

Whither Japanese Corporate Governance: Symptoms of Institutional Change

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Good evening, Ladies and Gentlemen. It is an honor to deliver the 2002 Mansfield American-Pacific Lecture to this body of distinguished guests. I am grateful to the Mansfield Center for Pacific Affairs for giving me this unique opportunity. I did not have the fortune of getting acquainted with the late Ambassador personally. But I firmly share with my fellow countrymen and countrywomen a deep admiration and respect for his distinguished, lifelong contributions to the mutual understanding of perspectives between Americans and Japanese, as well as the promotion of cooperation between us, whenever it is appropriate. I sincerely hope to be able to deliver this lecture in the spirit of the foundation that he firmly laid for us.

The topic of the lecture series that the Mansfield Center selected for this year is corporate governance. The prolonged banking problem in Japan, as well as recent disclosures of irregularities in corporate accounting and associated business failures in the U.S., undoubtedly make corporate governance issues and reforms one of the most important public policy issues in both countries.

Today I plan to speak on the issues primarily from a Japanese perspective. I am very much aware that there is much to be learned from American practices and experiences in order for the Japanese to improve upon their own corporate governance. However, tonight I would like to focus on the fact that Japan is now at a very important turning point in its institutional evolution in general, and in corporate governance in particular. This process is conditioned by Japan's historical legacies, among other factors. Therefore, corporate governance issues in Japan will not be resolved simply by a wholesale attempt at emulating American practices, as some people seem to have strongly advocated until recently. From my perspective, the purpose of my lecture will be fulfilled if I am able to convey to you the unique aspects of Japanese corporate governance issues and reform.

As many of you might have heard, it has been very fashionable in the Japanese media to refer to the era of economic stagnation since the burst of the bubble as Japan's "lost decade." During most of this period I resided on this side of the Pacific Ocean and was engaged in an academic research project on institutional diversity and change. One and a half years ago I went back to Japan to direct RIETI and there had a chance to catch a glimpse of the workings of the Japanese public policymaking process from within. Leading a life in Tokyo after such a long absence with the curious eyes of a near stranger has been a fresh experience for me.

From my academic, public and personal experiences, I have come to feel at odds with the characterization of Japan's immediate past as a lost decade. I have become more and more convinced that Japan has actually entered an era of important institutional transformation, although this process

is gradual and very slow—too slow for my personal taste, and not necessarily explicit or clearly visible. I would now interpret the notion of this “lost decade” as reflecting the sense of uneasiness and powerlessness held by members of a relatively older generation. They built their early career paths in the context of the institutional arrangements that are now in eclipse but which prevailed during the era of high growth and the succeeding bubble. Those institutional arrangements, e.g., life-time employment, the main bank system, friendly business-government relationships, and so on, were regarded by this generation as the natural order, but they are not taken for granted any more. Nevertheless, an alternative arrangement has not clearly emerged yet.

Why do I say that Japan is now in the process of institutional transformation? Many observers argue that the Koizumi reform has turned out to be another disappointment. The banking and bad debt problem has not yet been resolved. Manufacturing bases are said to be eroding because of the rise of industrial China. Universities rank low internationally in terms of their contribution to industrial competitiveness and innovation. Insider-dominated corporate governance is not working effectively to respond to stock market signals, not to mention its outright failure to check wrongdoings in some cases. This list of dismal features appears to be easily expanded. In order to justify my claim, therefore, please allow me to begin my argument based on the institutional analysis in which I have been engaged.

In my opinion the difference between my view that Japan is now in the process of institutional transformation, on one hand, and the conventional view that reforms in Japan are again failing, on the other, basically stems from a different notion of institutions. The conventional view seems to regard institutions as laws, regulations and explicit rules. In contrast, I regard institutions as more than laws, regulations and rules. For example, there are laws that are neither observed nor enforced. If people know that they can circumvent a drug regulation by paying a bribe to the law enforcement officer and such practices are widespread, it seems more appropriate for the purpose of public policy analysis to regard the bribery, rather than the unenforceable law, as an institution.

