the United States during its bubble in real estate market). The development of new financial instruments and derivatives further boosted the real estate boom (Lin and Theichel, 2012). In Greece and Portugal, the inflowing capital was used to boost demand and excessive consumption. In the meantime, banks abandoned local business credit that could lead to more sustainable economic growth (Perotti, 2011). Household indebtedness also was increasing sharply, particularly in Ireland, Spain and Portugal, due to very low borrowing costs (Angeloni, 2012).

Before the crisis, Germany, Italy and Portugal had the weakest growth prospects among the eurozone countries. Nevertheless, Germany significantly improved its competitiveness. Trade unions, workers' representatives and employers achieved a consensus that wage restraint was crucial to preserve Germany's competitiveness and to prevent further relocation of working places to Eastern Europe and third countries (Lin and Theichel, 2012). Consequently, from 2001 till 2011 labour costs per unit in Germany rose only by 0.9%. Other countries were not able to emulate the German approach and labour costs per unit in the same period (2001-2011) rose by 33% in Greece, 31% in Italy, 27% in Spain and 20% in Ireland (Lin and Theichel, 2012, p.10). The devastating consequences of the crisis on the peripheral eurozone economies can be explained by the fact that they had not carried out the necessary reforms to remain competitive. Moreover, the eurozone was experiencing a high degree of sector specialization and differences in the structure of production. This has led to a lower speed of adjustment which, in conjunction with the rigidity of labour and product markets, has even more aggravated the structural problems (Alexiou and Nellis, 2002).

### 1.3 THE INTERDEPENDENCE OF BANKING SECTOR AND SOVEREIGNS

The sovereign debt crisis and the banking crisis were deeply entangled. One of the main reasons was the explicit and implicit government guarantees for the banks in their jurisdiction. In fact, it was implicitly assumed that there would certainly be a bailout (Angeloni, et al, 2012; Brunnermeier, et al, 2011). Most of the eurozone banks had an excessive exposure to their own sovereign credit risk. During the crisis, the share increased: less and less non-residents wanted to buy their obligations. Such reliance on domestic bonds resulted in a situation where problems with state finances would affect the banking sector (as in the case of Greece) and vice versa (Ireland) (Darvas, 2012). Moreover, bank financing constituted around 75–80% of corporate funding in the eurozone (Maddaloni and Peydró, 2013). Eurozone member states covered both the direct fiscal costs of recapitalisation of banks (or providing other fiscal support) and the indirect fiscal costs linked to lower GDP and tax revenues in the aftermath of the banking crisis (Lane, 2012). From October 2008 till October 2011, European countries had mobilised 4.5 trillion euro in form of state support and guarantees (BBC, 2010).

## 2 THE RESPONSE TO THE CRISIS

### 2.1 THE IMPROVEMENT OF THE CRISIS MECHANISMS

One of the most significant problems facing the eurozone was that there was no crisis mechanism available. Moreover, one of the founding principles of the eurozone was that the member states should be responsible for their financial liabilities (no bail-out clause). The eurozone lacked the capacity for speedy reaction, policy discretion and centralised action (Featherstone, 2011).

The initial response to the crisis was through temporary ad hoc measures. First, in 2010 the member states provided bilateral loans to Greece (in cooperation with IMF). Afterwards, two temporary financing mechanisms were established – European Financial Stability Facility (EFSF) with total effective lending capacity is 440 bn euros and European Financial Stabilisation Mechanism (EFSM) estimated at approximately 60 bn euros. These funds were used to provide financial help to Ireland, Portugal, as well as Greece. The scope of these instruments was enlarged to include the banking sector. Only on 8 October 2012, the European Stability Mechanism (ESM) was inaugurated, which is a permanent crisis fund with a lending capacity of 500 bn euros later increased to 700bn euros. These amounts will be sufficient should the help be needed for some smaller eurozone countries, perhaps even for Spain. For instance, Cyprus is expected to be granted 17.5 bn euros, which is almost equivalent to its GDP in 2011, that is, 17,98 bn euros at current prices (Eurostat). However, ESM lending capacity would be insufficient if Italy needed help (Allen and Ngai, 2012). In this context, Italy's recent elections (24-25 February 2013) cause serious concerns



and indicate that the majority of Italians do not support any further reforms that are crucial to revitalise its economy.

## 2.2 STRENGTHENING THE GROWTH AND STABILITY PACT

Several decisions have been taken in order to strengthen the GSP. The most important was the new intergovernmental Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (TSCG, the so-called “fiscal compact”). On 2 March 2012, 25 of 27 Member States signed the treaty (with the exception of the Czech Republic and the United Kingdom) and it entered into force on 1 January 2013. The TSCG stipulates that national budgets should be in balance or in surplus. The rules will be embedded into national legislation within one year of the entry into force of the TSCG. (Council of the European Union, 21 December 2012) Unfortunately, there are still several countries that do not comply with their deficit-reduction targets. For instance, it is expected that France’s deficit will reach 3.7% in 2013, well above the 3% target (Wishart, 28 February 2013).

Another novelty, complementing the TSCG, is the new Macroeconomic Imbalance Procedure (MIP) that was created to prevent and correct macroeconomic imbalances within the EU. The MIP has two components: preventive (covers all 27 member states) and corrective (only applies to eurozone member states). The Commission and the Council can adopt preventive recommendations in order to avoid that imbalances become large. The corrective component will be activated in the case of serious imbalances. Firstly, interest-bearing deposit will be imposed after a failure to comply with the corrective action. Secondly, the deposit could be converted into a fine (up to 0.1% of GDP). So far, the MIP has been implemented in twelve EU member states.<sup>1</sup> The macroeconomic imbalances observed were not qualified as “excessive” thus not leading to sanctions (European Commission, 30 May 2012). Therefore, the efficiency of the mechanism in case of “excessive” imbalances within the eurozone still has to be tested in practice.

## 2.3 ECB INTERVENTION IN THE SECONDARY BOND MARKETS

In case of non-eurozone countries, the central banks can act as a lender of last resort to governments by printing money or by buying government bonds (as it was done by the central banks in US, UK or Japan). The eurozone countries on the other hand have to borrow on such terms as if they were borrowing in foreign currencies (Darvas, 2012). Till the outset of the eurozone debt crisis, many eurozone countries had a free ride on the German bonds; financial markets did not distinguish between reliable and unreliable eurozone bonds. Greece could

<sup>1</sup> Belgium, Bulgaria, Cyprus, Denmark, Finland, France, Italy, Hungary, Slovenia, Spain, Sweden and the United Kingdom.

borrow on almost the same terms as Germany. However, since the crisis, the borrowing costs had significantly increased.

The ECB has found ways to intervene, even though its statutes do not allow it to act as a lender of last resort. On 6 September 2012, the ECB announced that it would start the Outright Monetary Transactions (OMT) in secondary markets for sovereign bonds in the eurozone, with the aim to lower the borrowing costs of the eurozone countries affected by the debt crisis. The ECB hoped to address severe distortions in government bond markets arising from “unfounded fears (...) of the reversibility of the euro” (European Central Bank, 6 September 2012). In fact, the ECB has undertaken a new function even though its most important task is to guarantee price stability. These two aims – securing low inflation and low borrowing costs – can be mutually incompatible. Therefore it is important that the ECB’s focus would not switch from inflation to the borrowing rates.

Markets’ reaction to the OMT so far has been positive and the bond rates have lowered and investor confidence has increased. From August till December 2012, a total of 93 bn euros have flown back into the countries hit the hardest by the eurozone crisis (Greece, Ireland, Italy, Portugal and Spain). However, in the first eight months 406 bn euros left the same countries (equivalent of 20% of their total GDP) (Financial Times, 29 January 2013).

The OMT can temporarily alleviate problems, yet it cannot resolve the eurozone crisis. It can even cause negative effects in case if politicians would become less motivated to implement the necessary structural reforms. The next step in this direction could be Eurobonds. Eurobonds probably could be envisaged in a distant future, when more national policies will be harmonized at the EU level. At the present moment, debt mutualisation would not solve the problem of irresponsible spending patterns in certain member states of the eurozone. Therefore, strict conditionality needs to be applied.

