CHAPTER 24

Employee Ownership and Unions: Lessons From the Airline Industry

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The U.S. airline industry has, in recent years, offered some conspicuous examples of a phenomenon that has now become familiar, both in the U.S. and abroad, among firms that face economic difficulties: the granting to employees of a substantial ownership stake in return for wage and work rule concessions necessary to maintain the firm's viability. Jeffrey Gordon has given us a close look at these transactions, which he refers to as "transitional" uses of employee ownership.[1] Although he is not the first to examine the potential virtues of employee ownership in economically troubled firms,[2] his analysis is particularly comprehensive and his discussion of the specific developments in the airline industry is uniquely thoughtful and well informed.[3]

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[1] Jeffrey Gordon, Employee Stock Ownership in Economic Transitions: The Case of United Air Lines, chapter 23 in this volume.

[2] See, for example, Keith Bradley and Alan Gelb, Worker Capitalism: The New Industrial Relations (1983).

[3] In the essay included in this volume, Gordon has chosen United Air Lines as his principal example. Elsewhere, Gordon has also explored in detail the transactions that led to large employee ownership stakes in other leading U.S. airlines during the same period. See Jeffrey Gordon, Employee Stock Ownership as a Transitional Device: The Case of the Airline Industry, in The Handbook of Airline Economics (Darryl Jenkins ed., 1995).

§24-1. ALTERNATIVE CONTEXTS FOR EMPLOYEE OWNERSHIP

As a means of putting into sharper relief some of the issues presented by employee ownership in the airline industry, I want to draw two types of distinctions concerning the contexts in which employee ownership appears.

To begin with, although Gordon considers four different types of "transition problems" that can be addressed by employee ownership, I would like to focus on a simpler distinction between two fundamentally different ways in which employee ownership can be used to solve contracting problems between a firm and its employees. The first of these is what I shall refer to as the *transactional* use of employee ownership. Here, employee ownership serves as a bargaining chip — something of value that can be given to employees in exchange for concessions they give to the firm. The focus is on overcoming a bargaining problem that is obstructing a particular one-time transaction. This contrasts with the second role that employee ownership can serve, which I shall refer to as the *relational* use of employee ownership. Here, employees are granted an ownership stake in order to achieve a permanent restructuring of the relationship between the firm and its employees that will establish more efficient labor relationships over the long run.

The other important distinction I would like to make — whether we are dealing with transactional or relational uses of employee ownership — is between those contexts in which the employees involved are unionized and those where they are not. In all of the recent transactions in the airline industry in which employees were granted an ownership stake, including in particular the restructuring of United Air Lines, the employees were represented by strong unions. But unions of this character are becoming increasingly uncommon in U.S. industry. Therefore, the relationship between employee ownership and unionism — which is a very close relationship in the airline industry — is important to understand.

§24-2. THE TRANSACTIONAL USE OF EMPLOYEE OWNERSHIP

As Gordon points out, the most conspicuous role that employee ownership has played in the airline industry is as a means of resolving a potential impasse in bargaining: concessions in wages and work rules were needed from the airlines' employees if the firms were to remain competitive, yet the employees were very reluctant to grant those concessions. Gordon does a nice job of describing the important advantages of offering the employees an ownership stake in these circumstances. To begin with, management's willingness to offer stock is credible evidence that givebacks are truly necessary for the firm's health. Further, stock ownership guarantees the employees that if the firm succeeds as a result of the concessions, they will receive a well-defined proportion of the resulting gains. And if continued participation in ownership proves unattractive once the crisis has passed, the employees remain free to sell their ownership stake and reinvest their funds elsewhere.

There would have been no bargaining impasse to overcome, however, and hence no need to grant employees a stake in ownership, if the employees involved had not long been represented by powerful unions that had in the past extracted very generous wages and working conditions and that were capable of protecting those generous terms by credibly threatening the airlines' viability. Had United's employees — and particularly their pilots — never been unionized, then presumably there would have been much less need for givebacks to begin with, and whatever recontracting was needed would probably have occurred on an individual basis, with some employees being laid off and others accepting reductions in salary and changes in work rules without receiving any meaningful share in ownership in exchange — more or less as happened at Delta.

In short, the employee ownership stake at United was extracted by unions in order to protect terms that had been extracted by those unions earlier. The efficiency and fairness of granting the employees a stake in ownership as a transactional expedient therefore depends on the efficiency and fairness of the labor relations established through unionization. Before exploring the latter question, however, let us look briefly at the relational use of employee ownership in the airline industry.

§24-3. THE RELATIONAL USE OF EMPLOYEE OWNERSHIP

Gordon also emphasizes that employee ownership may be helpful in improving the efficiency and fairness of labor contracting in the airline industry on an ongoing basis. In this regard, he makes brief mention of the potential incentive effects of giving employees a visible stake in the firm's net earnings: such a stake might mitigate the problem of employee moral hazard — that is, reduce incentives for inefficient shirking. Yet Gordon devotes little attention to this possibility — a possibility for which, in any case, the theoretical and empirical support is rather mixed.[4] Instead, Gordon devotes most of his attention to the potential role of employee ownership in mitigating problems of strategic bargaining between the firm and its employees in the future. As he points out, employee ownership might serve such a role both by improving information flows between the firm and its employees and by changing the economic stakes for the employees.

