The Japanese Economy and Corporate Reform: What Path to Sustainable Prosperity?

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The collapse of Japan's bubble economy in 1990 and the persistence of recessionary conditions in the 1990s have raised doubts about the viability of the 'Japanese model', particularly in the West but increasingly in Japan as well. This paper argues that Japan's economic problems—unemployment, unstable banks, underconsumption and underfunded pensions—are largely the direct results of the nation's rapid and successful economic development in the previous four decades. An understanding of the transition of the Japanese economy from the boom of the 1980s to the stagnation of the 1990s is essential for assessing how the institutional foundations of Japanese economic development can be reformed to generate economic growth that is both stable and equitable over the next generation.

1. *Japan's Economic Problems*

In the 1980s, as Japan reaped the rewards of its extraordinary economic development of the post-World War II decades, companies around the world sought to learn from Japanese managerial practices. Even as in the United States financial interests, including a growing number of corporate CEOs, were more aggressively advocating 'maximization of shareholder value' as a managerial ideology, within American industrial corporations, slogans such as 'total quality management' also vied for attention (Goldstein, 1997). But the collapse of Japan's bubble economy in 1990 and the persistence of recessionary conditions during the 1990s have raised doubts about the viability of the 'Japanese model', particularly in the West but increasingly in Japan as well. Japan's negative rates of economic growth in 1997 and 1998

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have prompted calls for Japanese corporations to embrace the corporate governance principle of maximizing shareholder value.

Most vocal have been the foreign investment bankers, business analysts and management consultants whose presence in Japan has been much increased, and influence much enhanced, by their involvement in 'Financial Big Bang'. Foreigners accounted for a record high of more than 40% of trading value on the Tokyo Stock Exchange in fiscal 1998 (*Nihon Keizai Shimbun*, 1999c), and increased their holdings of outstanding stocks from a pre-bubble high of 6.3% in 1985 to 9.8% in March 1997 and 13.4% in March 1998 (Furukawa, 1998; Tokyo Stock Exchange, 1998, p.115). During the winter of 1999, announcements of significant staff cuts by some major Japanese corporations kindled the hope among the expatriate financial community that Japan would at long last shed its 'retain-and-reinvest' system of corporate governance, based on the institutions of lifetime employment and cross-shareholding, and opt instead for a 'downsize-and-distribute' regime. Much of the 20% rise in the Nikkei 225 stock index during the first three months of 1999 was attributed to stock purchases by foreigners who, inspired by the exuberance of the foreign press over planned staff cuts by major Japanese companies, believed that a new era of corporate restructuring was at hand (Strom, 1999).

Under a retain-and-reinvest system, a corporation emphasizes the retention of corporate revenues for the purpose of reinvesting in the physical and human resources of the enterprise. Such investments, when successful, generate an augmented stream of revenues that can increase the returns to stakeholders while still permitting renewed investment. Retain and reinvest is the normal orientation of a corporation when it is growing in scale and scope. Indeed, a new venture that seeks to transform itself into a going concern typically has no other choice. But an enterprise that has already experienced sustained growth can, if it so chooses, downsize its operations—which generally means shedding labor—and distribute corporate revenues in the forms of dividends and stock repurchases to shareholders.

When, in the 1990s, Western financial analysts called for Japanese companies to engage in 'corporate restructuring', they were really advocating a change in corporate strategy from an emphasis on retain and reinvest to a focus on downsize and distribute. For example, in March 1999, Alexander Kinmont of Morgan Stanley Japan opined: 'If Japanese firms conduct drastic restructuring as they have announced so far, the Nikkei index will rise to as high as 18,000 points toward the end of this year. Otherwise, it will waver in the 15,000s' (Shimizu, 1999). A strategist at Merrill Lynch Japan, commenting on the continuing net stock purchases by foreign investors, stated: 'Foreigners are probably encouraged by the recent restructuring efforts of

Japanese companies, which involve staffing cuts, a measure rarely employed in the past' (*Nihon Keizai Shimbun*, 1999d,h).

The fact is that Japan has experienced serious economic difficulties throughout the 1990s that, if not remedied, could plunge the nation, the region and even an already fragile global economy into depression. As in other advanced economies, the resource-allocation strategies of established corporations are central to resource allocation in, and the economic performance of, the economy as a whole. In a world of industrial and corporate change, the issue is not whether Japanese corporations should alter the ways in which they allocate resources and returns. What is at issue is the principle of corporate governance that determines for whom, by whom and in what ways such reallocations are carried out.[1]

Japan's current economic problems are well known. When the rate of unemployment reached 4.9% in June 1999, it was the highest level that had been recorded since the compilation of monthly statistics began in 1953. There were 3.3 million people unemployed in June 1999, 450 000 more than 12 months earlier. Among the unemployed in June 1999, a record 1.18 million people had left jobs involuntarily, as their former employers went bankrupt or restructured (*Nikkei Weekly*, 1999c).

An unemployment rate of under 5% is low by the standard of cross-national experience but high by the standard of Japan's experience over the last half-century. Most worrying is the fact—much noticed and indeed acclaimed by the proponents of shareholder value—that a number of Japanese corporations that were central to the nation's phenomenal postwar development were in the late 1990s making significant cuts in employment.

Meanwhile the banking system, which played a major intermediary role in the mobilization of financial resources that enabled Japanese businesses to grow and prosper, has found itself in the 1990s burdened with mountains of bad debt. The recent efforts to restore the liquidity of, and confidence in, the banking system have been at the significant cost of curtailing credit to many businesses that desperately need infusions of funds to keep people productively employed. Over the course of 1997 and well into 1998 increasing numbers of bankruptcies of companies with more than ¥10 m. in liabilities were attributed to the unavailability of bank credit (Ishibashi, 1998; *Nikkei Weekly*, 1998). Government intervention helped to reduce these numbers during the last quarter of 1998 and into 1999, but in historical perspective bankruptcies remained high (*Nikkei Weekly*, 1999b).