Moreover, the ECB does not have “unlimited” resources to invest in government bonds. While the ECB is the only institution that could provide a certain price guarantee for eurozone sovereign bonds, it must be remembered that the total value of eurozone public debts is estimated around 8300 bn euros, which is more than three times the German GDP (Wyplosz, 2011).

## 2.4 THE ESTABLISHMENT OF A BANKING UNION

In order to disentangle the interdependence between sovereigns and banks, it was proposed to establish a banking union. It was clearly a politically more acceptable alternative than the proposals to establish Eurobonds or to move faster to a complete fiscal union. The EC has presented proposals for a single European supervisory mechanism, the first concrete step to a banking union. It suggested the ECB should be entrusted with supervision functions over all 6000 eurozone banks. National supervisors would still continue to play an important

role in day-to-day supervision and in preparing and implementing ECB decisions (European Commission, 12 September 2012).

The road towards a full-fledged banking union will be difficult. An efficient banking union should include four fundamental elements: banking regulations, supervision, resolution and a deposit guarantee scheme. Yet there are still many unanswered questions currently discussed between the EU institutions and the member states.

Although the final compromise is not yet known, it could be in Latvia's interests to join the common supervision mechanism. Latvia's supervision criteria are one of the strictest in Europe, so it would not significantly change the rules. However, it would make banks in Latvia more secure, especially given the growing risk posed by the rapid rise in non-resident deposits.<sup>2</sup>

## 2.5 GETTING BACK TO GROWTH

With the economies stagnating or even shrinking in many eurozone countries, also the government debts continue to rise. In the southern eurozone countries, it is possible to observe a clear downward spiral. Fiscal adjustment weakens the economies and their revenues are continuing to fall thus causing even further fiscal adjustment measures. There is also a negative link between the crisis in the southern eurozone countries and the more stable eurozone member states: both private sector and households are becoming more reluctant to invest and consume in the economically stronger countries as well (Darvas, 2012). The result is a slowdown or even regression in growth rates throughout the eurozone.

The EU's response to the growth crisis was the "Compact for Growth and Jobs", adopted on 29 June 2012. It contains many important structural reforms, including restructuration of banking sector, growth-friendly fiscal consolidation, restoring normal lending to the economy and completing the restructuring of the banking sector, modernising public administration, as well as the evaluation of the social consequences (European Council, 28/29 June 2012). A decision was taken to allocate 10 bn euros more to the European Investment Bank, thus increasing its overall lending capacity by 60 bn euros. This unlocked up to 180 bn euros of additional investment across the whole EU. It was also decided to start Project Bond pilot phase that was awarded 4.5 bn euros (European Council, 28/29 June 2012). However, these will have insufficient impact on the overall EU growth. Moreover, measures taken to improve competitiveness may take many years to have tangible effects. Improvements in product market competition usually have effect on growth in three to five years. Reforms in labour market can take even longer – from eight to ten years (Allen and Ngai, 2012).

<sup>2</sup> IMF has warned Latvia that "given the size of the sector, a sudden reversal of NDR flows, and the and the potential of contagion to resident deposits (largely denominated in foreign currency), represents a source of vulnerability to international reserves and a significant contingent fiscal liability (via sovereign backing for the deposit insurance system)". (International Monetary Fund, January 2013: 12)

Some of the eurozone peripheral countries are regaining their competitiveness. In 2010–11, exports were growing in all EU member states, with the exception of Greece and Finland. Notwithstanding positive tendencies, it is too early to conclude that the Southern eurozone member states have overcome their structural problems. For instance, in case of Spain, the GDP has shrunk by 0.5% and the unemployment level stands at 26.6%. The positive evolution of exports is not sufficient to compensate for the unfavourable evolution of domestic demand (European Competitiveness Report 2012).

In this context, it is unfortunate that the agreement reached by the Council on 8 February 2013 on the next multiannual financial framework provides less funding for economic, social and territorial cohesion (–8%). Many of the less developed regions will face a decrease in net cohesion funding compared to the current period. In this way, the gaps between various regions will persist and even increase; it will not be possible to achieve higher level of real convergence which is very important for a well-functioning optimum currency area. At the same time, despite the crisis, the administrative expenditure of the EU institutions is expected to stay at the same level (6% of the total budget) with a net increase of 4.5 bn euros. (Council, 8 February 2013)

### 3 BENEFITS AND RISKS OF THE EURO ADOPTION IN LATVIA

#### 3.1 EXPECTATIONS AND A REALITY CHECK

By joining the eurozone all the countries expect to enjoy a greater monetary stability, reduced transaction costs, decreased exchange rate volatility and lower interest rates. Nevertheless, in case of Latvia, there are also serious concerns regarding the eurozone current member states' ability to fulfil their own commitments and the fact that the eurozone still cannot be described as an optimum currency area.

Since autumn 2012 Latvia meets all the Maastricht criteria and therefore it is widely argued that now is the right moment to join the eurozone. On 4 March 2013, Latvian authorities requested the EC and the ECB to assess Latvia's readiness to join the eurozone. This fact together with declarations by the Polish Prime Minister Donald Tusk that Poland should re-launch membership preparations, have been perceived as a sign of confidence in the eurozone (Barley, 2013). Latvia is also considered as an example within the EU on how to overcome the crisis and create growth and stability (Daul, 2013). Latvia has made significant improvements to its regulatory environment and, according to World Bank, the quality of the business environment has improved substantially (World Bank, 2012). Discussions regarding euro adoption in Latvia mainly revolve around questions whether 2014 is the right time to join the eurozone and whether Latvia will join a stable and sustainable currency union; yet there is a risk

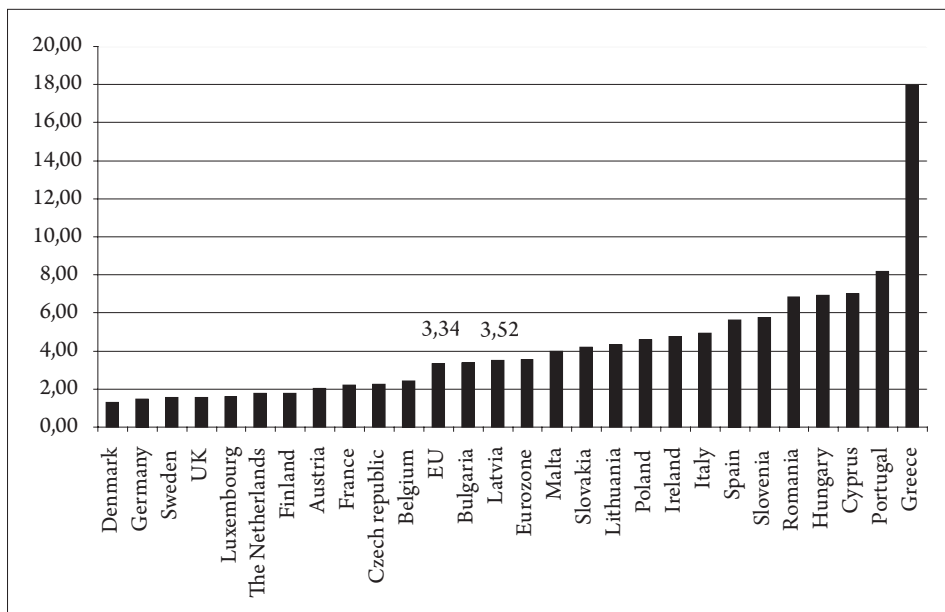
that proper foundation has not yet been laid for the eurozone to develop into such well-functioning currency union.