Again, however, the problem that employee ownership is being used to solve here is in large part a consequence of unionism. If the employees were not unionized, then the potential pathologies of strategic bargaining under incomplete information — which include a bargaining process that is costly owing to strikes and lockouts, as well as bargains that are costly because their terms do not reflect a joint optimum between the interests of the firm and those of its employees — would arguably not be a threat to begin with. The employees would not be in a position to bargain strategically without a union.

Thus, whether we are looking at the transactional or the relational use of employee ownership, the virtues that Gordon sees in employee ownership lie largely in its ability to resolve bargaining problems that arise under unionism. This necessarily leads us to ask what role unionism is playing in the airline industry to begin with. If unions are themselves a response to inefficiencies or unfairness in labor contracting that would appear in the absence of unions, then it may be that unions with employee ownership are superior not only to unions without employee ownership but also to the other two obvious alternatives, which are (1) employee ownership without unions and (2) neither unions nor employee ownership.

§24-4. WHY DO PILOTS NEED COLLECTIVE REPRESENTATION?

In addressing this latter issue — the potential efficiency and fairness of labor contracting in the absence of unions — I shall focus, for simplicity,

[4]See Douglas L. Kruse and Joseph R. Blasi, Employee Ownership, Employee Attitudes, and Firm Performance, chapter 25 in this volume.

just on pilots. Although, in the United transaction, the members of United's machinists' union were also ultimately given an ownership stake, the airline's 7,000 pilots were the driving force behind the transaction, and during the first six years in which there was serious bargaining for employee ownership it was only the pilots who were seeking a share in ownership — against the strong opposition of the machinists, in fact, for most of that period. Moreover, the pilots are an unusual group of employees, and their role in employee ownership throws the institution into strong relief.

Gordon points out that, absent some structure such as employee ownership or unionism for collective representation of employees, labor contracting may be subject to inefficiencies. The principal problem he focuses on in this regard is the need to protect employees' firm-specific investments. As employees go, however, airline pilots seem to be characterized by uniquely low levels of firm-specific investments. The skills that pilots offer, though substantial, are apparently quite general: if a pilot is capable of flying a 747 for United, presumably he is just as capable of flying one for American or Northwest, and he is therefore just as attractive to them as an employee as he is to United. Moreover, pilots are uncommonly free in not having their place of residence tied closely to their place of work, so that they can change employers without changing their residence and losing thereby whatever specific invesments they and their family have made in their home and in their ties to the local community. Consequently, pilots seem to present no meaningful potential for opportunistic exploitation of firm-specific invesments, and thus no need for special structures — whether unionism or employee ownership or both — to protect such investments.

The reverse is also true. Airlines do not need to make specific investments in their pilots that would be subject to expropriation by the pilots. The skills that pilots offer are quite standardized, and all large airlines employ many pilots with the same sets of skills. United, for example, presumably employs many hundreds of 747 pilots of more or less equal abilities. Moreover, as Gordon points out, those skills are generally acquired in large part before the pilots begin to work for the airlines.

In short, airline pilots are, as workers go, essentially commodities. One would therefore expect a free labor market for pilots to be quite efficient, with pilots being hired (and fired) at wages that closely reflect their marginal product. Of course, though such contracting would presumably be efficient, there might be objections to its fairness. Perhaps pilots should be given a share in the economic rents, if any, that airlines experience just as a matter of justice, rather than being driven down — owing to their commody-like character — to a wage that just reflects their marginal product. Yet, however compelling such an argument might be for other forms of commodity labor — which is generally unskilled labor that is very poorly paid — it does not have much power in the case of airline pilots, who even in a free labor market would presumably earn a wage very far above the median family income for work of substantial interest that is performed under conditions that are not onerous and that brings considerable status.

It is therefore difficult to explain unionism among airline pilots as a response to potential inefficiency or distributive unfairness in labor contracting. Why, then, are pilots unionized, and how do pilots' unions manage, as seems the case, to extract substantial rents from the airlines? The reason seems to be simply that unionization gives pilots extraordinary bargaining power. Airlines are highly vulnerable to strikes, since airlines produce a non-storable service, have high fixed costs, and need a reputation for reliability if they are to attract the many customers who need to reserve flights well in advance. Pilots, being crucial to the operation of an airline, are in a uniquely good position to shut it down quickly and completely if they act together. And since pilots are a highly homogeneous group of workers, they are relatively easy to organize for collective action.

