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# Corporate Governance in Japanese Firms: Organization Specific Human Capital and Friendly Shareholders

Firms and Industrial Organization in Japan (10)

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Chapter 11 (with the same title),
in Part IV: Intrafirm Oaganization and Interfirm Relationships,
of the book forthcoming in 1995

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[Part IV. Intrafirm Organization and Interfirm Relationships]

## Chapter 11. Corporate Governance in Japanese Firms: Organization Specific Human Capital and Friendly Shareholders

### 11-1. Introduction

In the preceding Parts, I assumed a neoclassical firm as the basic decision unit: a firm in the real world behaves like a neoclassical firm; shareholders control the firm; directors make decisions as an agent of shareholders; it purchases other factors of production than "capital" in the market; and its behavior can be explained as maximizing profit under given constraints, such as production function and demand conditions. Also assumed that a firm is like an iceberg floating on the sea, called the market, implicitly assuming, too, zero transaction costs unless otherwise stated like in Chapter 4. Everybody knows, however, that institutions matter and the costs of market transactions are non-zero, and that once we are interested in the formation and working mechanism of each firm, interfirm relationships, and the market, we need a close examination of the validity of these assumptions. For the study of intrafirm organization and interfirm relationships in Japan, it is indispensable.

As will be shown in Section 11-2, the predominance of small business and the slimness of large firms are the two basic facts of the Japanese economy. With these, one may argue that thus the extensive use of the advantage of division of labor is a source of Japan's industrial success. The critical issues here are, who coordinates the divided work of individual agents? how she attains it? are there any specific institutional arrangements which contribute it greatly? why these arrangements have functioned well particularly, for instance, in Japan? Most readers realize that the Japanese economy is full of stylized facts, some of which are misunderstanding or stand on shaky grounds, and that there is a strong

temptation to explain its success as owing to some of them, which often leads us to the "Japan-Is-Different-View." Each of those conventional views and models of the Japanese economy, such as the Dual-Structure-View, Keiretsu-Loan-Model, Mainbank-Model, and Corporate-Group-Model, embodies own specific view of the coordinating agent and related institutional arrangements. But as shown above both on the theoretical and empirical grounds, they are totally false. Thereby, the market may be an infallible answer, but almost always unsatisfactory. As I will mention in Section 11-2, it is far from the truth that economists have a highly developed theory either of the firm or the market, and thereby it is infeasible now to attack the above issues beyond this infallible answer rigorously with the established standard model. However, I will try to explain some of the issues related to the above mentioned ones with theories that attempt to incorporate real world features of a firm, though they are still rudimentary. By this we can reach, I believe, an understanding of the organizational issues far better than those the conventional ones provide, which in return will contribute to the progress of the study of the firm and the market.

Focus of Part IV centers on two specific aspects of firm organizations in Japan, on corporate governance in this chapter and on interfirm relationships in the next. To begin a study of interfirm organization and interfirm relationships, we need a definition of a firm. Thereby the discussion of this chapter begins with three questions related to it: where is the boundary of a firm? who decides the boundary and internal organization of a firm? how is the boundary related to the legal definition of a firm? Underlying these is the basic question of Coase[1937]: "why a firm emerges at all in a specialized exchange economy?"

My argument in this chapter is basically the nexus of contract theory associated with Jensen and Mechling[1976]. The central point for organizational issues, however, is who is "the controlling group" in Simon's words, that is who has the power to set the terms of membership for all the participants. With the importance of employee's investment in

organization specific human capital formation, the body of employees takes this key position, and selects as their representative the directors. Other stakeholders rationally exchange the agreement with it to be and stay friendly, like friendly shareholders and friendly banks. Since a firm in the real world is a legal fiction, the legal boundary of a firm usually does not coincide for this controlling group with the effective boundary for their decision making. A firm in the Coase's question and economic analysis in general is the set of activities and/or agents within the effective boundary, and therefore is different from a firm in the real world and thereby those in statistics.

Once we realize that the basic factor which determines the controlling group of an organization is none of such factors as shareholdings, loans, and directors despatched by them but the organization specific human capital accumulated by the body of employees, many economic phenomena related to organization, for instance, the above mentioned two basic facts of the Japanese economy, must be explained differently. For the controlling group the legal boundary is only one of the constraints for their decision making, and may not be critically binding for designing the organizations, such as intrafirm organization and interfirm relationships. Inside-outside distinction of a firm in Coase's sense depends on transaction costs, and the legal definition does not necessarily affect it heavily. In this view, even for an owner-manager it is for their interest to be friendly to the body of employees, and therefore the question of whether the management is separated from control is irrelevant.

I study firms in Japan in this chapter, but never I argue that they are different in any sense from those in other countries. Neither Japanese nor American firms (or firms in other countries) are particularly badly managed. The reason is straightforward: most badly managed firms either fire their managers and improve their performance, or go out of business. "Elementary notions of comparative advantage suggest that some firms in any country will <u>always</u> be uncompetitive compared to firms in the same industry elsewhere" (Ramseyer[1993, p.2020]). The basic logic underlying the

discussion in this chapter, that the fundamental factor which determines the form, character, and working mechanism of organizations is organization specific human capital embodied by the body of employees, is technological and thereby not peculiar to any countries like Japan and US. When some crucial difference is observed between economies A and B, it must be caused by some environmental factors, including the legal system, history, and culture. As I will mention in the last section, we observe both the same type of observations and arguments on firms outside Japan and the literature with closely related arguments on the nature of organizations.