It is widely expected that by joining the eurozone conversion costs and risks would be reduced. The Bank of Latvia estimates that benefits from eliminating currency conversion costs will be around 330 million euros per year (Bank of Latvia, 2 November 2012). Euro is already the main currency used in international payments. In 2011, 59% of the payments for imported or exported goods and services were made in euro. Therefore, Latvian businesses face additional currency transfer costs that affect their international competitiveness. However, it is hard to predict whether the benefit will be greater for the companies that are exporting products and services or for the importing companies. While in 2012 the manufacturing sector was significantly fostered by the increased exports (17.7%) (Kasjanovs, 4 February 2013), joining the eurozone would also mean an increased competition from other eurozone countries. Trade has increased in all new eurozone countries; yet the increase has concerned mainly imports and has left a negative impact on the current account balance. Therefore, in order to benefit from reduced transaction costs, Latvia's exporting industries should be capable of exporting competitive products in great quantities to the European market. Otherwise, the major beneficiaries from the euro adoption would be importers.

The Bank of Latvia argues that euro adoption would also improve Latvia's credit ratings. While there is a high probability of a positive impact on the credit ratings if the euro will be adopted as planned, the opposite scenario, i.e. if Latvia would not be accepted in the eurozone, would most probably lead to a downgrade of its credit ratings. Bank of Latvia estimates that by staying out of the eurozone, Latvia would spend additional 900 million euro within the next 10 years to refinance the government debt (the difference would arise from lower interest rates: 2–2.5% instead of 5.5–6%) (Bank of Latvia, 2 November 2012).

Among the EU member states with the lowest bond yields are non-eurozone countries, i.e. Denmark, Sweden and United Kingdom (see Fig. 1). In the meantime, some of the eurozone countries have the highest bond yields in the EU, i.e. Greece, Portugal and Cyprus. It is not possible to establish a correlation between the fact of a country being the eurozone member state and its credit rating.

While fulfilment of the nominal convergence criteria is mandatory for joining the eurozone, it is also crucially important to achieve a certain level of real and structural convergence. Lack of doing so leads to higher costs of adopting the euro. Successful convergence could be achieved by a rapid increase of labour productivity and a remarkable export performance (Kolasa, 2010). The ECB recommends Latvia to ensure that it maintains the competitiveness that it had achieved in recent years by avoiding a renewed increase in unit labour costs. Additionally, it is important to rebalance the economy towards the tradable sector. The ECB also points to the fact that Latvia's labour market is characterised



Source: Eurostat

Fig. 1. Government bond yields in the EU member states, %

by high unemployment which coincides with skill mismatches and labour shortages in some sectors (European Central Bank, May 2012). Moreover, development of exporting industries is closely linked to the economic situation and demand in destination markets. The Bank of Latvia warns that Latvia is more than ever dependent on external market developments (Bank of Latvia, 1 February 2013). Unfortunately, given the continuous problems facing the eurozone and pessimistic consumer and business outlooks in major trade partner countries, a strong increase in external demand cannot be expected (Bank of Latvia, January 2013).

### 3.2 THE MAIN RISKS: SITUATION WITHIN THE EUROZONE AND LATVIA'S CONVERGENCE CAPACITY

After joining the eurozone, the GDP per capita increased in all countries including Estonia that achieved particularly good results. However, there is still a significant risk level and the GDP growth prognosis for 2013 has been lowered from 3.6% to 3% (Eesti Pank, 12 December 2012). By no means can it be accurately claimed that the increase in the GDP is a result of adopting the euro. Being a part of the currency union has provided an additional boost to the economies of the new eurozone member states; however, the cyclical development of economy has to be considered as one of the main factors influencing economic indicators, including the GDP.

All the new eurozone member states have experienced increased inflation (see table 1). However, the analysis of the inflation in the new eurozone member states after the adoption of the common currency shows that the inflation levels were not significantly higher than the normal inflation rates observed before.

Table 1

**Inflation % in the new eurozone member states**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Eurozone	2.2	2.4	2.3	2.1	2.2	2.2	2.2	2.1	3.3	0.3	1.6	2.7
Estonia	3.9	5.6	3.6	1.4	3	4.1	4.4	6.7	10.6	0.2	2.7	5.1
Greece	2.9	3.7	3.9	3.4	3	3.5	3.3	3	4.2	1.3	4.7	3.1
Cyprus	4.9	2	2.8	4	1.9	2	2.2	2.2	4.4	0.2	2.6	3.5
Malta	3	2.5	2.6	1.9	2.7	2.5	2.6	0.7	4.7	1.8	2	2.5
Slovenia	8.9	8.6	7.5	5.7	3.7	2.5	2.5	3.8	5.5	0.9	2.1	2.1
Slovakia	12.2	7.2	3.5	8.4	7.5	2.8	4.3	1.9	3.9	0.9	0.7	4.1
Latvia	2.6	2.5	2	2.9	6.2	6.9	6.6	10.1	15.3	3.3	-1.2	4.2
	Decrease after joining the eurozone											
	Increase after joining the eurozone											

Source: Eurostat

Besides, it is not possible to establish a clear causal link between the euro adoption and these economic developments. Without applying in-depth mathematical analysis it is hardly possible to establish whether the increase of inflation levels occurred in the result of joining the eurozone or due to cyclical economic factors. The EC and the Eurostat have evaluated the maximal price increase after the adoption of the euro in various countries. The increase varies from 0.20% (in Malta) till 0.50% (in Finland) (Bank of Latvia, January 2013).

There is, nevertheless, also a risk that inflation rate in Latvia might rise as a result of economic growth. It is important to remember that after Latvia's accession to the EU in 2004, excessive demand and credit growth combined with very strong wage increases and fluctuations in global energy prices lead to higher inflation and erosion of competitiveness. As a result of the recession and the adjustment that followed, the annual inflation rate became similar to the average inflation rate in Latvia's major trading partners (European Central Bank, May 2012).

The ECB Convergence Report (2012) predicts that maintaining low inflation rates at all times in Latvia will be challenging in the medium term, because the GDP per capita and the price level is still significantly lower than in the

eurozone. Labour and product market characteristics can also be very important in explaining inflation differentials, because they influence the dynamics of real wages and of the marginal cost of firms. These can be additional driver of inflation (Jaumotte, 2012).

Further analysis of the risks arising from the adoption of the euro can be done by using the theory of optimum currency area which stipulates that a precondition for a well-functioning monetary union is the synchronisation of the business cycles. Even the present eurozone member states do not meet this condition. On the one hand, countries like Germany, France, Belgium, the Netherlands and Luxembourg experienced highly synchronized business cycles. On the other hand, countries like Spain, Italy, Portugal, Ireland, and Greece had business cycles that were less correlated with the rest of the eurozone (Giannone, et al., 2009). The risk is that if the harmonisation does not take place between the eurozone and non-eurozone countries, the monetary policy carried out by the ECB could induce long term imbalances in the economies that are fluctuating at different rates. In the case of the new EU member states the highest average business cycle correlation with the eurozone (before the crisis) was observed for Hungary, followed by Slovenia and Poland. Latvia, along with the Czech Republic and Estonia showed significantly lower correlations (Gächter, 2013: 4). During the crisis, the largest cyclical swings were reported in the Baltic states, where the output gaps exceed 10% of potential GDP in certain time periods. This can be explained by the relationship between the size and openness of the Baltic states which are to a great extent reliant on external markets (Gächter, 2013).

The adoption of the euro can also foster emigration. If there would be an OCA with a high level of real convergence, labour mobility can be very good for its smooth functioning and shock absorption. However, in the case of the eurozone huge differences persist between countries and regions and are even aggravated by the crisis. These gaps in economic development incite people to migrate from the poorest eurozone regions to the more prosperous ones. The recovery of the regions of net emigration can be affected, especially in case if the youngest, most skilled and most enterprising parts of workforce emigrate. This is a particularly important concern for Latvia; since 2008 it has already lost almost 10% of its labour force (Krasnopjorovs, 28 January 2013).

When it comes to trade, it has increased in the all new eurozone countries. However, it is important to stress that the increase has concerned mainly imports and has left a negative impact on the current account balance. Thus, there is a risk that after the adoption of the single currency increase in import will exceed increase in export creating a negative trade balance. For example, in case of Estonia, its trade balance changed from -0.5bn euro in 2010 before joining the eurozone to -0.6bn euro in 2010 after euro adoption (Eurostat, July 2012).