Indeed, so-called Japanese lifetime employment could until recently be considered a distinct institution in Japan, but it was neither initially dictated by statutory law nor explicitly written into private contracts. Rather, it evolved as a set of generally shared beliefs about mutual commitments between the employer and the employee, conditioned on the absence of extraordinary events. The same thing can be said regarding the main banking relationships, the so-called convoy system, etc. Thus, I join with several of my Stanford University colleagues representing different social science disciplines to propose a new concept of institutions as the “shared beliefs in how the game is being played in the society.” These beliefs are the rules of the game that are understood and observed by almost all people and thus they are self-enforcing. The reason that rules of the game become institutions in this sense is that they reflect and summarize the essence of equilibrium conditions in the strategic game being played by people and organizations, including the government.

If we accept this view regarding institutions, then it is clear that institutions are not easily transformed overnight, because they relate to the popular mindset. They cannot be changed simply by legislation, a politician’s will or administrative regulations. From this perspective, it is misleading to conclude that Japan’s reform is a failure just by looking at Koizumi’s achievements. In order for a real change to occur, there must emerge a critical mass of people who start to question old and accepted ways of doing things and start to competitively experiment with a new way. Through competitive and evolutionary selection and gradual acceptance of a new way of doing things, a new institution will gradually emerge.

Preceding the emergence of a new institution, there must be a time of crisis of the old institutions—a time when the general acceptance of rules of the game erodes. I consider that Japan is now experiencing such a transitory phase. Old institutions are questioned, new ways of doing things have started to emerge and are being put to the test, but none of these new institutions has yet gained decisive force and general acceptance. I admit that my argument so far has been abstract and simply assertive. Therefore, let me try to illustrate and substantiate my argument by examining real phenomena more closely.

First of all, what kinds of institutions are now being questioned, or have ceased to be generally accepted in Japan? Let me quote three important examples, each having important bearings on the future of Japanese corporate governance.

The first institution to be questioned is lifetime employment practice. Among the younger generation the prospect of working for one employer for an entire lifetime is not necessarily taken for granted anymore. For example, the large number of young bureaucrats quitting their once-prestigious jobs at MOF, METI, MFAs and so on is a clear symptom of this tendency. According to a recent Survey on Career Bureaucrats of the First Class by the Agency of Administrative Personnel (2001), 84 bureaucrats under the age of 50 quit in 1998, compared with 46 the previous year. It is interesting to note that more than 70 percent of those who quit said that they would likely return to the public sector in the future if good opportunities arose. There have also been large numbers of exits from once-powerful financial institutions, such as International Bank of Japan and Nomura Securities, etc. One of the members of the working group formed by Minister Takenaka at the Financial Services Agency and currently a KPMG affiliate was a Bank of Japan official. As I will discuss later, although large-scale voluntary exits of engineers from manufacturing companies have not yet occurred, the situation may change somewhat in the near future.

The second institution is the demise of the main bank system. The belief that major financial institutions would never fail and that the main bank would bail out financially distressed firms is no longer firmly entertained. Recently, government actions indicated attempts to resurrect such beliefs, but I believe nobody really expects that could be possible. In fact, the burst of the bubble was not really the cause of the weakening of the banking sector. The bubble itself was a symptom of their weakened position. Banks were engaged in over-lending in high-risk, high-return real estate projects. They were prompted to behave in such a way in response to the drifting away of healthy corporate customers from the orbit of their influence. I predict that the banking sector will not regain the prominent power that it used to enjoy, even if it succeeds in containing its current bad-debt problems within a reasonable period of time in the future.