In Section 11-2, first, I point out two basic facts: the predominance of small business in Japan and the slimness of large Japanese firms. Next, I briefly discuss concepts of organization and their relation to firms in action. In Section 11-3, for an illustration I take, as the representative of Japanese firms, large firms in the transportation industry, and the actual figures of directors and large shareholders, so-called friendly shareholders. In Section 11-4, I duscuss why the body of employees becomes the controlling group of a firm, and the next section is to study why a friendly shareholder stays friendly. In Section 11-6, first, I discuss the position and role of other stakeholders, such as shareholders, banks, and directors, and next the irrelevance of the classical "separation of management from control" issue. Section 11-7 is again to explain why I conclude that the body of employees is the controlling group, since it is futile to ask who controls the firm as it is a matter of definition in a world of exchange of agreement. Section 11-8 is a preliminary for the next chapter, where how the discussion in this chapter is related to the study of interfirm relationships. The last section is concluding remarks, where besides a brief summary I describe two points to be noted: first, the basic logic underlying the argument in this chapter is technological and thereby applicable to other economies, and never I argue that something is peculiar to Japan; second, though the argument explains how the theory of comparative advantage works, it cannot be effective in describing the source of Japan's industrial success.

## 11-2. Two Basic Facts of the Japanese Firms and the Definition of the Problem

### Two Basic Facts of the Japanese Firms: the Predominance of Small Business and the Slimness of Large Firms

In discussing Japanese firms and Japan's industrial organization, most have in mind such firms as Toyota, Nissan, and Honda in the automobile industry and NEC, Hitachi, and SONY in the electronics industry. Some may believe that Toyota's unique "kanban-system" is common throughout the Japanese economy. On the contrary, most Japanese firms are small, most Japanese workers are employed by small firms, and more than half of Japan's value added is produced by small firms. Such dominance of small firms in Japan has a long history, and their share has not changed at least for 30 to 40 years.

The total number of establishments in the whole private sector of Japan (not including agriculture and fishery) is 6.5 million in 1991, and 99.1% of them are small business. The total number of the employees there is 55 million, and 79.2% of them are in small business. Limiting our attention to the manufacturing sector, we find almost the same picture. There are 857,000 establishments in 1991, and 99.4% of them are small business. The total number of employees is 14.1 million, with 73.8% in small business. The corresponding figures in the manufacturing sector in 1957 were 99.6% and 72.3%, respectively, which suggest the stable predominance of small business. Throughout these 30-40 years, more than 55% of the value added has been produced in small business sector, and therefore less than 45% in the large firm sector.[1]

A comparison of large Japanese firms and their American and European counterparts reveals that Japanese firms are rather slim and have far fewer employees in relationship to sales. Table 1-7 of Chapter 1 gives some

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[1] For these figures, see note 8 of Chapter 1.

examples. For example, Toyota's annual sales amount to some 1/2 that of General Motors and 1.3 times that of Volkswagen, but it employs (72,000) less than 1/10 the number of workers of GM (751,000) and less than 1/3 that of Volkswagen (266,000).

These are the two basic facts of the Japanese firms. Thus, in Japan large firms occupy a rather small portion of the economy, and large firms are relatively slim and depend more on transactions with outside suppliers. Some readers familiar with the literature on the Japanese economy may comment that the large number of small business are so heavily dependent on some large firms that they cannot make an independent decision, that many large firms form corporate groups, behave collectively, and thereby dominate the Japanese economy, or that a few large banks, as Mainbanks, dominate Japan's capital market and subordinates other firms. As shown in Part I and II, however, those conventional views and models are totally false. For instance, the view underlying the second comment is false since both the strength of group's unity and their size are too much emphasized, no matter what is the definition of "corporate groups." Therefore, these two basic facts are the result of independent choice of many firms, most of which are small business.

## The Definition of the Problem: Organizations and Firms

To begin a study of intrafirm organization and interfirm relationships, we need a definition of a "firm." Three questions related to it are critical for what follows: first, where is the boundary of a firm? second, who decides the boundary and internal organization of a firm? third, how is the boundary related to the legal definition of a firm? Underlying this term is the basic question of Coase[1937]: "why a firm emerges at all in a specialized exchange economy?"

What we observe and adopted in the previous parts as "firm" is a legal entity, based on laws, such as corporate law and antitrust law, which implies that we have assumed a consistency between an actual firm and a

relevant unit for economic analysis. What happened if an actual firm much differs from a relevant analytical unit, particularly for analyzing interfirm relationships and intrafirm organization? If the leading player who decides the boundary and internal organization of a firm is not the one corporate law assumes, namely the body of stockholders, the relevant boundary can be different from the legal one and the latter might be regarded only as one of the constraints for decision making.

"The firm in economic theory...is a 'shadowy figure'" (Coase [1988, p. 5]). As Oliver Hart [1989, p. 1757] frankly noted that little could be further from the truth that economists have a highly developed theory of the firm. Most formal models of the firm are extremely rudimentary, and bear little relation to the complex organizations we see in the world. Theories that attempt to incorporate real world features of firms often lack precision and rigor, and have therefore failed to be accepted by the theoretical mainstream. Neoclassical theory, the staple diet of modern economists, views the firm as a set of feasible production plans. "It does not explain how production is organized within a firm, how conflicts of interest between the firm's various constituencies - its owners, managers, workers, and consumers - are resolved, or more generally, how the goal of profit-maximization is achieved. More subtly, neoclassical theory begs the question of what defines a given firm or what determines its boundaries" (ibid., p. 1958).

The above mentioned two basic facts of Japanese firms and industrial organization, namely the predominance of small business and slimness of large firms, must be interrelated and should be explained by a manner recognizing Coase's question. As it applies to "organization" in general, let us begin with a discussion of organization.

> [T]he term <u>organization</u> refers to the complex pattern of communication and relationships in a group of human beings. This pattern provides to each member of the group much of the information and many of the assumptions, goals, and attitudes

> that enter into his decisions, and provides him also with a set of stable and comprehensible expectations as to what the other members of the group are doing and how they will react to what he says and does. The sociologist calls this pattern a 'role system'; to most of us it is known as an 'organization' (Simon[1976], p. xvii of "Introduction").