Stronger bilateral trade relations might lead to more symmetric shocks across member states (Gächter, 2013). However, Latvia is already closely linked to the eurozone countries and in 2011 58% of Latvian external trade was with eurozone



countries or the countries that has a fixed currency rate with euro (European Central Bank, May 2012).

When applying the theory of optimum currency area, it can be seen that the structural readiness is the most important factor that determines countries' ability to benefit from the opportunities provided by the eurozone.

### 3.3 COSTS AND POLITICAL ASPECTS OF EURO ADOPTION IN LATVIA

The biggest costs of euro adoption will arise from the contributions to ESM. For instance, the Czech Republic has decided not to set a target date for joining the eurozone due to the rising costs in the expected contributions to bailout facilities (Barley, 2013). In case of Latvia contributions to the ESM will amount to 199 million euro, and will have to be covered in 5 payments. Moreover, after 12 years when the special conditions will cease, the contributions should reach 324 million euro (Rutkaste, 2012). The exact payment terms will be agreed when Latvia will join the eurozone. The total subscribed capital will be 1.4 bn euro. The payments made into the bail-out facilities have been seen as surprising among people in Estonia and now also in Latvia, because the largest recipient of the bail-out funding has been Greece (240 bn euro since 2010) whose economic indicators show that it might find some additional resources within its own economy. In 2011, GDP per capita in Greece was 15900 euro, while in Estonia only 9100 euro but in Latvia – 6400 euro (Eurostat, 13 February 2013). Average gross annual earnings of full-time employees in 2009 amounted to 29160 euro in Greece, 9492 euro in Estonia and 8728 euro in Latvia (Eurostat, August 2012). Minimum wages in January 2013 were 684 euro in Greece, 320 euro in Estonia and 287 euro in Latvia (Eurostat, January 2013). Meanwhile an equivalised net annual income (2009) in Greece was 11496 euro, in Estonia 6209 euro and in Latvia 5474 euro (Bílková, 2012).

The costs of euro adoption in the public sector will amount to 12.2 million euro. In the private sector, the direct costs of adopting the euro in other eurozone countries have been in the margins of 0.3 till 0.8% from GDP (Rutkaste, 2012).

It is important to emphasize that the geopolitical factor plays an important role when considering the euro adoption in Latvia. It, rather than economic indicators, has tipped the scale towards adoption of the euro. It is not a secret that Russia has been attempting to regain and increase its political and economic influence in the Baltic region, particularly in Latvia. Soviet occupation denied Latvia the possibility to be among the founding member states of the EU, therefore joining the eurozone would bring Latvia back to where it belongs – at the core of the European integration processes.

## CONCLUSIONS

- Countries that formed the monetary union did not meet the criteria of the optimum currency area. Almost one third of member states did not respect the criteria put forward by the Growth and Stability Pact outlining the maximum limit for government deficit and debt.
- There was no efficient surveillance mechanism and sanctions were never applied. Among other drawbacks, the eurozone had not established the exit procedure for countries that would breach the rules.
- Increased lending by German and French banks resulted in large external deficits in non-core eurozone countries, such as Greece, Spain and Portugal. Inconsiderate spending in these countries turned into a sharp economic recession.
- Governments and banks were deeply entangled through explicit and implicit government guarantees for the banks such as bailouts. In the result, problems with state finances would affect the banking sector and vice versa.
- The eurozone was not prepared for the crisis and there were no mechanisms to safeguard the financial stability. The solutions had to be found on *ad hoc* basis and with limited resources. Only in October 2012, the permanent European Stability Mechanism was inaugurated.
- Preventive and corrective steps to strengthen the GSP were taken. However, the effectiveness of the mechanism to resolve “excessive” macro-economic imbalances are yet to be tested.
- The ECB has found ways to intervene via Outright Monetary Transactions in secondary market for sovereign bonds. It aims to lower the borrowing costs of the eurozone countries affected by the debt crisis. Although this mechanism resulted in a positive market reaction, it can only temporarily alleviate the problem. However, the aims of securing both low inflation and low borrowing costs can be mutually incompatible.
- The EC has proposed the first step towards the establishment of a banking union – a single European supervisory mechanism. It is politically more acceptable decision than proposals to establish Eurobonds.
- Economic growth has slowed down in almost all eurozone member states and many of them are facing recession. The EU’s response to it has been the “Compact for Growth and Jobs”. While it contains many important structural reforms and growth-oriented measures, in the short-term perspective they will have insufficient impact on the overall EU economy.
- For Latvia, which has fulfilled the Maastricht Criteria, the euro adoption could generally bring positive results, yet there are also many risks associated with the development of the eurozone.
- In order to achieve sustainable future development of the eurozone, it is necessary to comply with the Growth and Stability Pact. Currently, there are

still several countries that do not comply with their deficit-reduction targets. It is a worrying signal for the sustainability of the eurozone.

- The trade sector will benefit from the elimination of currency conversion costs. However, it is hard to predict whether the benefits will be greater for exporting or importing businesses.
- There is no strong correlation between adopting the euro and higher credit ratings. Thus, it cannot be predicted whether the euro adoption will lower Latvia's bond yields. However, in case if Latvia will not join the eurozone, its credit ratings will most probably be downgraded. The most important factor that could improve Latvia's credit ratings in the long term is real and structural convergence. Therefore, it is necessary to increase labour productivity, maintain competitiveness and rebalance the economy towards tradable sector.
- Maintaining low inflation rates will be challenging, if steady growth is expected. At the same time it is difficult to predict whether the reason for increased inflation will be joining to the currency union or cyclical economic factors.
- The euro adoption is associated with significant costs including contributions to the ESM. People may not find it reasonable to bail out countries with higher GDP per capita than it is in their country.
- If the eurozone proves its sustainability by complying with strict budget discipline and rational public sector financing, it is in Latvia's interests joining the eurozone.
- Latvia's geopolitical situation is an additional rationale to join the currency union. The adoption of the euro would lessen Russia's influence and would give a clear political signal that is it a country that is fully integrated within the EU and at the core of the European integration processes.

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# STAKEHOLDER MANAGEMENT IN THE HOSPITALITY INDUSTRY – AN EMPIRICAL SURVEY OF THE STATUS QUO

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NICOLA ZECH\*

Doctoral Student  
University of Latvia, Riga

**Abstract.** Although Stakeholder Management has become a key discipline in Business Administration in various industries, it is still largely neglected in the most part of the Hospitality Industry. Based on a literature review on Stakeholder Management followed by its application to the Hospitality Industry and its characteristics, the analysis of web content in regard to the top ten international hotel groups was conducted. The findings reveal that Stakeholder Engagement is definitely recognisable among all hotel groups, while Stakeholder Relationship Management and Stakeholder Reporting still need to be professionalised for setting up a real competitive advantage in a highly competitive business environment.

**Key words:** Stakeholder Management, Stakeholder Relationship Management, Hospitality Industry

**JEL code:** M100

## INTRODUCTION

Organisations are facing an unprecedented rate of environmental change these days; among others due to globalization, dissemination of technologies and a movement toward market-based socioeconomic systems. More than ever the success and survival of an organisation depends on its ability to adapt to this change in environment. (Schneider, 2002) According to Wolfe and Putler (2002) “the purpose of Stakeholder Management is to facilitate our understanding of, and thereby our ability to manage within increasingly unpredictable external environments.” This is especially true for the Hospitality Industry. Nevertheless, literature reveals only few Hospitality Management approaches considering the Stakeholder Theory. The aim of this research is to analyse to what extent hospitality organisations currently integrate Stakeholder Management into their corporate management in order to professionally manage relationships between their organisation and its environment.