That, throughout the recessionary conditions of the 1990s, modest growth

[1] For a perspective on the corporate governance system as the institutions that influence the corporate allocation of resources and returns, see O'Sullivan (2000a,b).

in household earnings was maintained, and that, at the end of the 1990s, the rate of unemployment is still as *low* as it is, means that there is still plenty of consuming power in the Japanese economy. But, with rates of household savings out of disposable income about 13% during the 1990s, much of this potential demand was not being translated into effective demand. In a developing or inflationary economy such abstemious consumer behavior is much admired. But in the current recessionary conditions, higher savings rates mean less consumer demand to prime the pump that can get the springs of prosperity flowing again.

Of longer-run importance to the achievement of sustainable prosperity in Japan is the problem of maintaining the disposable incomes of people who do not have employment incomes to translate their consumption needs into effective demand. In Japan the current problem is much less poverty-stricken armies of unemployed and unable—although the encampments of the homeless in Shinjuku Station provide very real and visible examples of what at the end of the twentieth century is possible even in Japan. Rather it is much more the problem of supporting the world's most rapidly aging population. The proportion of the Japanese population aged 65 or older increased from 5% in 1950 to 15% in 1995, a period during which the proportion of the US population aged 65 and over rose from 8% to just over 12%. In 1995 Japan's elderly population was still a smaller proportion of the total than in most Western European nations. But, with the elderly rate expected to rise to 20% by 2010 and 25% by 2020, Japan will have the most aged society in the world within the next generation (Bosworth and Burtless, 1997, p.11; *Nikkei Weekly*, 1997b, p. 143; Seike, 1997, p. 152).

Driving this rapid aging of Japanese society is a combination of longer life expectancies and declining birth-rates. In 1955, on the eve of the era of high-speed growth, average life expectancy at birth was 64 years for a Japanese man and 69 years for a Japanese woman. By 1987 these figures were 76 years for men and 81 years for women—the highest average life expectancies in the world, a distinction that Japan still maintains (Statistics Bureau, 1989, p. 55). Meanwhile, the birth-rate has declined persistently, reaching a record low of 1.39 in 1997, down from 1.50 in 1990. The Japanese birth-rate has plunged so low that since 1995 the absolute number of births per year have been lower than at anytime since records began to be kept in 1899 (*Nikkei Weekly*, 1997a, p.142).

These demographic trends have generated a long-run problem of intergenerational dependence. In 1990 17% of the Japanese population were in the 20–29 age group, while only 12% were in the 60–69 age group. The proportion of the younger group rose to 19% in the mid-1990s but will

decline steadily into the early decades of the next century. Around 2005 the proportions will be about equal at between 15 and 16%, but then the proportion of the older group will become increasingly greater than the proportion of the younger group. In 30 years, it is expected that the proportion of those receiving government pension payments will increase to over 40% from the current 20%. Yet, already in Japan, recessionary conditions have forced the government, corporations and life insurers to reduce the levels of old-age pension benefits and increase the ages of eligibility for receiving these benefits from those that had earlier been promised (Ogura, 1994, pp. 146–148,170; Suzuki, 1996; Seike, 1997, p. 153).

Indeed, a major objective of Financial Big Bang, launched in 1997 and still ongoing, is to transform the Japanese financial sector into a highly efficient machine for financial asset management that can generate higher returns on the nation's massive retirement savings. Toward that end, Financial Big Bang regulatory reforms have enabled various types of previously specialized financial institutions to enter into each other's lines of business, permitted the setting up of financial holding companies, given unrestricted access of households to foreign exchange, opened the doors for the integral involvement of foreign financial enterprises in the management of Japanese financial assets, and, most recently, facilitated the privatization of pensions by supporting the growth of stock-based mutual funds (Ishizawa, 1997; Shimizu, 1997). Given the extremely low rates of returns on corporate securities in Japan, including a dividend yield rate on First Section TSE stocks that has remained below 1% since 1985 (Tokyo Stock Exchange, 1998, p. 114), the generation of higher returns on Japanese corporate securities offers a prime means for increasing the rate of return on household savings. Largely through these market-oriented changes in the organization and orientation of Japan's system of saving and pension provision, the ideology of 'maximizing shareholder value' has been introduced into the Japanese corporate governance debates.

2. *Origins of the Current Economic Problems*

Cogent proposals for reforming Japan's system of corporate governance to generate sustainable prosperity require a perspective on the postwar development of the Japanese economy that can explain the relation between nation's phenomenal success from the 1950s to the 1980s and its economic problems in the 1990s. Japan's economic problems of the 1990s—unemployment, unstable banks, underconsumption and underfunded pensions—are largely the direct results of the nation's rapid and successful economic development in

the previous four decades. An understanding of the transition of the Japanese economy from the boom of the 1980s to the stagnation of the 1990s is essential for assessing how the institutional foundations of Japanese economic development can be reformed to generate economic growth that is both stable and equitable over the next generation.

Although some of the conditions for Japan's postwar success—in particular its accumulation of technological knowledge and skill—go back to the Meiji era, the basis for its rapid catchup to the United States and Europe in the postwar decades was its ability to develop and utilize productive resources to become a world leader in a range of technology-intensive industries (Lazonick, 1998b). The Japanese corporations that led this development process did so by continuously reinvesting in plant, equipment and people to generate innovative products and processes, and then shared the gains of their competitive successes with their employees, suppliers, distributors and communities. Through a variety of government policies aimed at creating a greater equality of incomes throughout the economy, the gains of the successful business enterprises in the high value-added sectors also supported the reallocation of returns to those employed in lower value-added sectors of the economy. In the 1990s, as a result of this development process, the Japanese people enjoy one of the highest levels of per capita income and one of the most equal distributions of income across households in the world. Despite the recessionary conditions of the 1990s, Japan remains a world-leading innovator, exporter and creditor.