There are various types of organization and "firms" are one of them. Therefore it is not appropriate to begin the study of organizations with "firms." The economic system consists of a network of people and organizations, with lower-level organizations linked together through higher-level organizations. A key characteristic of the organization at the level, such as firms, which is next to the highest, the economy as a whole, is their independent legal identity, which enables them to enter binding contracts, to seek court enforcement of those contracts.

The nexus of contract theory, on which my argument depends, is often associated with Jensen and Mechling[1976]. They argue (p.310-11), "it is important to recognize that most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals." "The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships . . . " (By legal fiction they mean that the artificial construct under the law which allows organizations to be treated as individuals.) "The firm is not an individual. It is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals . . . are brought into equilibrium within a framework of contractual relations. In this sense the 'behavior' of the firm is like the behavior of a market; i.e., the outcome of a complex equilibrium process."

As Milgrom and Roberts [1992, p.20] pointed, a full description of organizational architecture involves many more elements: the pattern of resource and information flows, the authority and control relationship and the distribution of effective power, the allocation of responsibilities and

decision rights. Once our focus becomes the elements of organizational architecture, defining an organization as a legal entity can become quite inappropriate because it can easily misidentify the effective boundaries of the organization.

The effective boundary of the organization does not always coincide with the actual boundary of the organization as a legal entity. If there exists an discrepancy, it makes little or no sense to distinguish the "inside" of the firm from the "outside" of it and to try to understand the underlying mechanism. The central issue is Who decides the effective boundary? Thus, as March and Simon [1958] noted,

> The distinction between units in a production-distribution process that are 'in' the organization and those that are 'out' of the organization typically follows the legal definition of the boundaries of a particular firm. We find it fruitful to use a more functional criterion that includes both the suppliers and the distributors of the manufacturing core of the organization . . . Thus, in the automobile industry it is useful to consider the automobile dealers as component parts of an automobile manufacturing organization" (pp.89-90).

They listed, as the chief participants of most business organizations, the following five classes: employees, investors, suppliers, distributors, and consumers. This argument on the irrelevance of in-and-out distinction based on the legal definition of the organization and for the effective boundary directly leads us to the discussion of interfirm relationships in the nest chapter via Section 11-8. In the following sections, I investigate the corporate governance in Japanese firms.

11-3. Directors and Friendly Shareholders

The view one takes of firms and organizations is apt to depend on his assumption about how investors, employees, and other players come to be associated in a common venture. In what follows I take the view of Easterbrook and Fischel [1990, p.185]:

> The corporation and its securities are products to as great an extent as the sewing machines . . . the firm makes. Just as the founders of a firm have incentives to make the kinds of sewing machines people want to buy, they have incentives to create the kind of firm, governance structure, and securities people value. The founders of the firm will find it profitable to establish the governance structure that is most beneficial to investors, net of the costs of maintaining the structure. People who seek resources to control will have to deliver more returns . . . will obtain the largest investments.

Thereby, managers who control such resources do their best to take advantage of their investors, but they find that the dynamics of the market drive them to act as if they had investors' interests at heart. It is almost as if there were an invisible hand.

The basic issue is who are the founders of the corporation and who occupy their position when the firm grows large, that is, in Simon's [1976] words, what is "the controlling group." By controlling group he means "the group that has the power to set the terms of membership for all the participants," and selects for the organization "[t]he basic value criteria that will be employed in making decisions and choices among alternatives in an organization" (p.119]).[2] Here I do not intend to develop a general theory. Instead, following Dore [1992], I focus on the controlling group of large Japanese firms and the roles of shareholders in corporate management. As will be mentioned later, the same argument applies to small business.

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[2] This concept corresponds to Alchian and Demsetz's [1972, p.778] "the centralized contractual agent in a team productive process."

> The essence of Dore's argument is found in the following statement. "In the conception of the firms -- or at least of the large corporation -- which is overwhelmingly dominant in Japan, among union leaders as well as in the business class, the one stakeholder whose stake is seen to be of paramount importance is the body of employees. The primary definition of the firm is a community of people, rather than a property of the shareholders, and this conception shapes business practice . . . The economic behavior encouraged by these underlying conceptions is more conducive to business efficiency . . . than behavior based on the assumptions embodied in American -- or for that matter Japanese -- corporation law" (p.18).[3]

I agree with Dore that employees are the most important stakeholder in most large Japanese firms, which means that "the controlling group" is the body of employees. In such firms, the directors and managers are selected from among employees, and are almost always able to expect strong support from the majority of employees, as long as their decision making is generally consistent with their interests.[4]

Antei-Kabunushi (friendly shareholders)

The question is how this group secures their stable position and defends themselves from attacks by other stakeholder, especially shareholders. The most basic and important reason is that such attacks are generally not for

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[3]Dore[1992] does not assert that this community nature is peculiar only to Japanese firms. In the corresponding commentary, Harold E. Edmondson, a Vice President of Hewlett-Packard, wrote that "[w]hile the entity is important in Japan, but feeling is present in many American companies, too," and that "I feel that there is a fair amount of the cooperative or Japanese approach to things in our industry" (p.26).

[4]This relationship is what Simon calls "authority." See chapter VII of Simon [1976].

the benefit of other stakeholders. An additional reason[5] is the role played by Antei-Kabunushi those stable shareholders friendly to the existing management (hereafter, friendly shareholders). This is important for the defense of management's position against noisy shareholders, especially during takeover bids. Dore [1992, p.20] wrote that "[a] large part of a firm's equity is in the hands of friendly, corporate stockholders: the suppliers, banks, insurers, trading companies, dealers it does business with."