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\* Corresponding author – e-mail: [nicola.zech@zech-hotelmarketing.de](mailto:nicola.zech@zech-hotelmarketing.de), telephone: 0049 89 37066487, fax: 0049 89 37066489

The present paper presents an in-depth literature review on Stakeholder Theory followed by an introduction to characteristics of the Hospitality Industry. A content analysis identifies and describes Stakeholder Management patterns on web sites and in annual reports of the top ten international hotel groups. Subsequently a consideration is given to the status quo and to key success factors of Stakeholder Management in Hospitality Industry practice.

## 1 STAKEHOLDER MANAGEMENT

Whereas from the traditional perspective a company is seen as an economic entity, the stakeholder view sees it as a network of relationships among the firm and its stakeholders. Consequently, the stakeholder view does not attribute competitive advantage solely to the best way of adaptation to company environment by taking advantage of strengths and opportunities as well as by overcoming weaknesses and threats, but for the most part to superior linkages to stakeholders leading to trust, goodwill, reduced uncertainty, improved business practice, and ultimately higher firm performance. (Enz, 2010) While managers still think first about what the organisation wants and needs to generate profit, true Stakeholder Engagement implies understanding of what stakeholders value and view as important. (McEuen, 2011)

Even before questioning if stakeholders are managed right, it should be questioned if those are the right stakeholders who are managed. In 1963, the term “Stakeholder” was introduced in an internal memorandum of the Stanford Research Institute (now SRI International, Inc.). (Freeman, 1984) In 1984, R. Edward Freeman published his landmark book “Strategic Management: A Stakeholder Approach” and defined a stakeholder as follows:

“A stakeholder in an organisation is any group or individual who can affect or is affected by the achievement of the organisation’s objectives.” (Freeman, 1984, p. 46) “Stakeholders include employees, customers, suppliers, stockholders, banks, environmentalist, government and other groups who can help or hurt the corporation.” (Freeman, 1984, p. vi)

Organisations need to understand how far their stakeholders will go to achieve, promote, or protect their stake. A stake – by definition – may be:

- “An interest;
- Right (legal or moral);
- Ownership;
- Contribution in the form of knowledge or support.” (Bourne, 2009, p. 30)

Generally legitimate stakeholders are identified “by the existence of a contract, expressed or implied, between them and the firm.” (Donaldson & Preston, 1995, p.85) Stakeholder influence can be rated even more precisely by three elements as displayed in Fig. 1:

- Power: the ability to exercise one’s will over others;

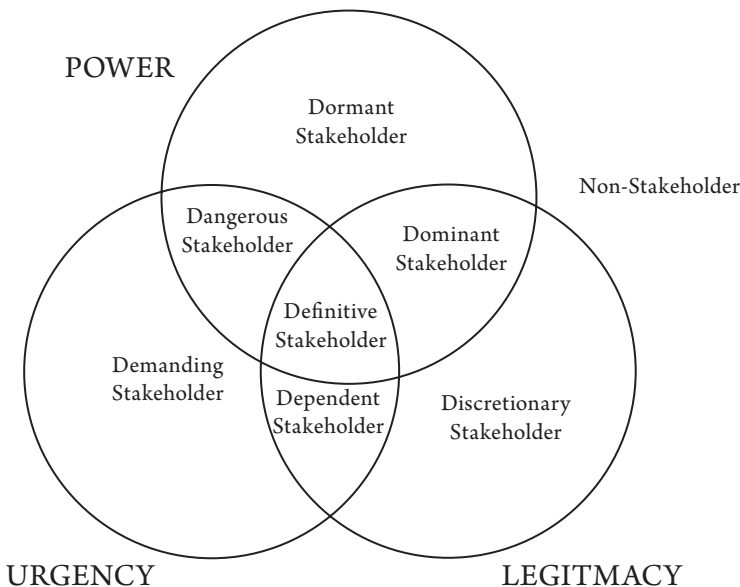


- Legitimacy: socially accepted and expected structures that help define whose concerns or claims really count;
- Urgency: the dynamics of the time-sensitive nature of stakeholder interactions. (Maignan, Ferrell, & Ferrell, 2005)

Stakeholder power implies a situation where the stakeholder can get the organisation to do something which it would not otherwise have done. Means of influence by stakeholders could be incentives, penalties, advice, etc. to varying degrees. (Céspedes-Lorente, De Burgos-Jiménez, & Álvarez-Gil, 2003)

Stakeholder Management is not static, but stakeholder's significance may change over time or depending on the related topic. According to Bourne (2009) "the process of identifying, prioritizing, and engaging stakeholders cannot be a once-only event. The work of managing relationships with stakeholders does not stop with planning. The nature and membership of the stakeholder community changes as the stakeholders:

- are re-assigned;
- leave the organisation;
- assume different levels of relative importance to the activity;
- experience fluctuations in their power, interest or influence."



Source: author's construction based on Mitchell et al. (1997)

Fig. 1. Stakeholder Typology

Also, managers often underestimate the complexity of stakeholder identification and solely consider the most obvious ones such as customers, owners/stockholders or government agencies and administration. (Sautter, 1999) This may possibly result in short-term salient Stakeholder Management. Managing an organisation based on a short-term salient stakeholder (who possesses all three attributes: legitimacy, power, urgency) orientation predominantly does not lead to sustainable corporate success. (Vilanova, 2007)

Key attribute of Stakeholder Management is simultaneous attention to the legitimate interests of all appropriate stakeholders in the establishment of organisational structures as well as in case-by-case decision making. (Donaldson & Preston, 1995) In other words: "Stakeholder theory is about managing potential conflict stemming from divergent interests." (Frooman, 1999, p. 193)

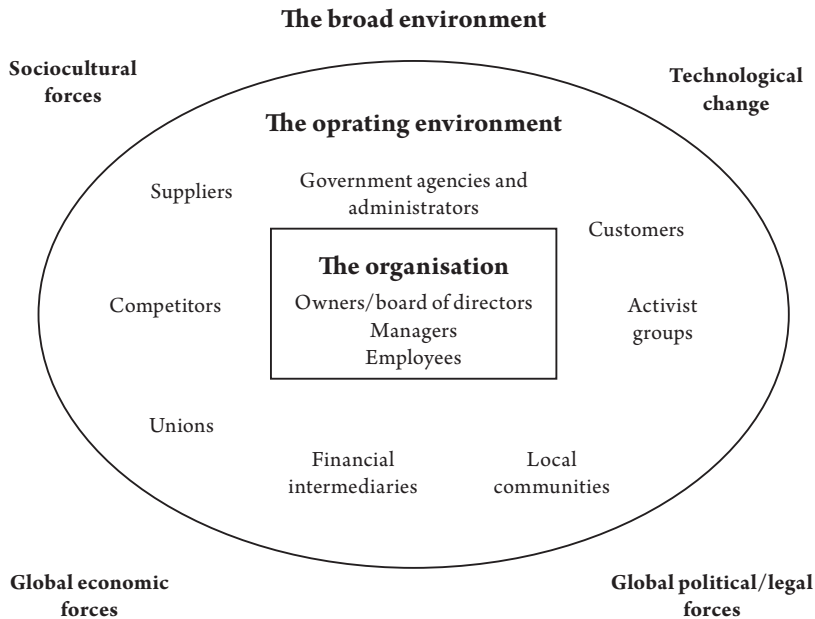
Classically, literature on Stakeholder Theory considers two branches: a strategic and a moral branch. (Buysse & Verbeke, 2003) As in recent times, a shift of marketing from consumer orientation to stakeholder orientation becomes apparent in most industries, this aspect will also be included in the subsequent reflection on Stakeholder Management. (Payne, Ballantyne, & Christopher, 2005) Organisational, Marketing and Relationship approaches to Stakeholder Management will be illustrated.