So why do I argue that Japan's problems in the 1990s are largely the results of its success in the previous decades? That an unemployment rate of less than 5% is unacceptably high in Japan, but is now viewed as admirably low in most of the other advanced economies, is a legacy of Japan's ability to generate productive opportunities for the population that kept the unemployment rate very low from the 1950s to the 1980s. True, it did so, and still does so, by highly segmenting male employment from female employment and by strictly limiting the employment of foreigners in Japan (Lazonick, 1995). A challenge that faces Japanese society is to make more productive and creative use of its female labor force than has heretofore been the case—a process that was begun amidst labor shortages in the 1980s but that was disrupted when the bubble burst. As for foreign labor, during the past two decades Japanese companies have employed large numbers of non-Japanese employees through foreign direct investment, so much so that during the 1990s such employment has raised fears of 'hollowing out' in Japan. The fact that these fears of hollowing out have not materialized is in part because of the fundamental strength of Japanese industrial corporations both at home and abroad

throughout the 1990s and their commitment to keep their domestic labor forces employed (Okina and Kohsaka, 1996; Yahata, 1996, p. 5). In particular, during the first half of the 1990s, influenced by the strengthening yen, Japanese foreign direct investment in Asia was part of a dynamic of growth in the region as a whole that created new export markets for Japanese capital goods (Hobday, 1995; Hatch and Yamamura, 1996).

Japan's relatively low unemployment rates are also partly the result of massive government spending in the 1990s. Given the importance of the Fiscal Investment and Loan Program, administered by the Trust Fund Bureau of the Ministry of Finance, to Japanese development over the past half century, large-scale government involvement in resource allocation is not new to Japan (Endo, 1996; Nakamura and Yamada, 1996). What is new in the 1990s is the extent of budgetary expenditures, as are the levels of taxes and bond issues that are needed to support these expenditures. With a high rate of domestic savings, the Japanese economy can afford these government budgetary expenditures. But if the corporate system that remains central to resource allocation in the Japanese economy should falter in its incentive and ability to maintain employment, the burden cast on government spending to support the economy could become untenable, both politically and economically.

In the era of high-speed growth, the main role of Japan's 'developmental' state was less to exercise direct control over the allocation of society's productive resources and more to mobilize the nation's savings through the banking system to 'developmental' enterprises. Within these enterprises, corporate managers controlled the allocation of resources to investments in particular products and processes. Retained earnings, protected by the system of cross-shareholding, provided the foundation for what Mary O'Sullivan and I call 'financial commitment': the sustained access of a business enterprise to the financial resources required to develop and utilize productive resources until the enterprise can generate products of sufficiently high quality and low cost to be competitive on markets and to generate returns (Lazonick and O'Sullivan, 1996, 1997a,b). But the pace of Japan's development and the capital requirements of the sectors in which Japan's competitive success occurred meant that, to secure the requisite financial commitment, retained earnings had to be highly leveraged through bank loans under the 'main bank system'.

Influenced by Western agency theory, many economic analyses of the role of the main bank system in Japan's postwar development contend that the banks played a major role in monitoring the performance of the industrial corporations, thus making the banks rather than the corporations the critical

loci for control over corporate resource allocation (Aoki and Patrick, 1994; Miyajima, 1996; Sheard, 1998). But, given the complexities and uncertainties of the industries in which Japanese corporations achieved success, it was corporate managers, not bank managers, who had the knowledge of organizations and technologies required to make informed allocation decisions. Moreover, as, through the development and utilization of productive resources, these corporations transformed these investment decisions into sustained competitive advantage, their reliance on their main banks—and on bank debt more generally—loosened. Indeed by the late 1970s and even more so over the course of the 1980s, successful industrial corporations were able to restructure their balance sheets using retained earnings or, especially in the late 1980s at the peak of the bubble, stock and convertible or warrant bond issues to pay off bank debt (Nakamura and Yamada, 1996, p. 139).

Thus the competitive success of these corporations on international markets in the 1970s and 1980s laid the basis for the financial problems of the Japanese banking system in the 1990s. As the wealth of the Japanese economy grew in these decades, the banks were flooded with corporate and household deposits. Yet at the same time, the bank's biggest and best borrowers—the successful industrial corporations—were able to scale back their reliance on bank finance. The banks—including the much-admired main banks that the agency theorists had deemed to be such excellent monitors of economic activity—now became sources of easy money, often accepting the market value of the borrower's stocks and land as collateral (Ziemba, 1991; Shimizu, 1992). That stock prices and land prices were rising in the 1970s and 1980s was in large part the result of the very real success of Japan's industrial economy. In the late 1980s, however, bank lending helped fuel the speculative bubbles in stock and land prices until, as the 1980s ended and the 1990s began, these bubbles burst. The recessionary conditions of the 1990s ensured that existing problem loans would become more problematic and that many new loans, even those more prudently extended, would turn bad. But the origins of the banking crisis of the 1990s can be found in the changed relation of the banking sector to the industrial sector in the 1980s. Successful industrial corporations were able to reduce their bank debt, thus diminishing the need for the banks to play their traditional intermediary role at the same time that these banks were awash with loanable funds—funds that, when lent, permitted the land and stock speculations of the bubble economy.

During the 1990s, the banking system still had a central role to play in channeling investment finance to business enterprises, and especially to small- and medium-sized enterprises that were able and willing to grow. But there

is no doubt that, given its changed relation between its major industrial clients in a rich economy, the banking system that emerged from the 1980s and that was so troubled in the 1990s needed to be reduced in size and transformed to perform new functions. In terms of the banks' traditional intermediary functions, a major overhaul of the banking system—including consolidation of banks, writing-off of bad loans, stricter adherence to Bank of International Settlements capital–adequacy ratios and closer financial supervision—has been underway since the government permitted the Hokkaido Takushoku Bank to fail in November 1997 (Yokota, 1997). At the same time, under Financial Big Bang, the banking system is being transformed into an integrated financial system that, in addition to channeling savings to businesses for the sake of productive investment, can participate in managing the savings of the Japanese population for the sake of financial returns.

Alongside corporate disintermediation, the massive accumulation of savings by Japanese households was one reason why in the 1980s Japanese banks had too much money to lend. Not that Japan in the 1980s was not a consumer society. Indeed, since the 1950s, it had been through serving domestic consumer markets that Japanese industrial companies developed the productive capabilities and financial resources that then enabled them to compete successfully for high-income international markets in the 1970s and 1980s. At a point in time, what a household does not consume, it saves. But over time, when incomes are rising, a household can both consume more and save more. When during the postwar decades the incomes of Japanese households were rising so rapidly and persistently, these households greatly increased their levels of consumption even as they continued to accumulate savings out of disposable income at a high rate (Katz, 1998, pp. 210–213).