I explain here why it is the basic reason, which is the essence of my view underlying the following sections and the next chapter. Let me begin with the characteristics of shareholdings in large firms. For the illustration, I take the figures for large firms in the transportation equipment industry listed on the Tokyo Stock Exchange, such as automobiles, automobile parts, shipbuilding, railway vehicles, and so on. First, in most large Japanese firms, a large part of the equity is in the hands of small number of shareholders. The average concentration ratio of the 10 largest shareholders of 11 firms with more than 10,000 employees in 1990 (Group A) was 35.03% in 1980, and 36.49% in 1990. The figure ranges from 26.20 (Mitsubishi Heavy Industries) to 59.50 (Isuzu) in 1990.The corresponding figures for 29 firms with employees of 2,000-10,000 in 1990 (Group B) were 55.70% in 1980 and 54.53% in 1990.[6] Second, most such large shareholders are corporations, mainly financial institutions and trade partners. In Group A, of the largest 10 shareholders, all were corporate shareholders in 1990, of which the number of financial institutions was 10 in 2 cases, 9 in 8 cases, and 8 only in one case. Of 29 Group B firms, non-corporate shareholders, including employees shareholding associations, appeared only in 3 cases in the 10 largest shareholder's list, and 7.6 was the average

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[5]This is only a result of the position of the body of employees, not vice versa as is often misunderstood. When the latter is the case, nothing can prevent shareholders gathering together and deciding for their own profits to neglect the will of directors and managers, and therefore at least we would observe some such examples.

[6] The corresponding figures for 20 firms with employees of 1,000-2,000 in 1990 were 58.47% in 1980 and 55.25% in 1990.

number of financial institutions in the list. For instance, at the end of March, 1990, all 10 largest shareholders of Nissan and Honda were financial institutions. In many cases, the largest shareholder was a non-financial corporation and the others were financial institutions, such as Mazda (Ford holds 24%), Daihatsu (Toyota, 14.19%), Fuji Heavy Industries (Nissan, 4.24%), Aichi Machine (Nissan, 32.10%), Yamaha Motor (Yamaha, 33.42%), and etc. Of the ten largest shareholders of Toyota, nine were financial institutions and Toyoda Automatic Loom, from which Toyota spun off, was the fourth largest with 4.35% of the equity.

The term Antei-Kabunushi is widely used, but ill-defined. Antei [literally, stable] here has dual meanings, one for their stable position as shareholders and the other for their contribution to the stable position of the existing directors. Emphasizing the importance of the latter, I choose "friendly shareholders" as the English translation. The positions of large shareholders has remained stable for a long time. Of the 10 largest shareholders in 1990 of 11 Group A firms, 7.5 on average were on the list in 1980, and most large shareholders newly appeared in the list in 1990 were financial institutions which were listed between 11th and 20th in 1980. Newly listed non-financial institutions in total were only two, Ford as the largest shareholder of Mazda with 24% and GM as the third of Suzuki with 3.6%. The stability of large shareholders was symbolically revealed in the case of Koito, a car-part manufacturer, which was the target of a take-over attempt by Boone Pickens, a well-known corporate raider from the U.S., who owned 26.43% of Koito's share at the end of March 1990 as the largest shareholder. Because of the event, the stock price, had stayed at the level around ¥500 per share, rose drastically to the highest of ¥5,470 on the 31st of March, 1989. The striking fact is the stability of the large shareholder's behavior: (1) Of the 20 largest shareholders at the end of March, 1980, 17 stayed in the list of the 20 largest at the end of March, 1990, none of which decreased the number of shares in his hands, and 14 increased; (2) All three which disappeared from the list in 1990 were not in the largest 10 in 1980 (the largest one of them was the 13th in the

ranking) and held in total 3.24% in 1980. Two newly appeared large shareholders other than Boone Company in the list of 1990 were two mutual life insurance companies, which in total held 2.17%. In 1980, the 10 largest shareholders in total owned 50.78%, and the 20 largest 61.71%.

In most large Japanese firms, the controlling group is the body of employees. In such firms, the directors and managers are selected from among employees, and are almost always able to expect strong support from the majority of employees, as long as their decision making is generally consistent with their interests. Large shareholders, staying stably in their position, also support the existing management. They maintain the right as large shareholders and can use the present corporate law and legal system to deprive the existing management of their leadership in the firm, and we are in a world of exchange by agreement rather than by coercion. Thereby, they must have no incentive to unite for this purpose: otherwise, nothing can prevent them from uniting in order to realize the benefits, and in these circumstances the positions of directors and managers cannot be stable. Thus, they are friendly to the existing management, and called, "friendly shareholders [Antei-Kabunushi]."

In most large Japanese firms, most members of the board of directors are selected from among employees. For instance, all 55 directors of Toyota in June 1993 are former employees, and also are 31 of 33 directors of Honda in March 1993, one of two remainings is a former high official of the Ministry of Foreign Affairs and the other is an interlocking directorate of the chairman of Mitsubishi Bank. All 35 directors except one of Nihon Denso in December 1993 (with 41,996 employees), of which Toyota owns 23.07% of the share and Toyoda Automatic Loom 7.28%, are former employees. The only exception is an interlocking directorate of the chairman of Toyota. Almost the same is true for Aisin Seiki (employees: 10,935) 21.67% of whose equity is owned by Toyota in March 1993, where 25 of 28 directors are the former employees and remaining 3 are all from Toyota one of whom is an interlocking directorate of a vice president of Toyota. The same picture applies also to smaller firms. All 24 directors of NOK (a car-part

manufacturer with 3,790 employees) are former employees, 22.55% of whose equity is owned by Freutenberg of Germany and 4.04% by Toyota, the fourth largest. Of 21 directors of Kayaba (a car-part manufacturer with 4,480) 19 are former employees, the largest share, 9.12%, of whose equity is owned by Toyota and the second position by Nissan with 8.73%. The remaining two directors are both former managers of Fuji Bank, the third largest shareholder. Koito is the final case for the exposition. In March 1990, 16 of 20 directors were former employees, and three were former managers of Toyota and one was an interlocking directorate of a vice-president of Matsushita, the third largest shareholder.