## ORGANISATIONAL APPROACH

Robert Philips (2003) claims that "organisations are dependent on their stakeholders for their success and their failures". In other words, in modern society organisations have become collective units who are more or less unable to realize independent action. (Astley, 1984) Therefore, a modern Stakeholder Management approach can be interpreted as obtaining "optimal benefits for all identified stakeholder groups, without giving priority to one stakeholder's interests over another. Under this philosophy, the entire purpose of the firm becomes the co-ordination of stakeholder interests." (Sautter, 1999, p. 314) Kotler claims that companies can no longer operate as self-contained, fully capable units without dedicated partners, but they are increasingly dependent on their employees, their suppliers, their distributors and dealers, and their advertising company. (Freeman, Harrison, Wicks, Parmar, & De Colle, 2010) In summary, Stakeholder Management goes well beyond the descriptive observation that organisations have stakeholders, but "it views the corporation as an organisational entity through which numerous and diverse participants accomplish multiple, and not always entirely congruent, purposes". (Donaldson & Preston, 1995, p. 70)

From an organisational perspective, the stakeholder environment is divided into three regions (see Fig. 2). "The broad environment (society, technology, economy, and political/legal) forms the context in which the firm and its operating environment exist. The firm has little or no influence over components of the broad environment. The operating environment consists of external stakeholders that influence the firm and over which the firm has some

influence. Finally, the internal organisation is made up of stakeholders with formal ties to the firm.” (Freeman et al., 2010, p. 105) The operating environment may be influenced by establishing inter-organisational relationships, e.g. joint ventures, networks, consortia, strategic alliances and trade associations. As managers generally do not have the time (nor other resources either) to pursue inter-organisational relationships with all external stakeholders, they need to concentrate on these stakeholder that are strategically important. (Enz, 2010)



Source: author's construction based on Freeman et al. (2010)

Fig. 2. **The organisation, its primary stakeholders and the broad environment**

Enz (2010) defines strategic management as follows: “A process through which organisations analyse and learn from their internal and external environments, establish strategic direction, create strategies that are intended to move the organisation in that direction, and implement those strategies, all in an effort to satisfy key stakeholders.” This implies that strategic management is a continuous process and must be done year-round, not just during regular planning meetings. (Freeman, 1984)

Much of the stakeholder research has been conducted at the organisational level with an emphasis on the Stakeholder Theory's organisational implications, but Stakeholder Theory can also be seen from a managerial point of view as it portrays managers as individuals balancing stakeholders' interests. (Reynolds, Schultz, & Hekman, 2006) This is opposed to the extremely popular shareholder concept as opposed in Fig. 3.

		<b>Shareholder management</b>	<b>Stakeholder management</b>
Key idea		Managers should maximize the wealth of shareholders	Managers should satisfy the interests of all (legitimate) stakeholders
Representation of firms	Nature of firms	Nexus of contracts or relationships between groups with conflicting objectives	
	Importance of management	Managers are key actors because they have residual control rights	
	Role of management	Managers are viewed as “hired” agents of shareholders and are in charge of day-to-day management in an incomplete contract framework. Managers can destroy shareholder value.	Managers are viewed as referees between groups with conflicting objectives. Managers can increase the aggregate value of the firm.
	Behavioural assumption	Self-interested and opportunistic agents.	The assumption of self-interested and opportunistic agents is overly simplistic. Agents can be organization-centred and altruist.
Optimal governance system		Control should be concentrated in the hands of shareholders	Control should be divided between the different (legitimate) stakeholders
Good governance practises		Control mechanisms limiting managerial discretion Incentive mechanisms aligning managers’ objectives with those of shareholders	The ones that increase the democratic representation of non-controlling stakeholders

Source: author’s construction based on Vilanova (2007)

Fig. 3. A comparison between Shareholder and Stakeholder Management

### MARKETING APPROACH

In general, marketing literature emphasizes customer orientation. Maignan et al. (2005) present a marketing concept which also considers other important stakeholder groups. Providing for both social and economic processes including a network of relationships supplying all stakeholders with skills and knowledge is fundamental for their logic of marketing. Marketing in the context of the Stakeholder Approach was defined by the American Marketing Association as follows: “Marketing is the activity, set of institutions, and processes for creating, communicating, delivering, and exchanging offerings that have value for

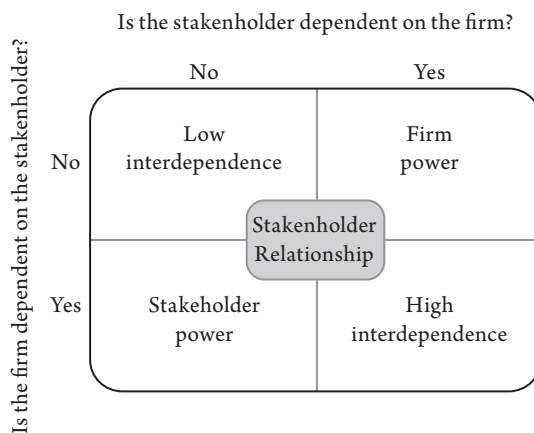
customers, clients, partners, and society at large.” (Marketingpower) A shift from customer orientation to stakeholder orientation (that is, a balanced perspective on stakeholder interests) gets obvious. Marketing supports constructing a cognitive image of the organisation by the perception and interpretation of presented organisational images. “When stakeholders perceive an overlap between their self-identity and the cognitive image they constructed of an organisation, they identify with the organisation.” (Scott & Lane, 2000, p. 48)

## RELATIONSHIP APPROACH

It is presumed that in the majority of cases “the enhancement of corporate relations with stakeholders and the incorporation of stakeholder concerns into the organisational strategy may also have a positive impact on the financial performance of the firms in question” (Céspedes-Lorente et al., 2003, p. 354). McEuen (2011) offers a veritable summary: “There is massive untapped potential in every stakeholder that a business touches. Consider what could happen if business leaders shifted their paradigm to think of their businesses as vehicles for unleashing the potential of people – whether these people are their employees, channel partners, or customers.”

Stakeholder Relationship Management includes the following strategic steps:

- “Identifying stakeholders,
- Understanding their expectations,
- Managing those expectations,
- Monitoring the effectiveness of Stakeholder Engagement activities,
- Continuous review of the stakeholder community”. (Bourne, 2009, p. 4)



Source: author's construction based on Frooman (1999)

Fig. 4. Classification of Stakeholder Relationships

A classification of stakeholder relationships is displayed in Fig. 4. The maturity of stakeholder relationships is particularly expressed in the level of mutuality. At best, “a partnership where both parties recognize and practice in an environment that is mutually beneficial; best described as a trusting/trustworthy relationship” (Bourne, 2009, p. 52) has progressed. An essential condition for building and maintaining promising stakeholder relationships is target communication. Key strategies in achieving an appropriate level of stakeholder communication means that stakeholders receive the information they require in a form they prefer. Effective means of communication are:

- progress reports;
- risk and issue action plans;
- financial reports;
- meetings;
- emails;
- formal letters;
- face-to face discussions. (Bourne, 2009)

If an organisation is truly considering interests of all stakeholder groups instead of the (economically) most important ones, it usually implements a CSR program as introduced in the following chapter. In large organisations, CSR might be issue and life cycle specific. Therefore individual business units preferably define their own CSR strategies. (Maignan et al., 2005)

## CSR

CSR stands for “Corporate Social Responsibility”. There still is no universally agreed upon definition for that in Business Administration. The European Commission defined CSR in 2001 as “a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis” (European Commission, 2011). In 2011, the European Commission revised the definition as “the responsibility of enterprises for their impacts on society. Respect for applicable legislation, and for collective agreements between social partners, is a prerequisite for meeting that responsibility. To fully meet their corporate social responsibility, enterprises should have in place a process to integrate social, environmental, ethical, human rights and consumer concerns into their business operations and core strategy in close collaboration with their stakeholders, with the aim of:

- Maximizing the creation of shared value for their owners/shareholders and for their other stakeholders and society at large;
- Identifying, preventing and mitigating their possible adverse impacts.” (European Commission, 2011)

The above listed definition elements show that CSR is closely linked to Stakeholder Management and therefore needs to be included into any systematic

Stakeholder Approach. The voluntariness is one of the key elements in CSR. Especially for SMEs, the CSR process is likely to remain informal and intuitive.