During the 1990s, with their employment incomes and retirement incomes much more uncertain than had been the case in the past, Japanese households have increased their rate of savings as compared with the late 1980s. But as a percentage of GDP, private consumption is actually somewhat higher in the 1990s than it was in previous decades. In 1985 private consumption was 58.5% of GDP, whereas in 1995 it was 60.0%. Moreover, as a proportion of GDP, Japan's allocation to private consumption is in line with those of continental European countries, although lower than in the United States and Britain; in 1995 private consumption as a proportion of GDP was 60.1% in France, 57.2% in Germany, 68.0% in the United States and 63.8% in Britain (OECD, 1999). But then one might argue that, for sustainable prosperity, the Americans should save more and the British should invest more.

An increase in Japanese consumer spending may well help to increase production and employment in the short term. But over the long term it is

not at all clear that an increase in the propensity of households to consume will keep growth rates up and unemployment rates down. Rather, sustainable prosperity requires continuous productive transformations that generate higher-quality goods and services at prices that large sections of the population can afford. Given the maturation of many of the industries that made Japan a rich nation, it can be argued that what Japan needs now is not a quick fix of more consumption but new definitions of high-quality goods and services whose unit costs can be lowered through continuous process improvement and achievement of scale economies, while maintaining high and stable earnings for the producers who are also Japan's consumers.

The overly optimistic promises of pension benefits to Japan's households are also a product of the rapid rate of economic growth prior to the 1990s. The postwar transformation of Japan from a poor nation into a rich nation created expectations concerning not only employment incomes but also the retirement incomes that could be yielded by that growth on a sustainable basis. Even in the boom years of the 1980s, the Japanese government recognized that the unexpectedly rapid aging of the population would require that people spend more of their lives in productive employment if intergenerational dependence was not to overwhelm the pension system even in good times. In fact, the Japanese remain in the labor force much longer than is the case in any other advanced nation. In the early 1990s, the labor-force participation rate of men aged 60–64 was 75% in Japan, compared with 55% in the United States and 35% in Germany (Seike, 1997, p. 155).

Although high by international standards, the current labor-force participation rate of Japanese men aged 60–64 represents a sharp *decrease* from the rate of 84% that prevailed in the 1960s. It appears that, as in other countries, Japanese workers responded to increases in pension benefits by retiring earlier. The labor-force participation rate of men aged 60–64 declined to 71% in the late 1980s, primarily because of an increase in real pension benefits—in 1973 the government began indexing public pension benefits to inflation—but also because of a decline of the self-employed proportion of the population, who have a higher labor-force participation rate of older workers. When combined with the government policies from the mid-1980s to reduce pension benefits, the recessionary conditions of the early 1990s reversed the direction of the labor-force participation rate of 60–64 year old men, increasing it from 71% in 1988 to 75% in 1993 (Seike and Shimada, 1994; Seike, 1997, pp. 155–157).

In 1994 the Japanese government revised the public pension system by moderating benefit levels and by gradually extending the age at which people would be eligible to draw the full pension annuity from 60 to 65, effective in

2013. The reform also introduced a new partial pension for those between the ages of 60 and 64 that provides about half of the full pension for those who would like to retire before 65. For those eligible for pensions who still remain employed, the reform increased the amount of permitted earnings to ensure that total income (earnings plus pension benefit) would not decrease as earnings rise (Seike, 1996, p. 4; 1997, pp. 161–162). Public pension policy is therefore working to keep people employed longer. The government and the unions have pressed companies to keep people employed for more years of their lives. The unions tempered their wage demands in the 1999 Spring Offensive, but focused their attention on issues related to severance pay, pension plans and mandatory retirement ages (*Nihon Keizai Shimbun*, 1999i; *Nikkei Weekly*, 1999a). By the early 1990s virtually all large companies and even the vast majority of small companies had increased the retirement age to 60, which in effect meant that, under the system of lifetime employment, companies undertook to keep their workers employed to this age. Starting in the 1998 fiscal year, under the Law Concerning the Stabilization of Employment of Older Persons, in line with the changes in public pension policy, employers were requested to extend the retirement age to 65 by the year 2013 (Seike, 1996, p. 5).

In the late 1990s, the age-structure of corporate employment combined with the continuing recession to place a strain on most companies that would seek to keep people employed even longer than is presently the case. The postwar baby boomers were creating a big bulge of middle-aged employees in Japanese companies. But the demographics were changing; the size of the population in their twenties peaked at 19.2 million in 1996, with a predicted drop to 12.5 million in 2015. Over this period, the number of people in their sixties will increase by about 4 million (Seike, 1996, p. 5). Between 2000 and 2010, the proportion of the labor force aged 15–29 is expected to decline from 23% to 18%, while the proportion over the age of 55 years is expected to increase from 23% to 27% (Sugeno and Suwa, 1997, p. 56). Other things being equal, employers will find it necessary to employ an aging labor force over the next two decades.

3. *Corporate Responses to Adverse Conditions*

But in an employment system that is influenced by corporate strategy, technological change and international competition, other things are never equal. To remain competitive, Japanese companies that employ an aging labor force have to concern themselves with the productive contributions of older workers, relative both to their pay and to the productive contributions

that could be made by younger workers. In the Japanese case, high levels of education and training, and the good health of the labor force in general, have combined with the prevalence of in-house organizational learning to enhance the productivity of employees over the course of their careers. Nevertheless, the intense effort and commitment that organizational learning demands of workers, particularly in the presence of rapid technological change, place limits on the incentive and ability of older workers to attain higher levels of productivity. To enable companies to fulfil the commitment of keeping workers employed even longer than is currently the case, the employment system must be flexible enough to permit the reallocation of labor resources and restructuring of returns to labor in response to changes in the productive and competitive environments.

During the 1990s the flexibility of the system of lifetime employment increased in a number of dimensions (Kameyama, 1993; Ornatowski, 1998; Takanashi, 1998). The first source of flexibility of the employment system was the ability to maintain employment of existing workers by reducing the number of new hires. The Japanese employment system is noted for the practice, especially among the major companies, of recruiting new employees directly from the educational system (high school in the case of blue-collar workers, university in the case of white-collar workers). In the past, a company that was growing rapidly could hire large numbers of new university graduates and then, after a decade or so, decide who among the cohort were best suited for employment tracks that provided more responsibility, authority and pay.