On average, a director is selected to be a board member at the age of the early fifties, and stays on the board for 6-7 years. For instance, most directors of Toyota in 1993 are selected at the age between 50 and 53,[7] and on average 4 years after the selection promoted to the higher position, such as managing director, executive managing director, vice-president, and president, or resign. Of 55 directors, 23 are on the higher positions, and 10 are newly selected at the general meeting of shareholders in September 1993. The important facts are threefold: every year new directors are selected from among employees and follow the seats of resigning board members, by which the board members change step by step; as a result, such directors continuously dominate the board; large shareholders individually and as a group continuously support the selection of board members and the board itself.

The case of Koito symbolically illustrates the stability of the board constitution and the position of each member even when the constitution of large shareholders changes drastically. No impact of the appearance of Boone Company as the largest shareholder can be observed in the board

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[7] However, for instance, directors are selected at a bit higher age in Kayaba, and lower in Koito. Though only a few, directors are selected from outside the firm, who are selected also on average at the age of early fifties. For instance, two directors of Kayaba from Fuji Bank were both selected at the age of 52. Also two directors Aisin Seiki from Toyota were selected at 52.

constitution supported at the general meeting of shareholders in June 1991. Both the constitution of large shareholders and that of the board of Koito have remained stable for 20 years since the drastic change in 1971-72. The point is that even such a drastic change in the large shareholders constitution did not accompany a spectacular impact on the board constitution. In September 1971, before the change, the largest shareholder was Matsushita. Neither Toyota nor Nissan was in the 10 largest shareholders. 9 of 10 directors were former employees and the founder of the firm, and one was an interlocking directorate of a vice-president of Matsushita. By September 1972, Toyota acquired the largest share of 21.81% and Nissan the second with 8.89%, while Matsushita maintained the number of shares and remained as the third largest. The board changed at the general meeting of shareholders in June 1972 in three points: the number of directors increased from 10 to 14; former directors all remained in the board, and 2 from Toyota joined both as managing directors and 2 selected from among employees; the chairs of the president and a vice-president (no.1 and no.2 position) were occupied by two former vice-presidents (no.3 and no.4), and for the former two tops (presumably only nominally) higher positions were created within the board.[8] No other change occurred, including in the position of an interlocking directorate of Matsushita's vice-president. The two directors from Toyota stayed as directors for more than 20 years, and were the president and a vice president when Boone Company appeared as the largest shareholder.[9]

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[8] At the time of change, the former president was 88 years old, and the former no.2 was 64.

[9] When Boone Pickens attempted a take-over of Koito, commentators and journalism introduced this firm as a member of Toyota group both because of the large shareholding and because the president was once a manager of Toyota. It is a matter of definition of a "member of Toyota group," however, note the two points. First, Nissan appeared as a large shareholder at the same time with Toyota, and has been a stable and large shareholder. Second, Mr. Matsuura, a former manager of Toyota, was selected the president of Koito in 1985 at the age of 59, after 13 years' experience as a board member of Koito. Mr. Ohtake, who was the former president selected in 1979 at the age of 65 and had been a board member since 1961, has remained in the board as the chairman since then. Another Mr. Ohtake was the president since 1972 to 1979, and then became the chairman at 68.

## 11-4. The Body of Employees as the Controlling Group

Why is the body of employees the controlling group and large shareholders accept and support it? "Today the essential task for a firm is not to carry out routine works steadily but through interaction of agents to create information, to search new context for business, and develop an accumulation process for continual innovation" (Imai[1989, p.141]). To be efficient in order to survive and grow, a firm has to accumulate stock of human capital with which it establishes an organization suitable for the task. It takes long time and needs guarantee that in the foreseeable future nothing will occur which devaluates drastically the result of these activities. This requests friendly shareholders.

This process, when effective, has four characteristics. First, it requires a long-term investment by each participant in his own human capital. Second, the required investment is more or less specific to the organization he belongs, that is, the skill is organization-specific. Third, it is used in a team production process of Alchian and Demsetz [1972, pp.782-83], in that the product is not a sum of separable output of each cooperating resource, and not all resources used in team production belong to one person. Fourth, with long-term investment each participant gets the right to be a member of the organization, but can recover the investment cost and receive its reward not by selling the right but by staying there and making a success in the competition within the organization. Quitting the organization will devaluate miserably the value of the skill, since it is organization-specific. When the stability of the organization is uncertain, participants will hesitate in investment in the skill formation of the required type. It results in low performance of the firm, which will discourage talented young to join it. When only a part of the participants are confident in the stability, the value of confident worker's skill will be lower than otherwise because of the lower skill of less confident workers. Thus by making the stability certain, the body of employees can make the best use of their resources.

Besides securing large, stable shareholders friendly to the existing management, selecting directors and top managers from among employees is a measure for the stability. A director who was a former employee, say for 30 years, and made a long-term organization-specific investment realizes what is the core asset of the firm and its essence, and how important is the stability of the organization. Moreover, once established a de facto rule to select directors as their representatives, every participant is confident of the stability since they can change directors unfamiliar or hostile to the present organization.

The economic organization through which resource owners cooperate will make better use of their comparative advantages to the extent it facilitates the payment of rewards with productivity. This applies to every type of resource owner. Investors, for instance, part with their money willingly, putting it in equities instead of bonds or banks or land because they believe the returns of equities more attractive, likewise the equity of firm A instead of firm B. Once he owns the equity of a firm, he realizes the importance of the stability of the organization, and wants to be a friendly shareholder since it is profitable. Moreover, an investor can recover the investment cost and receive its reward by selling the equity. He can also decrease the risk of investment by diversifying his portfolio. Neither is feasible for an employee who makes investment in organization-specific skill.