The third change taking place is the structure of political economy. Until 1993, the one-party rule of the LDP was believed to be as sure as the sun rising in the east every morning. Under the LDP one-party rule, the refined structure of tripartite collusions between interest groups, allied politicians and administrative bureaus was formed in almost all the spheres of the political economy. This structure, which I call administered pluralism or compartmentalized pluralism (*shikirareta tagenshugi*), provided an important mechanism for absorbing and arbitrating pluralist interests through administrative processes with the intervention of politicians. This structure was expected to provide income and job security for members of pluralist interest groups within the larger group. Earlier, it made feasible the transfer of income from productive exporting sectors to disadvantaged, unproductive sectors. As the competitiveness of the former began to be challenged in the newly

emergent international environment, the costs of sustaining such mechanisms were largely shifted to future generations by the accumulation of large fiscal deficits accumulating to about 140 percent of GNP. Obviously this mechanism cannot be sustained as it has been and a public debate concerning the wisdom of sustaining the equality of outcome and job security with the support of inefficient fiscal expenditures such as unproductive civil works is becoming ever more heated. Politicians of the old guard (*shukyu*-sect) who played prominent roles in the defense of incumbent interest groups and arbitrated among them are now on the defensive.

The formation of a non-LDP coalition government in 1993 ended in disappointment and the LDP subsequently returned to power in coalitions with other parties. Nevertheless, the threat of the loss of power through the electoral process has remained real since then; this explains why Koizumi, who has only a very weak political base within his own party but enjoys popularity among voters, has not been seriously challenged from within. Thus the Japanese polity is beginning to be embedded in real electoral competition, especially in local politics where executive offices are chosen by direct election. The reformist governors of Mie, Miyagi, Tottori, Nagano and Kochi prefectures are implementing participatory politics on the basis of liberal and open information disclosure. Unfortunately, party lines on the national level have not yet been clearly drawn on the basis of political implications for institutional change. The potential for government change, however, seems to have begun to have profound impacts on the basic institutional structure of the political economy.

Actually these three institutions I have just referred to—lifetime employment, the main bank system and administered pluralism—have not existed independently. Rather, they were mutually supportive as well as complementary to the organizational architecture and corporate governance arrangement that evolved in Japan in the era of high economic growth. As you may know, the typical Japanese firm of that time could be called a “share-firm”: information, decision-making and outcomes were widely shared throughout the organization.

With this organizational structure, employees tended to be associated with one organization, exploiting benefits from sharing. Thus management’s role was to strike a balance of interests between the investors (profit-making) and the employees (job and income securities, promotion opportunities) rather than serve as a sole agent of the former. As long as the firm was run profitably, the manager, who was promoted from within, was expected to hold the reins. Any moral hazard from insider control was expected to be held in check by the belief that the main bank would intervene in the event of financial difficulty. Industrial associations in collusion with relevant administrative bureaus provided effective political-economy frameworks for protecting the interests of incumbent firms along industrial lines. In particular, until the mid-1990s, banking and securities interests were firmly protected by relevant bureaus of MOF.

Thus, it is not coincidental that the institutions of lifetime employment, the main bank system, and administered pluralism were eclipsed at the same time when the basic nature of the shared firm itself began to face challenges. In particular, the impact of the IT revolution was crucial. As the costs of processing and transmitting information have been dramatically reduced, the advantages that the Japanese firm enjoyed from smooth coordination of intra-organizational activities through internal information sharing have been substantially reduced. By this I do not mean that the value of tacit knowledge sharing within the firm has declined in general. I mean rather that Japanese firms may have become too large to sustain any competitive advantage from their superior ability to share tacit knowledge internally. Clearly it is no longer a profitable strategy for the Japanese firm or its corporate grouping to produce and market an entire product system in a closed manner. Further, any attempt to

become engaged in unrelated business lines has become relatively more costly, because in such cases, management skills tend to be consumed in unproductive arbitration among various internal interest groups.