What was new in the 1990s was that employers had to be more selective about new hires. Hence there was a heightened competition for university graduates with specific capabilities. Japanese companies used to adhere to the principle of hiring new employees at the same time every year to begin work on April 1. This hiring institution was meant to reduce competition among companies for employees and ensure that the new employees would enter the company and continue their careers in it as a cohort. During the 1990s it became acceptable for companies to hire out of season. According to a 1996 survey by Keidanren of 501 Japanese companies, 13% said that they already hired at various times during the year and another 32% that they were considering such hiring practices (Ishibashi, 1996).

In addition, Japanese companies have traditionally filled all openings for lifetime employment positions with men who were newly graduated from high school or university. These employees would then be trained internally to develop specialized skills. Now, however, many Japanese companies are hiring people who have already developed specialized skills, either through

work experience or university training. The Keidanren survey found that 27% of the companies it covered were already recruiting people for specific jobs, another 12% for specific research jobs only, and 22% were considering such recruiting practices. At the same time, an increasing proportion of young workers who go to work for corporations are engaging in job-hopping, although the ultimate objective of such labor mobility is still to find the particular company that can offer an attractive lifetime career (Nitta, 1995; Ishibashi, 1996; Ornatowski, 1998).

The second source of flexibility is in rewards. Traditionally, lifetime employees have been recruited to companies from high schools or colleges, and then over the course of their careers have seen their earnings increase primarily on the basis of seniority pay (with supplements for larger numbers of dependents). The main forms of competition among employees were over the pace and type of promotion, although even then seniority bulked large as a criterion for eligibility for promotion over the first two decades of company service. During the 1990s individual performance began to count much more in determining promotion and pay. A 1995 survey of 210 companies based in Tokyo found that 24% had introduced merit pay systems and another 28% planned to do so in the next three years (Nitta, 1995; Ornatowski, 1998).

The third, and perhaps most important, source of flexibility is the reallocation of labor resources to positions in subsidiary companies that offer lower pay and/or responsibility. As employees reach their late forties and early fifties, major companies, in consultation with their enterprise unions, maintain the right to relocate employees—either through *shukko* (temporary) or *tenseki* (permanent) transfers—to subsidiary enterprises where pay is generally substantially lower (although, especially in the case of *shukko*, the core company often supplements the pay of the transferred worker). Provided they can absorb these employees, the benefit for the subsidiary is that it gets experienced personnel without having to invest in their skill development. In some companies, the core company assigns employees to the subsidiaries, whereas in other companies the subsidiaries recruit employees from the core company. At the same time, a small proportion of managerial employees who are considered to be especially valuable to the company are given the opportunity to continue to work for the company in positions of executive responsibility and at relatively high pay even after the official retirement age.

In theory, under *shukko*, the employee can be transferred back to the core company, but in practice the transfer often becomes permanent with the subsidiary taking over responsibility for the employee. Most *shukko* and *tenseki* transfers are from larger to smaller companies. Around the mid-1990s, of all companies with 1000 or more employees, about 87% engaged in *shukko* and

tenseki, and these transfers applied particularly to employees in their fifties. Many, if not most, employees who are loaned to another company find that their new employment eventually becomes permanent, their status at the new company being transformed from *shukko* to *tenseki* (Sato, 1996, pp. 5–6).

Traditionally, both *shukko* and *tenseki* transfers were from a core company to a related company within the enterprise group. But increasingly in the 1990s, as subsidiaries found it difficult to absorb the number of experienced personnel that the core companies wanted to relocate, the core companies located unrelated enterprises to which they could make *tenseki* transfers. Thus, the commitment to lifetime employment on the part of the core company was maintained, but the web of companies at which an employee might end his career became wider. Within this wider web for maintaining lifetime employment, however, transferred workers often accepted late-career pay that was lower and late-career working conditions that were less attractive than would have previously been the case (Harukiyo, 1993; Inoki, 1993; Morishima, 1995; Sato, 1996, 1997).

It is from this perspective of the reallocation of labor resources that enterprise 'spin-off' became of increased importance in the 1990s (Odagiri, 1994, pp. 144–151; Ito, 1995). Major companies take people and money, and spin-off new businesses rather than keeping this labor and capital under the control of the parent enterprises. Spin-offs can be suppliers or distributors in a vertical *keiretsu* or manufacturers of a new line of products as part of a horizontal *keiretsu*. Spin-off cuts down on layers of management and decentralizes authority and responsibility far more effectively than the multidivisional enterprise structure, in which there is often a decentralization of responsibility while maintaining a centralization of authority (O'Sullivan, 1996, ch. 3). In horizontal *keiretsu*, by creating new units of strategic decision-making that are focused on particular products, spin-off facilitates the integration of enterprise strategy and organizational learning. Spin-off increases the number of managerial positions that entail authority and responsibility, without increasing the layers of management, and hence is of great importance to the functioning of *shukko*.

Spin-off, therefore, reflects a system of corporate governance that permits a successful company to allocate both money and people to the creation of a new business enterprise, which then itself has considerable autonomy in the allocation of resources and returns. During the 1970s and 1980s, Japanese companies increasingly used spin-off as an organizational strategy (Odagiri, 1994, pp. 145–146). During the 1990s, it became a particularly effective means for a company to reallocate labor resources in ways that created new

opportunities for its employees and potential sources of new employment in the economy more generally.

Although not all spin-offs entail the development of new technology, spin-off often functions as the Japanese form of venture capital (Irie, 1996; Morishita, 1996; Nitta, 1997).[2] In May 1997, the Committee on Economic Policy of Keidanren proposed such new ventures as one way of meeting the challenges to the Japanese employment system in the 1990s. The company that has taken the lead in spinning-off new ventures is Toyota Motor Corporation, whose former president, Shoichiro Toyoda, was chairman of Keidanren at the time this policy was promulgated. In the summer of 1996, Toyota set up a ¥50 b. venture-capital fund to provide financial assistance to ventures within its group. In June 1997 it expanded the program to include ventures outside the Toyota group, generally taking equity stakes of 50% or more in each company. In so doing, Toyota Motor Corporation became the biggest single source of venture capital in Japan; in 1997 the next largest fund had ¥20 b. As of June 1997 the Toyota fund had financed eight ventures, and, with applications from about 300 companies, Toyota planned to invest in about ten companies per year in industries such as semiconductors, information and communications, biotechnology, environmental technologies, and services for senior citizens (*Nikkei Weekly*, 1997c; Odagiri, 1998).