Note two points. First, this is a result in a world of exchange by agreement rather than by coercion, and who controls the firm is a matter of definition and futile to ask. Therefore my argument that the body of employees is the controlling group is a judgement based both on the theoretical model and observations, as shown above and will be discussed again in Section II-7.[10] Second, one may take seriously much of the

[10] One may argue that corporation is based on the corporate law which assigns the residual claimants to shareholders, who therefore obviously control the firm. However, as Komiya [1990, pp.168-69] argued "Irrespective of legal definition of rights and responsibilities, ownership of the firm, in an economic sense, is not easily defined. 'ownership' is not a black-and-white affair" (quoted above in Section 7-4). When shareholders cannot

literature regarding the "discretionary" power held by managers of large firms and apply them to firms where the controlling group is employees. How does it happen that they are willing to allow directors hurt their interest, since the reward for the investment largely depends on their performance.[11]

## 11-5. Why is a Friendly Shareholder Stays Friendly?

In a world of exchange by agreement, a shareholder agrees to be friendly and stays as a friendly shareholder because the expected reward will be higher than otherwise. The controlling group of the firm has to deliver reward large enough to attract them. In order to induce a large shareholder to be friendly and stay as a friendly shareholder, it has to offer additional incentive other than those delivered to an ordinary shareholder, like dividend. Otherwise, those who hold rather pessimistic expectation than the market on the firm's prospects for the future will cease to be friendly. Three types of incentive are popular. First, by cross-holding the equity with another firm, they exchange a contribution to the stability each other, which functions as a hostage to make an agreement on friendly shareholding credible. Second, a trade partner often benefits from the stability of the organization of the firm and is willing to pay a premium for it, since the stability is the basis of the firm's prosperity which increases profitable business for a seller and enables it to provide better products at lower price to a buyer. Also it serves as a guarantee for a buyer that the supply of the products will never stop unilaterally either at the supplier's will or by an invasion, such as a take-over, of some

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decide by themselves what is the residual, the assigned residual claimants position makes no sense. One simple fact is that in Japan there has been no case where shareholders received positive dividend by liquidating a firm listed on an stock exchange.

[11] Thus, Kaplan and Minton's [1993] finding that in Japanese firms the turnover of directors is higher when the shareholder's rate of return is lower can be interpreted also as a result of employees complaint on the performance of directors.

buyer's rival. In this case, the seller's skill becomes relation specific, too. Third, it can offer additional incentive through allocating profitable business.

Mutual life insurance companies, some of them are the largest shareholders in Japan, are the representative of the receiver of the third type incentive. Since they are not corporations but mutual companies, cross-holding is not a feasible measure. Usually they neither are big users of the product of manufacturing firms nor have deep interest in the stability of their organization, and we observe both loan transaction and insurer-customer relationship between a life insurance company and its shareholding firm. Almost the same picture applies to other financial institutions, such as banks and trust banks. In this case, however, cross-holding prevails. For instance, of the 10 largest shareholders of Toyota in June 1993, 9 are financial institutions including 2 mutual life insurance companies. The largest three shareholders, with the same share of 4.9%, are banks, of which Toyota is a large shareholder, that is, the largest of Tokai Bank, and the fifth largest both of Sakura Bank and Sanwa Bank.[12] Also smaller firms such as Kayaba owns large amount of stocks of Fuji Bank and Yasuda Trust Bank which in turn own 5.0% and 4.3%, respectively, of the equity of Kayaba in March 1993.[13]

Cross-holding of the equity prevails between trade partners. For instance, Toyota cross-holds the equity not only with so-called Toyota group firms such as Nihon Denso and Aishin Seiki, and other Kyoho-kai (Toyota's supplier's association) members such as Kayaba, Koito,[14] and Asahi Glass, but also materilal suppliers like Nippon Steel. The case of

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[12] The larger four shareholders in each case are all life insurance companies. Toyota also owns large amount of equity of these banks, whose market value is roughly 40% that of Toyota's equity in their portfolio in March 1993.

[13] The market value of each of these banks' stocks owned by Kayaba is about 40% that of Kayaba's stock it holds in March 1993.

[14] As shown in Chapter 4, almost every Kyoho-kai member is also a member of other assembler's supplier's association, and cross-holds the equity with Toyota's rival assemblers. For instance, Kayaba does it also with Nissan, Mitsubishi, Suzuki, Hino, and Mazda.

Akebono Brake, the largest brake supplier in Japan, is symbolic. Of the 10 largest shareholders, 5 are car assemblers in March 1993, Nissan (no.1 with 15.66%), Toyota (no.2 with 15.49%), Isuzu (no.4 with 5.12%), Hino (no.6 with 2.30%), and Mitsubishi (no.9 with 1.50%). Akebono cross-holds the stocks with all these firms, though in each case the market value of the holding stock is around 10% that cross-held.

Unless an shareholder enjoys such additional incentives, it agrees neither to be friendly nor to stay friendly. Thereby, individuals seldom appear in the list of friendly shareholders except when she is a member of the controlling group, for instance, when she is one of the founders or directors of the firm. A corporation without such additional incentives, even when it owns the equity of the firm, do not intend so strongly to stay friendly, and sells the stock, usually with a prior notification to the firm, when it is profitable.[15][16]

Though friendly shareholders receive as an additional incentive higher reward than the ordinary shareholders, on some occasions this premium is not high enough to stay as a friendly shareholder. For instance when the stock price of Koito rose to the level of ¥5,000, almost 10 times higher than the previously stable level, the expected capital loss in the next few years would exceed the premium. Even in such an occasion, as shown above, no friendly shareholders sold their shares. This is because of the following mechanism. The stability of the organization, which is the

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[15] 20 June 1994 issue of Nihon Keizai Shimbun reports that recently some corporation shareholders supposed to be friendly tend to sell the shares, especially shares of banks, in the market, and comments that cross-holding of the equity between firms without close trade relationship will decrease steadily though slowly.