Related to Stakeholder Management, CSR creates a positive organisational reputation among stakeholders at best. The assessment of an organisation's success or failure has changed within the last decades: In an observer's perception shareholder value is not the only business driver any more, but "organisations are now expected to consider socially beneficial behaviours such as sustainability and corporate social responsibility as part of their mission and vision" (Bourne, 2009, p. 4). In other words, "CSR is defined as the responsibility of an organisation towards stakeholders (individual or groups) who may be overlooked or unfairly treated in the shareholder value model of organisational management" (Bourne, 2009, p. 37). Apart from that, a strategic approach to CSR can bring benefits in terms of risk management, cost savings, access to capital, customer relationships, human resource management, and innovative capacity. (European Commission, 2011) Competitive advantage can be expanded. A code of ethics "communicates the values of the corporation to employees and other stakeholders" (Enz, 2010, p. 646). Whenever the values of different stakeholders of a hospitality company are in conflict, a so-called ethical dilemma emerges. "Strategic managers are



Source: author's construction based on Carroll (1991)

Fig. 5. The pyramid of Corporate Social Responsibility

charged with the responsibility of providing long-term direction for their organisations, while balancing the competing interests of key stakeholders.” (Enz, 2010, p. 111) For instance, managers “experience pressure from shareholders to maximize the value of the firm at the same time that stakeholders such as governments, employees, clients, local communities, and ecologists demand that they strive for environmental protection” (Céspedes-Lorente et al., 2003, p. 334). This approach is supported by numerous experts who define Stakeholder Management as a sub item of CSR.

Carroll even took the next step creating a framework of “Moral Management of Organisational Stakeholders” by developing a pyramid of CSR which considers four kinds of social responsibilities. Fig. 5 shows that economic responsibilities build up the foundation of CSR. This implies that at any time organisations have to consider if they can respond to social issues and continue being economically viable. (Hillman & Keim, 2001)

## 2 STAKEHOLDER MANAGEMENT IN THE HOSPITALITY INDUSTRY

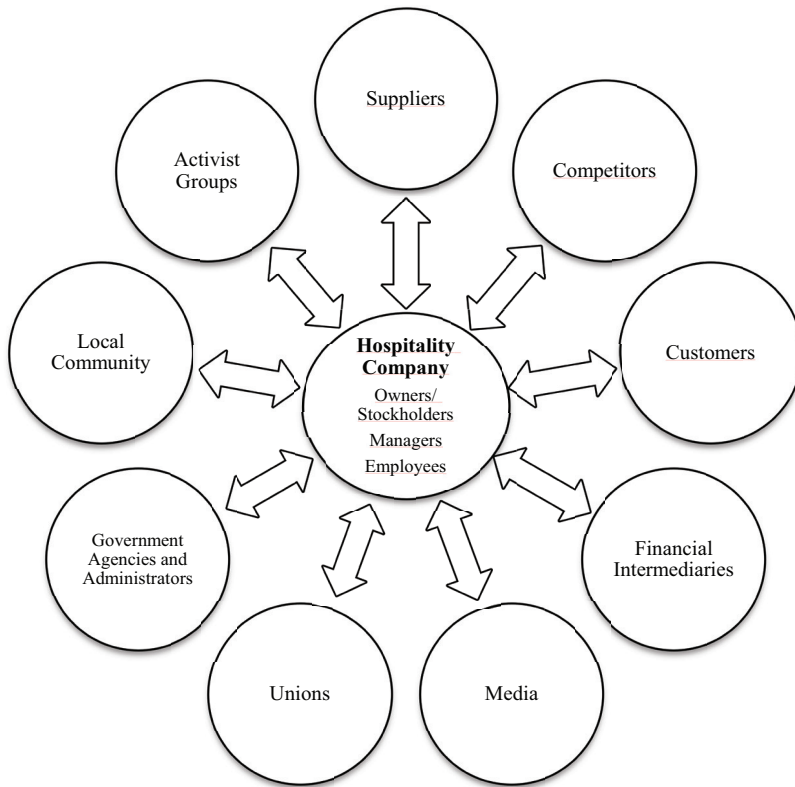
Based on the definition of industry as “a group of organisations that compete directly with one another to win customers or sales in the marketplace” (Enz, 2010, p. 650), Hospitality Industry is defined as “a group of businesses that welcome travellers and guests by providing accommodation, food and/or beverages” (Enz, 2010, p. 650). Most prominent representatives are hotels, motels, resorts, inns and related businesses.

Hospitality Management is characterized by the following attributes:

- service provider;
- location and destination development as unalterable key success factors;
- short product cycles in combination;
- high investments;
- (unpredictable) changing demand;
- lack of highly educated employees;
- limited resources in SMEs;
- high fluctuation rate;
- lack of theoretical background knowledge (“hospitality” vs. “management”);
- high competition.

Being part of the service industry, the Hotel Industry is naturally embedded in a stakeholder environment. Besides internal stakeholders, such as employees and managers who “produce” the hotel services, external stakeholders are unconditionally vital for a hotel company’s success. Fig. 6 outlines sample Hotel Industry stakeholder groups.





Source: author's construction

Fig. 6. **Hospitality Company Stakeholders**

The European Hospitality Industry is characterized by consisting predominantly of SMEs (micro, small, and medium-sized enterprises) implying that they have less than 250 employees and report an annual turnover of less than € 50 million or present an annual balance sheet total of less than € 43 million. (European Commission, 2005) For instance, approximately 98.3 per cent of businesses in the UK hotel and restaurant sector have less than 50 employees. Owing to recurrent shortage of labour, lack of skilled labour and limited resources, hospitality organisations often rely on “hard” financial information as opposed to holistic competitive benchmarking when forming performance measurement strategies. (Hwang & Lockwood, 2006) For instance, hotels compare room rates of perceived competitors without considering who their competitors really are in terms of geographical and services scope. A large part of small business owners do not see how and why they should build up partnerships with stakeholders or join organisations and networks. In addition, they may pay less attention to international customers and suppliers. (Buysse & Verbeke, 2003) Generally spoken, at the most, active involvement by the owner decides on

strategic success or failure of an SME. Vice versa, “membership of a hotel chain may alter the competitive strengths of an organisation, in that such membership may provide the affiliates with resources of knowledge, reputation and market power” (Céspedes-Lorente et al., 2003, p. 345).

Integrating stakeholder concerns into hospitality organisations may help to generate new points of view and lead to innovation. (Rueda-Manzanares, Aragón-Correa, & Sharma, 2008) McEuen (2011) reveals her strong conviction as follows: “To engage stakeholders in a manner that is meaningful and motivating requires an understanding of what they value and view as important.” In this context, she also uses the term “true engagement”. In the establishment of organisational structures, Stakeholder Management accordingly requires simultaneous attention to the legitimate interests of all appropriate stakeholders. (Donaldson & Preston, 1995) Even though organisations that are attuned to their stakeholders and devote resources to manage them seem to be rewarded financially and socially for this behaviour (Key, 1999), “strategic management is a continuous process, and even though discrete points in time must be chosen for the purpose of making a decision, it must be done year-round, not just during the yearly planning meetings” (Freeman, 1984, p. 85). Consequently, Hilton Hotels defines Stakeholder Management as follows: “Value creation is not just another program du jour. Instead, it requires a change in the corporate culture.” (Huckestein & Duhoff, 1999, p. 38) A trend towards intensified strategic alliances, joint ventures and subcontracting arrangements with stakeholders is notable. (Enz, 2010) “Stakeholders that have high economic or political power are likely candidates for an alliance, because such a partnership can reduce uncertainty in the external environment or enhance a firm’s ability to be a high performer.” (Harrison, 2003, p. 148)

## METHODOLOGY

This survey used a content analysis as a technique to identify and describe patterns in web sites as well as in annual reports. According to Collis and Hussey (2009) a content analysis is “a method by which selected items of qualitative data are systematically converted to numerical data for analysis”.

Web sites and annual reports of the top ten international hotel groups (see Table 1) have been analysed. Key terms in a supporting Google electronic media content analysis have been:

- [hotel group] stakeholders;
- [hotel group] annual report;
- [hotel group] stakeholder report
- [hotel group] csr report’.