4. *Corporate Governance and Sustainable Prosperity*

There are no guarantees that these new ventures will achieve success. But then there were no guarantees in the late 1940s and early 1950s that Japan would emerge from its devastating economic and political crisis, let alone develop over the next four decades into the world's second largest economy and industrial leader. In 1946 a group of young, forward-looking middle managers founded Keizai Doyukai (actual translation, Meeting of Friends; current translation, Japanese Association of Corporate Executives). As the historian William Tsutsui (1998, p.125) has described the outlook of Keizai Doyukai in its early years:

> In the Keizai Doyukai analysis, the experience of war and occupation was catalyzing fundamental structural changes in Japanese capitalism. The most important of these was the so-called 'separation of management and capital,' a phenomenon which was said to have derived from the expansion of the modern corporation, with its increasingly diffused pattern of

[2] On the weakness of 'American-style' venture capital in Japan, see Clark (1987).

> ownership and its bureaucratic superstructure of expert managers. The result of this process, the Doyukai maintained, was a transformation of authority relations within industry, as ownership no longer connoted control and as the capital-labor divide was blurred by the appearance of management technicians as an independent interest group. Not subservient to capital (as the zaibatsu *banto* had been) but likewise differentiated from labor (in that they possessed the ability to lead modern industry and comprehend modern technology), the managers of this intermediate stratum were touted as the agents of a new political and economic equilibrium.

In 1948 the business economist, Eiichi Furakawa, declared that the 'new managers' of the Doyukai, 'emphasize benefits to state, society, and the people rather than individual profits. They esteem jobs and labor more than money' (Tsutsui, 1998, p.125).

Four months after the founding of Keizai Doyukai, the Supreme Commander for the Allied Powers (SCAP) began the dissolution of the *zaibatsu*, a process that not only dispossessed the *zaibatsu* owners but also removed from office the top layers of management of the *zaibatsu* holding companies and major affiliated companies (Bisson, 1954; Hadley, 1970; Adams and Hoshii, 1972, pp. 23–25). Hidemasa Morikawa (1997, pp. 319–320) places the number of *zaibatsu* managers who were forced to resign between 1945 and 1948 at about 5000, with the average age of top managers falling from 60 to 50 over this short period. Taking over control of strategic decision-making in Japan's industrial enterprises were 'third-rank executives', so-called because they were plucked from the ranks of middle management to take leadership positions. The vision that united Keizai Doyukai had been put into practice. Commenting on this elevation of the 'third-rank executives' to positions of corporate control, Yutaka Kosai (1986, p. 26) has argued that 'nowhere was the separation of management and ownership more thoroughgoing than in postwar Japan'.

The control exercised by these 'third-rank' executives was by no means secure. Stockholders who were outsiders to the companies might join forces to demand their traditional control rights as owners. In the aftermath of the *zaibatsu* dissolution and with the reopening of the Tokyo Stock Exchange in 1949, individuals owned 69% of outstanding stock, securities companies 13%, other financial institutions 10%, nonfinancial companies less than 6%, and the government less than 3% (Zielinski and Holloway, 1991, pp. 26–27). To finance the growth of their companies, enterprise managers needed to maintain as much control as possible over surplus revenues, both as an internal source of funds and as a financial base for taking on bank loans.

Managerial control over the allocation of surplus revenues had been accomplished in the United States earlier in the century through the widespread distribution among the wealthholding public of the outstanding shares of dominant enterprises (O'Sullivan, 2000b, ch. 3). But in post-World War II Japan, subsequent to the dissolution of the *zaibatsu*, the undeveloped state of the companies and the stock markets left Japanese enterprises vulnerable, if not to takeovers, then to debilitating demands on their earnings from outside interests (Japan Securities Research Institute, 1986, p. 51).

To defend themselves against the demands for 'shareholder value' by these outside interests, the community of corporate executives engaged in the practice of cross-shareholding. Banks and industrial companies took equities off the market by holding each other's shares. Increasingly, business relations among companies, be they industrial or financial, became cemented by cross-shareholding arrangements, with a company that had closer relations with another company being more likely to hold larger amounts of that company's shares, up to the legal maximum of 5% of shares outstanding (10% in the case of insurance companies). Over time, as business relations among financial and industrial enterprises changed, the web of cross-shareholding became more intricate.

By 1955 cross-shareholding—according to its broadest definition as stock in the hands of stable shareholders—represented 25% of outstanding stocks listed on the Tokyo Stock Exchange, and by 1960 it was about 40%. It declined slightly in the early 1960s, but after the opening up of Japanese capital markets in 1964, when Japan joined OECD, the business community, fearing foreign takeovers, took steps to increase cross-shareholding. It surpassed 60% in 1975, and since then 60–70% of corporate shares have been kept off the market through cross-shareholding (Hodder and Tschoegl, 1993, p. 50). In the postwar decades, cross-shareholding has been the institution that has ensured that organizational control rather than market control would govern Japanese corporations (Lazonick and O'Sullivan, 1997b). It is an institution that was designed to ensure, and that continues to ensure, that outsiders to the corporate organization, including first and foremost public stockholders, will be unable to lay claim to the corporate revenues that provide the financial foundation for a company to retain its earnings and reinvest in productive resources.

Corporate resource allocation according to the principles of retain and reinvest does not ensure enterprise growth. How a business enterprise develops and utilizes the productive resources in which it invests will determine whether or not it can remain competitive in markets while still maintaining or improving the conditions of work and pay of those who

contribute their skills and efforts to generating corporate products and revenues. In a world of complex technologies and global markets, the enterprises that can remain competitive while enhancing employment opportunities in the economy are those that invest in organizations that can engage in collective and cumulative learning. Such organizational learning requires the organizational integration of the skills and efforts of large numbers of people with different functional specialties and hierarchical responsibilities. It also requires that the enterprise, through its allocation of resources and returns, sustain these collective skill bases so that their learning can cumulate.[3]

When a company makes such investments in improving its organizational capabilities, its employees cease to be commodities whose wages entail a current expense that can be economically justified only by the addition to current income that their employment makes possible. Rather they become assets in whose capabilities the company has invested, and from which the employees as individuals and the company as a collectivity expects returns over a sustained period of time. At the macroeconomic level, it is the sum total of such corporate returns and their distribution to the workforce or their reinvestment in new learning processes that permits an economy to prosper on a sustainable basis.