Thus, pilots have both the incentive and the ability to extract rents through unionization. Among these rents, apparently, were the high seniority wages that United's older pilots had been receiving. One consequence of those seniority wages was that if one of United's pilots were to leave United to take a job at another airline, he would enter at the bottom of that other airline's seniority ladder and thus be paid much less than he had been receiving at United. This should not, however, be mistaken for a firm-specific investment that the pilots have made in United whose value needs to be protected for the sake of efficiency. Rather, it appears that those seniority wages were in fact just economic rents — amounts which did not have to be offered to the pilots to attract them to their jobs initially, and whose loss would not cause them to leave the industry.[5]

[5]As a means of extracting rents, cash payments such as seniority wages at least have the advantage that they are relatively efficient (that is, non-distorting). The pilots had evidently also succeeded in extracting rents in less efficient ways as well, however, such as through inefficient work rules, or even by inducing the airline to purchase excessively expensive aircraft or to maintain unremunerative routes simply because pilots wanted to fly them.

§24-5. CONCLUSION

Most of the advantages of employee ownership that Gordon points to — whether in the transactional or the relational use of employee ownership — derive, as we have noted, from its ability to mitigate the inefficiencies of, and to protect the distributive consequences of, unionism. It follows that, while employee ownership in the airline industry may represent an improvement in efficiency over the previous state of affairs, it may nevertheless involve substantial inefficiency. To begin with, the unions remain in place and powerful at those airlines, including United, that have granted substantial ownership to their employees. Moreover, employee ownership itself brings some evident inefficiencies. On the financial side, it brings high levels of risk and capital illiquidity to the participating employees. And, to the extent that (as in United Air Lines) ownership involves a substantial employee role in governance of the firm, the evidence suggests that it threatens to yield expensive and skewed decision-making as well.[6]

At least so far as the pilots are concerned, then, employee ownership arguably just involves adoption of one inefficient contracting structure to mitigate the inefficiencies of another. This implies that efficiency, and perhaps even equity, would be better served if both were eliminated. This is a rather negative conclusion, to be sure. Yet, in the end, Gordon does not give us much argument or evidence to support a different conclusion.

To be sure, there are more than just pilots involved in employee ownership at United Air Lines. In particular, the members of United's machinists' union — which represents most of the rest of United's employees — also ultimately received a substantial share in ownership. Yet, while this complicates the issues involved, it arguably does not change the big picture.[7] Absent the union, those employees probably would not have been

[6]See Henry Hansmann, The Ownership of Enterprise, chs. 5 & 6 (1996); Henry Hansmann, When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy, 99 Yale Law Journal 1749 (1990).

[7]For some further thoughts about the United Air Lines employee buyout in this connection, see Henry Hansmann, The Ownership of Enterprise 117-18 (1996). As noted there, the prognosis for the long-term success of employee ownership at United Air Lines would arguably be much better if, as was originally intended, the pilots had obtained sole ownership of the firm without the participation of the machinists.

given a share in ownership. And the affirmative efficiency and distributional case for unionism among those employees, while more complicated than that for the pilots, is not clearly much more compelling.

The strong unions that are found among the leading airlines are largely a legacy of the days in which those firms were protected by extensive price and entry regulation. The future of the industry may now lie with those firms, such as Southwest, that are not unionized. Such a prognosis is consistent with the declining role of unionism in other industries. But if that prognosis is accurate, then employee ownership in industries such as air transportation may be transitional in a slightly different sense from that suggested by Gordon — namely, in easing the transition from unionism to non-unionism. Once unionism is gone, employee ownership — and particularly employee participation in governance — may disappear as well.

It is too soon, of course, to be certain of this. United Air Lines, with its substantial employee participation in both earnings and control through a complex and innovative ownership structure, is a bold experiment. That experiment may yet demonstrate that such extensive employee ownership has great strengths — beyond merely mitigating some of the most troubling consequences of unionism — even in large and complex firms such as airline companies, and not just in the relatively simple service firms to which true employee ownership has heretofore been largely confined. We can only say at this point that such a result would be surprising.

CHAPTER 25

Employee Ownership, Employee Attitudes, and Firm Performance: A Review of the Evidence

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§25-1. INTRODUCTION

Employee ownership of companies has attracted considerable attention in the business, labor, public policy, and academic communities over the past two decades. There has been substantial growth in employee ownership over this time. Much of the growth in employee-owned stock in the U.S. has come through Employee Stock Ownership Plans (ESOPs, first given recognition and special tax treatment as a form of pension plan by ERISA — the Employee Retirement Incomes Security Act of 1974), but there has also been considerable growth through other types of plans.[1] In addition, there has been strong interest overseas in employee ownership as one form of employee financial participation scheme, and a component of privatization programs as in the case of the Russian Federation.[2]

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[1]M.Conte and H. Lawrence, ESOPs, in Trends in Pensions 1992 135-48 (J. Turner and D. Belle eds., 1992; J. Blasi and D. Kruse, The New Owners 1991).

[2]J. Blasi, Russian Privatization: Ownership, Governance, and Restructuring, in Russia: Creating Private Enterprises and Efficient Markets (Ira W. Lieberman and John