Table 1

**Largest Hotel Groups in the World**

Ranking	Hotel group		No. Hotels	No. Hotel rooms
1	IHG	UK	4,480	658,348
2	Hilton Worldwide	USA	3,843	633,238
3	Marriott International	USA	3,537	617,837
4	Wyndham Hotel Group	USA	7,205	613,126
5	Accor	FRA	4,426	531,714
6	Choice Hotels	USA	6,203	502,460
7	Starwood Hotels and Resorts	USA	1,077	315,346
8	Best Western	USA	4,078	311,598
9	Home Inns (+ Motel 168)	CHI	1,426	176,562
10	Carlson Rezidor Hotel Group	USA	1,077	165,802

Source: author's construction based on *Breakingtravelnews* (2012)

**RESEARCH RESULTS AND DISCUSSION**

A matrix of the research findings is presented in Table 2. Key terms that were identified in the corresponding areas are marked with an X in the respective category.

Table 2

**Stakeholder Engagement Matrix**

		A	B	C	D	E	F
<b>IHG</b>	<a href="http://www.ihgplc.com">www.ihgplc.com</a>	X	X		X	X	X
<b>Hilton Worldwide</b>	<a href="http://www.hiltonworldwide.com">www.hiltonworldwide.com</a>			X	X		
<b>Marriott International</b>	<a href="http://www.marriott.com">www.marriott.com</a>			X	X		
<b>Wyndham Hotel Group</b>	<a href="http://www.wyndhamworldwide.com">www.wyndhamworldwide.com</a>			X	X		
<b>Accor</b>	<a href="http://www.accor.com">www.accor.com</a>			X			
<b>Choice Hotels</b>	<a href="http://www.choicehotels.com">www.choicehotels.com</a>			X	X		
<b>Starwood Hotels and Resorts</b>	<a href="http://www.starwoodhotels.com">www.starwoodhotels.com</a>			X			
<b>Best Western</b>	<a href="http://www.bestwestern.com">www.bestwestern.com</a>			X			
<b>Home Inns (+ Motel 168)</b>	<a href="http://phx.corporate-ir.net">http://phx.corporate-ir.net</a>						
<b>Carlson Rezidor Hotel Group</b>	<a href="http://www.carlsonrezidor.com">www.carlsonrezidor.com</a>	X	X		X	X	X

Source: author's construction

A = "stakeholder" is mentioned explicitly on the webpage

B = stakeholders are defined and listed

C = Stakeholder Engagement is mentioned indirectly on the webpage (either some or all stakeholders)

D = "CSR" (or related terms) is mentioned explicitly on the webpage

E = annual report cites "stakeholder"

F = annual report cites "CSR" (or related terms)

It becomes quite obvious that each of the top international hotel groups considers Stakeholder Theory as important – to varying extent. While 80 % of them mention their respective stakeholders or Stakeholder Engagement only indirectly, there are two hotel groups (representing 20 %) which explicitly refer to Stakeholder Engagement, including, in particular, the listing of their stakeholders. CSR and CSR Engagement is mentioned and defined by hotel groups far more often (60 %). Another term which is frequently used in this context is “Sustainability”. Obviously many hospitality organisations do not clearly distinguish between the meaning of Stakeholder Engagement, CSR and Sustainability. In addition, in some cases Stakeholder Engagement is used in the sense of a sub-item of CSR, in other cases, in the meaning of an equivalent term. Alerting is the fact that none of the researched companies publish a specific Stakeholder Report, and only two of them (representing 20 %) have dedicated one or several chapters to Stakeholder Management in their annual reports.

Of all the companies observed, IHG was the only one to provide exemplary detailed information on their Stakeholder Engagement. Besides a clearly structured online presence, they publish an annual CSR Report with a detailed outline of their Stakeholder Engagement. Similarly to IHG, the Carlson Rezidor hotel group conducts comprehensive Stakeholder Management and publishes a Responsible Business Report addressing its Stakeholder Engagement. The only international hotel group operating in the same manner and not included in the research list is Shangri-La.

Even if Hilton Hotels holds the opinion that a guarantee of success is “understanding the essential drivers of value [of individual stakeholders and stakeholder groups] and how to deliver against them consistently” (Huckestein & Duhoff, 1999, p. 28), they do not explicitly mention their Stakeholder Engagement either in their online presence or in their annual report. However they publish a CSR-driven “Hilton in the Community Foundation Annual Report”. IHG, Hilton and Choice Hotels demonstrate their Stakeholder Engagement indirectly by having installed vendor programs. (Enz, 2010) The annual reports of Marriott, Starwood and Home Inns are purely shareholder-driven.

Especially for SMEs, which are representing the majority of hospitality organisations, it seems most important to develop strong customer relationships. A Scottish Hotel Manager described this “customer focus” as follows: “Everything we do is because of our customer. We don’t do anything because we think it looks nice. It’s done because that is what the customer is going to want.” (Hwang & Lockwood, 2006, p. 431) Many of these and related processes are intuitive and informal in SMEs; e.g. feedback communication during check-out procedure, word-of-mouth communication, open-door-policy. In addition most hotels conduct measures such as sending Hotel or Brunch vouchers to frequent stayers or small presents to secretaries of business partners and to neighbours without even classifying these measures as Stakeholder Engagement.

## CONCLUSIONS, PROPOSALS, RECOMMENDATIONS

The Hotel Industry is facing fierce competition in almost all sectors. Therefore, it seems unreasonable that currently Stakeholder Management is – in the majority of hotel companies – not professionally embedded in the companies' organisational structure. For example, nowadays a decreasing percentage of hotel companies seem to publish Stakeholder Reports, an instrument widely spread among other industries. Stakeholder Communication and Relationship Management is mostly done by pure intuition without proper planning.

Reasons for the lack of the professional implementation of Stakeholder Theory may be seen in the still low academic education of hotel managers, insufficient time management and budgeting. Another obstacle to establishing long term Stakeholder Relationships and regular Stakeholder Communication is the usually high employee fluctuation rate which is not conducive to long-term dedication to true Stakeholder Engagement.

In summary, the status quo and key success factors of Stakeholder Management in the Hospitality Industry are as follows:

1. In the service sector context, professional Stakeholder Management may grant a solid competitive advantage for hospitality organisations.
2. Internationally operating hotel groups, for the most part, undertake Stakeholder Management but in most cases they do not assertively announce their engagement.
3. The first step in professionalising Stakeholder Management in Hospitality Industry should be the drawing and evaluation of a detailed Stakeholder Map followed by a Stakeholder Communication Plan considering means of communication, frequency, content, style, and others.
4. Consequently, regular and professional Stakeholder Reporting considering the GRI (Global Reporting Initiative) principles should be established.
5. SME hotel organisations should also be drawing and evaluating their stakeholder map. In addition, they should conceptualise at least some of their already existing intuitive actions.
6. Stakeholder Management should be considered in all of its approaches: organisational, marketing and relationship approach.
7. The "Global Code of Ethics" by the UNWTO World Tourism Organisation with its 10 principles to which tourism organisations' stakeholders may refer to may build up a helpful framework. (UNWTO, 1999)

The aim of this paper was to display the status quo of Stakeholder Management in the Hospitality Industry. The research – based on literature review and web content analysis – certainly had some limitations. First, website content is constantly changing. Therefore, the results represent a snapshot of the web content in October 2012. Second, the findings for the top ten international hotel groups can definitely not be generalized for the entire Hospitality Industry.

Third, the Stakeholder Engagement outlined on the web pages probably does not represent all the Stakeholder Management activities performed by the hotel groups. A more in-depth study considering a larger sample as well as more detailed information – obtained by means of questionnaires and interviews – seems advisable. This little-investigated field of research is a promising one for the highly competitive Hospitality Industry.

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LU Akadēmiskais apgāds  
Baznīcas iela 5, Rīga, LV-1010  
Tālrunis 67034535

Iespiests SIA "Latgales druka"