Corporate governance systems (and the underlying employment and financial institutions that characterize these systems) that promoted prosperity in the past may have difficulty responding to new productive and financial challenges in the present. For a nation to reform its system of corporate governance to respond to these challenges requires an understanding of the character of that nation's existing institutions for mobilizing labor and capital for the development and utilization of productive resources, as well as the character of the productive and financial challenges that it is facing.

5. *A Japanese Path to Sustainable Prosperity?*

As I noted at the outset, during recent years Japanese corporate executives have been introduced to the ideology, imported from the United States, that argues that the most efficient way to govern a corporation is to 'maximize shareholder value'.[4] A number of Japanese companies now include statements

[3] For elaboration of this perspective, see Lazonick and O'Sullivan (1996, 2000a), Lazonick (1998b) and O'Sullivan (2000b, ch. 1).

[4] For Western perspectives on Japan that look only at the role of financial interests in corporate governance, see Kester (1991), Gerlach (1992), Schaede (1994) and Sheard (1998). For critiques of this perspective as applied to the United States, see Lazonick (1992) and O'Sullivan (2000b, chs 3–5). For a perspectives on Japanese corporate governance that is broadly consistent with the arguments in this paper, see Abegglen and Stalk (1985).

concerning their positions on 'shareholder value' in their annual reports. For example, in its 1998 annual report, Sony reported that in 1997 it had introduced stock options for its top management in Japan and overseas as a practice that 'more closely aligns the interests of Sony's management with shareholder value' (Sony Corporation, 1998). In its 1998 annual report, Toyota included a section entitled 'A word about shareholder value', and went on to say: 'We maximize shareholder value over the long term by harmonizing the interests of all of our stakeholders: customers, suppliers, employees, and members of the community at large, as well as shareholders. At the same time, we are stepping up our efforts to address the special expectations of shareholders' (Toyota Motor Corporation, 1998). A few Japanese companies such as Hoya and Kao have even adopted measures of 'shareholder value' as their most important indicators of corporate performance (Hoya, 1998; *Nihon Keizai Shimbun*, 1999j). Recently, the business daily, *Nihon Keizai Shimbun* teamed up with Stern Stewart, the American consultancy that has created and marketed 'economic value added' (EVA) as a measure of corporate performance, to rank major Japanese companies in terms of their contributions to 'market value added' (MVA), a measure of performance based on the market valuation of a company's common stock (*Nihon Keizai Shimbun*, 1999a,b,j).

Is shareholder value appropriate for Japan? Over the past two decades the maximization of shareholder value has become the entrenched ideology of corporate governance in the United States. Even in the United States, the notion that the maximization of shareholder value results in superior economic performance is relatively new, having emerged out of structural changes in the US corporate economy and global competition in the 1960s and 1970s (Lazonick and O'Sullivan, 2000b). The proponents of maximizing shareholder value fail to explain how the US corporations (not to mention corporations in other advanced economies) managed to create value and drive the development of their economies during most of the twentieth century when maximizing shareholder value was not a principle (or even an ideology) of corporate governance (Lazonick, 1992; O'Sullivan, 2000b). While many analysts credit the focus on shareholder value with the boom in the US economy in the late 1990s, the sustainability of prosperity in a national economy in which corporations adhere to this principle of corporate governance has yet to be tested. There exist in the US economy many potential sources of instability—an unsustainable stock market boom, a worsening distribution of income and wealth, a persistent trade deficit, an unprecedentedly low household savings rate and a growing level of international borrowing—that could be related, directly or indirectly, to an obsessive focus of US corporations on maximizing shareholder value (Lazonick and O'Sullivan, 2000b). Japanese

corporate executives and public policy-makers should recognize that even in the United States there is considerable room for debate concerning the relation between a corporate governance regime that seeks to maximize shareholder value and sustainable prosperity in the economy as a whole (O'Sullivan, 2000b, chs 1–6).

In the very recent past, Japan has experienced the problems of letting its economy be overly influenced by the ways in which the stock market values the nation's assets. The recession of the 1990s is to a major extent the result of the failure of Japanese society to control stock-market speculation in the 1980s. The bursting of the bubble created a financial crisis, but stability and equity in the economy have been maintained by corporate and government policies that have supported the retention of corporate revenues and reinvestment in productive resources. Even then, to maintain high levels of employment, the Japanese government had been obliged to engage in spending that has given Japan a ratio of gross fiscal government deficit to GDP that is second highest (lower only than Italy's) among the OECD nations (Morishita, 1999). Indeed, when one recognizes that in the 1930s major US corporations cut back employment dramatically and that it took US entry into World War II to get that nation out of the Great Depression, one might ask what the condition of the world economy in the 1990s would have been had Japanese corporations not remained oriented toward retain and reinvest during the decade, and had the Japanese government not been able and willing to engage in massive fiscal intervention in the economy.[5]

Nevertheless, there is a need for Japanese corporations to find ways to improve the effectiveness of their strategies to retain and reinvest to ensure that Japanese companies remain internationally competitive, and that the intergenerational economic and social needs of the population are met. For a rich nation such as Japan, the immediate challenge is to maintain the stability of the economy while its business organizations and national institutions undergo the structural transformations that will enable them to support sustainable prosperity. The major long-term challenge is to put in place a system of value creation and distribution that that can maintain, if not improve, the living standards of both the working and retired populations.