In any case, the demise of the main bank has created a vacuum of corporate governance for Japanese firms, while they face challenges to modify some aspects of the shared firms. In my view, this is the state of institutional crisis in which the old ways of doing things are not taken for granted any more, but new ways of doing things have not clearly emerged. Will this crisis be resolved by emulating American practices? There are certainly many things to be learned from the United States. However, institutional transformation is usually conditioned by historical path—the phenomena referred to as “path-dependence” in economic jargon. Are there any symptoms of new ways of doing things to emerge? I would like to point out several such phenomena:

- After many years of disappointing results, engineers from large corporations have finally started to succeed in spin-offs of new firms (e.g., Incs, Thine, Megachips, Samco, Yozan, Futures, and many others) and they have started to successfully recruit the best graduates from first rate engineering schools in competition with large established engineering firms.
- Corporate restructuring through asset sales and corporate splits has finally begun to emerge since the introduction of tax incentives last year. There have been more than 300 cases involving asset restructuring among large corporations since then.
- All national universities will become independent private entities within two years and their professors as well as staff will cease to be civil servants. This will deregulate the terms of employment for university professors and accelerate mobility into and out of academia. Intermediary organizations, such as the incorporated Technological Licensing Office, are being formed to help with technology transfer from universities, the formation of joint development consortia between universities and small firms, and the spin-offs of venture businesses from universities. The effectiveness of such intermediary organizations is now increasingly recognized as crucially dependent on the supply of skills in technology management that have been accumulated within established firms, but which are now somewhat redundant.

On one hand, these new phenomena may result in the evolution of a more flexible and dynamic industrial organization. On the other hand, many problems that may hamper such evolution persist. These include:

- The biggest problem is that, at least until the recent reshuffling of the Koizumi cabinet, government regulators have tried to bail out troubled firms or hide their problems by arranging their mergers or acquisitions by healthier firms (even at great cost) rather than localize and resolve problems as early as possible. It remains to be seen whether the leadership of Economic Minister Takenaka and his expressed policy change in this regard will have a real impact.
- The older generation still has not been emancipated from the traditional value placed on quasi-egalitarian internal sharing and associated insider control. This inertia prevents the flexible redesign of the firm’s organizational architecture through the input of external advice and surveillance and the recruitment of individuals with new competencies and specialized skills from outside the organization, etc. This insider control in corporate governance arrangements renders a clear separation between control (monitoring) and executive management difficult.

The tension between the emerging phenomena and the inertial forces is a characteristic typical of institutional evolution at this juncture. As I emphasized throughout this talk, institutions cannot be designed and implemented simply by law and government actions alone, although laws and regulations can create favorable environments for institutional change. Since institutions are in reality shared beliefs about the ways social games are being played, changing them requires, above all, experimentation with and selection from among various business models. In particular, considering that there is a vacuum in the corporate governance domain as a result of the demise of the main bank system, enhanced outside representation on the board of directors, if not the introduction of outright stock market control, may be crucial.

I consider the reform in this direction as one of most important lessons learned from the American experience in spite of recent corporate debacles of Enron and World Com. About a quarter century ago, even in the United States the proportion of outside corporate board directors was less than one-quarter and many were associated with CEOs as friends, business partners and the like. Now, however, the proportion of insiders to outsiders has been reversed. This evolution was largely facilitated by tax incentives, among other things, such as allowing stock options to executive managers to be accounted as costs, provided that the scheme is designed and introduced by an outsider-dominated compensation committee. In Japan a new statutory provision to be implemented next April will require Japanese listed companies to include an independent outsider among the traditional auditors or to adopt an American-type system of board committees (compensation, appointment, and auditing) dominated by outsiders. This law may not change the substance of insider control overnight, but it could help contribute to a gradual change of the corporate governance arrangement in the direction of enhanced outsider monitoring and separation of control and management. Recently, progressive directors, managers and academics created the Society of Directors to promote such a direction.

Innovative experimentation in how to combine outside monitoring and disciplinary competence with the traditional, internal human and information resources is a necessary step for restructuring the Japanese corporate governance structure left in vacuum in a path-dependent way. This does not sound like a strikingly novel statement. However, institutional change in corporate governance will emerge only out of decentralized efforts at the corporate level; therefore, I would submit that no scholar or policy maker can really dictate or predict the direction of future change in a more specific way. Having made such apologetic statement, I shall stop here rather than continue to speculate. As I may be more optimistic than the media in this country about the current state of Japan (less so in my home country these days), however, it would be helpful and fruitful for us to engage in dialogue and debate. I am quite happy to receive critical comments and questions from you.

Thank you kindly for listening.

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