[16] The above story of Japanese friendly shareholders is affected by two characteristics of Japanese legal system. First, Section 9 of the Antimonopoly Law stipulates that "No holding company shall be established." Also, Section 11 states, "No company engaged in financial business shall acquire or hold stock of another company in Japan if by doing so it holds in excess of five percent (ten percent in the case of an insurance company) of the total outstanding stock." Second, corporate law (Sections 222-1 and 242 of Commercial Law) strictly limits the role of preferred stock, which results in almost non-existence of preferred stocks in Japan. For the roles of preferred stock, and more generally dual class common stock, see Gordon [1990].

objective of the controlling group for asking a group of shareholders to be friendly, is a result of team production, and the effectiveness of individual shareholder's action totally depends on the others' action. Thereby both the firm and other friendly shareholders hate such an action as to endanger the stability, which particularly for trade partners of the firm will give a serious damage on their business. Once it sells the share of a firm where it is supposed to be friendly it loses the trust as a friendly shareholder both of other shareholders and its cross-holding partners, which will endanger the stability of own organization by losing friendly shareholders. The stability has to be believed by the body of employees to last long, which requires a trust on each shareholder that it realizes such team character and does not behave against the team interest. It costs much for a corporation to recover[17] the once lost other's trust as a friendly shareholder, and has to suffer from a bad reputation.

When the body of employees establishes their position as the controlling group of a firm which is supported by friendly shareholders, it is tremendously costly for large shareholders to unite in order to deprive the existing management of their leadership in the firm. The existing management is strongly supported by the body of employees, and the new management, whether invited from the outside or selected from the inside, will face a strong resistance of the employees to change the organization and the corporate policy since their accumulated human capital is organization specific. Moreover, as a result of the prevalence of such type of firms and manager's skill, the manager's market has not developed well. Thereby it is hard to find a body of new management and improve the performance of the firm for shareholders. In case a bank with a large share of the equity selects its director as the president of the firm, hardly there is a remarkable difference. Unless accepted by the body of employees as their representative, she cannot change the corporate policy. Thus,

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[17] Recall the argument in Chapter 4 that suppliers' trust on an assembler not to sacrifice their interest for its own has played a crucial role for the development of an efficient system for automobile production.

rarely such selection of a leading director from the outside can be effective.

## 11-6. Related Issues: Role of Other Stakeholders, and Agency Costs

### Position and Role of Shareholders, Banks, and Directors

Thus the basic reason why the body of employees can secure their stable position and defends itself from attacks from other stakeholders is that such attacks are generally not for the benefit of other stakeholder, and the role played by friendly shareholders is an additional reason. One more step in this direction leads us to the following three logical results, all of which are contrary to the conventional view of the Japanese economy. The controlling group is the body of employees. They have the implied power to select the friendly shareholders and also the sources of corporate funds.

(1) The friendly shareholders are selected because they are supposed to be friendly to the present directors and managers. When once friendly large shareholders threaten the present management, the directors change their selection of the friendly shareholders. Cross-holdings or group holdings (e.g., among "corporate group" firms) are the result of such voluntary selection. Accordingly, shareholding patterns and the names of large shareholders give us limited information; although identifying friendly shareholders, this practice seldom reveals the true distribution of power.[18]

(2) The sources of corporate funds, including banks, are selected based on the lender's support of the present body of directors. Therefore, when large lenders, such as the Mainbank(s) or lead bank(s), once friendly to the present management become bothersome, the directors change their selection. The phenomenon that the largest lender often has a large share

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[18]For a critical review of the literature on corporate groups in Japan, recall the argument in Chapter 7.

of the borrower's stock is only a result of such voluntary selection.[19][20]

(3) The members of the board of directors and top managers are also selected based on their support of the present directors and employees. Even directors who are supposed to represent the interests of other stakeholder are friendly to the present body of directors, and they remain in the position unless they are troublesome. The structure of the board of directors is a result of such voluntary selection, and accordingly, the number of directors who were formerly members of other bodies of stakeholders, such as banks and trade partners, within the corporate structure gives us little information about the distribution of power.[21]

The Separation of Ownership and Management, and Agency Costs

> The Directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own,

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[19]This view is compatible with Dore's second feature of the Japanese economy(p.20). "One of the banks is generally considered a firm's lead bank. It may provide only marginally more loan capital than other banks, but it will own more of the firm's equity, it will put more effort into monitoring the companies performance, and it will be the prime mover in any brink-of-bankruptcy reconstruction." Often the supporters of this view proceed to suggest that this lead bank, usually called Mainbank, has strong power and even controls management of the borrower. Here, they confront a question, "Why does the controlling group continue to choose a certain Mainbank?" As shown in Chapter 6, I am quite skeptical on the current flood of literature on the Japanese Mainbank system which, instead of assuming a competitive market, implicitly assumes the existence of a tight cartel among Japanese financial institutions and its dominance in Japanese capital market.

[20]A similar view is often expressed for non-Japanese firms. For instance, Thurow[1992] pointed out that, among the four factors (natural resources, capital, technology, and skills, where skills include the management skills necessary to coordinate these factors of production) traditionally contributed to making individuals rich, companies successful, and nations prosperous, "managerial and work force skills" are left "as the critical strategic variable in the competitive equation"(p.v).

[21]Like firms shown above in Toyota Group, such as Nihon Denso and Aisin Seiki, even parent companies, which hold more than half of the stock of their subsidiaries, may not have the power to enforce their will. Because of the critical importance of management and work force skills, it is in the interests of the parent company to be only a friendly shareholder. Many cases of this kind are found in Japan, such as Hitachi Cable, Hitachi Metals, and Toshiba Machine discussed in Section 7-6.