Given these objectives, what types of corporate reform does Japan require? The 'Big Bang' transformation of the Japanese financial sector to engage in asset management and the consequent movement toward the 'securitization' of social security make it possible that a system of corporate governance that

[5] I am currently working on a major comparative analysis of corporate strategy, government intervention and economic performance in the United States in the 1920s and 1930s and Japan in the 1980s and 1990s, and the implications for economic theory and policy.

relies on the principle of shareholder value will come to play a much greater role in Japan over the next decade or so. Pressures will build in Japan, as has been the case in the United States over the past quarter century, to allow financial markets to determine the returns to households savings, and hence the size of retirement incomes. If industrial corporations succumb to these pressures, they will do so, as US corporations have done, by shifting their strategic orientation from retain and reinvest to downsize and distribute. But should the prevailing low yields on Japanese corporate (and government) securities persist, higher returns on Japanese household savings will have to come from asset management based on portfolio investment abroad—a rather risky business given the volatility of not only securities markets but also foreign exchange rates.

Recently, as a result of the persistence of the recession and in response to calls for US-style corporate restructuring, debate over the path to sustainable prosperity has become a high-profile issue in Japan (see Dore, 1998, 1999). Major business leaders have cautioned that Japan must find its own way forward. In advocating corporate reform that yields a 'market economy with a human face', Hiroshi Okuda, president of Toyota Motor Corporation and newly appointed head of Nikkeiren (the Japan Federation of Employers' Associations) has stated that 'putting unquestioning faith in markets is going too far' and that 'it's a pity that business leaders often equate restructuring with payroll cuts' (quoted in *Nihon Keizai Shimbun*, 1999f). Similarly, Yotaro Kobayashi, chairman of Fuji Xerox and head of Keizai Doyukai since April 1999, has called for a reform process that goes 'beyond the manifesto for a market economy'. As Kobayashi (1999, pp. 3–4) put it in his inaugural address to Keizai Doyukai:

> Companies are being evaluated with increasing strictness by the market. And as corporate citizens, they can maintain their dynamism in the long term only if they earn the trust of society and are responsive to its various needs. It is thus essential, from this point of view, to bring the market-oriented nature and the social nature of business corporations into harmony on a higher plane, within the context of the times. What is needed is a theoretical framework that will underpin the company's relationships with its stakeholders and orderly relations among those stakeholders. Such a framework is essential if we are to develop Japanese corporate management for the new era, beyond the market-oriented economy.

In seeking to resolve the problems of unemployment, unstable banks, underconsumption and underfunded pensions, Japan is now pursuing a

retain-and-reinvest path of corporate reform that is in keeping with its own institutional history, and that, if successful, could offer an alternative to the downsize-and-distribute path that has been taken in the United States. As we have seen, major Japanese corporations have been implementing more flexible hiring, promotion, relocation and pay practices in their employment relations without abandoning (despite repeated prognostications to the contrary by Western observers over the past decade) the institution of lifetime employment (see Lazonick, 1998a). Other things being equal, the demographics that will prevail over the next generation favor retention of a lifetime employment system, and indeed shortages of educated labor, as well as the growth of services employment, will help to bring women more fully into the paid labor force (Yokoyama, 1999). But one should not expect that it will be existing corporations alone that will regenerate and augment the volume of high-quality employment opportunities that sustainable prosperity requires. The growth of new businesses is and will remain important to the creation of stable and remunerative jobs. During the 1990s the Japanese have become much more conscious of the need to support new business formation, especially in high value-added activities (see, for example, *Nihon Keizai Shimbun*, 1999g). Japanese new ventures, however, rely much more on corporate venture capital and spin-off than on the American venture-capital model that is largely independent of the resource-allocation decisions of established corporations.

Despite the decline—although as of yet not the demise—of the main bank system, the banking sector remains of central importance as a lender to small and medium-sized enterprises (SMEs), including new ventures, that hope to grow (see, for example, *Nihon Keizai Shimbun*, 1999k). The main fallout of the concerted effort from 1997 to resolve the banking crisis by writing off huge amounts of bad debt and applying capital-adequacy standards more stringently has been a credit crunch on SMEs. Besides the financial restructuring required so that the banks can once again play a major role in the inherently risky business of financing the growth of new enterprises, the diminished importance of the banks in providing loans to established enterprises has meant significant downsizing of their labor forces—from a peak of 454,593 jobs in March 1994 to 398,942 in March 1999 (*Nihon Keizai Shimbun*, 1999e)—and, under Financial Big Bang, concerted efforts at diversification into new lines related to asset management, particularly for pension provision.

The Japanese model means, however, that higher returns on household savings through asset management will be hard to come by. An orientation toward retain and reinvest requires low levels of corporate dividends, a policy that the major Japanese corporations have continued to pursue. Nor, given

the massive buildup of government debt based on exceptionally low interest rates, can the higher returns come from Japanese government securities. The low rates of returns on household savings, however, are offset by the persistently high rates of savings of households that have resulted in much greater accumulations of savings by Japanese households than by their counterparts in the United States. For example, as a proportion of national income, the value of insurance policies in force in Japan is almost two and a half times the US ratio (Nakamura and Yamada, 1996, p. 149). But in addition to these high volumes of household savings, what is unique about the Japanese model is its emphasis on *reducing* the dependence of the older generation on younger generations by keeping people employed for more years of their lives. In contrast, in the United States an emphasis on early retirement, often made possible by high returns on accumulated household savings, has had the effect of *increasing* intergenerational dependence. These high returns to savings accruing to a retired population have also helped to fuel the American consumption binge in the 1990s. In Japan, the attempt to solve the problem of intergenerational dependence emphasizes saving and employment; in the United States, it emphasizes finance and consumption.

But keeping people employed for more years of their lives does not solve the problem of intergenerational dependence if these people are not productively employed. Nor can high levels of savings be maintained unless employees in their thirties and forties remain highly productive. Given the structure of the Japanese economy, the Japanese path must look to higher productivity, not to more consumption *per se* (as many Westerners have been advocating), if sustainable prosperity is to become a reality. Given the intensity of global competition in the industries that made Japan a rich nation, higher productivity will come through the continued development of the productive capabilities of the Japanese people and the mobilization of these capabilities to generate higher quality goods and services at lower unit costs. Government spending, not lacking in Japan, can help support such developmental investments. But, ultimately, sustainable prosperity will depend on the incentives and abilities of Japan's business enterprises, both established and new and in support of one another, to develop and utilize the productive resources that they control.

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