> it cannot be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. ... Negligence and profusion... must always prevail, more or less, in the management of affairs of such a company (Smith[1776, p.700]).??

Since the time of Adam Smith, the separation of ownership and management, or the separation of management from control, within a large modern corporation gathered wide attention, and Berle and Means [1932] provoked the public's interest on their social control.[22] Also in the postwar Japan, the same argument prevailed, and many insisted that in Japan the separation was even more clearly realized in Japan than in the U.S.[23]

My above argument presents another view. In the classical view of the separation, each shareholder is so small that the cost to unite for their interest is too big to be effective in controlling the management. In Japan, however, small number of large shareholders in total own the dominant portion of the equity, for whom uniting cost is not formidable. They support the existing management as friendly shareholders, since it is more advantageous for them to do so than, for instance, to manage the firm by themselves. Here, the separation of ownership and management, and that of management from control, is not a serious social problem, whatever is the definition.

The same is true for the argument on non-zero agency costs. As Jensen and Mechling [1976, p.328] pointed out, these costs (monitoring and bonding costs and 'residual loss') are an unavoidable result of the agency relationship, and therefore to conclude that the agency relationship is non-optimal is what Demsetz [1969] characterizes as the "Nirvana" form of

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[22] Another principal study was Gordon [1945]. On this point, see Bain [1968, pp.63-76] and Williamson [1964].

[23] As mentioned in Chapter 7, Miyazaki [1976] followed Gordon. For the separation in Japan, see, for instance, Chapter 4 of Hazama [1989].

analysis. Friendly shareholders choose to accept these costs instead of avoiding them by managing the firm by themselves.

Thus far, I focused only on large firms listed on stock exchanges. The same logic applies also to unlisted large firms, and even to unlisted small businesses. What will happen when an owner of a large unlisted firm makes a different choice from that of a firm where the body of employees is the controlling group, for instance, by suggesting to sell all the shares to some other firm in 10 years? Such a firm neither can attract talented young nor induce employees to invest in organization specific skill formation, which results in poor performance of the firm. Thus, an owner-manager chooses to be friendly to the body of employees, and non-separation and non-dispersion of ownership does not affect the firm's basic decisions. The same is true for small businesses. In order to survive and grow, even an owner-manager of a small business has to follow the same path.

## 11-7. The Body of Employees as the Controlling Group Revisited

In a world of exchange by agreement, who controls the firm is a matter of definition and futile to ask. It is basically unidentifiable who is the controlling group that has the power to set the terms of membership for all participants, and selects for the organization the basic value criteria that will be employed in making decisions and choices among alternatives in an organization.[24] However, with two points, I conclude that the body of employees is the controlling group, and other stakeholders, such as shareholders, trade partners, and banks, when they join the organization, accept their leader's position and stay friendly unless their promises become worthless.

First, large firms did not increase dividend payment for investors even when it earned a big profit. Instead, it retained its large part, and spent it mainly for the benefit of the employees when the firm fell into

[24] As mentioned above, this definition is from Simon [1976, p.119].

distress. Throughout a long period of boom and depression of a firm, other stakeholders are friendly unless their promises become worthless; for instance, shareholders are friendly with stable dividend payment, in many cases ¥5 a year per share, and banks with safe loan recovery and interest payment. Such once prosperous firms as Toyobo, Toray, large shipbuilding firms, and steel firms, are the notable examples. For instance, Toray earned big profits in 1960s as a monopoly of nylon and one of the pioneering suppliers of polyester, but it increased the dividend only very slowly to the maximum of ¥8 per year in FY 1969 and soon decreased to the stable level of ¥6 per year in 1971. Dividend increased again to ¥7.5 in 1973, but decreased soon and was maintained at the level of ¥5 even when dividend payment exceeded the profit, except for FY 1977 when it fell to ¥4.5 as the profit per share was only ¥0.9.[25]

Second, large firms make big expenditure even in sunny season for employees for rainy days, particularly for depression. Many large firms began their trial for diversification typically when they were in their heyday, for which they spent retained profits. M&As are not popular for this objective,[26] since the purpose is not the profit itself through efficient use of the internal funds but the creation of workplace for employees. As a result, on average the performance of such trials for diversification has been, at least financially, poor. Because of such investment, the profit in financial statement tends to be small. Besides such investment for diversification, large firms often pay extra money for employees working outside the firm, called <u>shukko</u>. For instance, recently Japanese steel firms suffer from a serious slump, and many employees, keeping their position as the employees, are working outside the firm. The reward is lower outside because their organization specific skill is almost

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[25] For the behavior of banks, including so-called Mainbank, recall the argument in Chapter 6.

[26] M&As, particularly those through takeovers, are not popular in Japan. Note, however, that takeovers, and in particular hostile bids, are not the normal form of corporate control. As Jenkinson and Mayer [1993] points, hostile takeovers are absent in most countries, including Continental Europe and Japan, outside the U.K. and U.S..

worthless, and the firm pays extra money for the gap. In the case of Nippon Steel, the largest steel maker, the number of such employees is more than 15,000 in 1993 (more than 10,000 since 1989), about 30% of the total, and the firm is said to pay the money till these employees become the retirement age of 60. This firm still pays shareholders annually ¥2.5 per share as dividend though the business is seriously in the red, but the other major steel makers cease to pay it, maintaining such extra payments.[27] In a world of exchange by agreement, at any moment each agent can reevaluate the prospects for the future and change the choice. The last case reveals that even in such a situation shareholders cannot force the directors to stop such decisions.

One may argue that friendly shareholders are not homogeneous and each has own requirement which both strictly conditions the firm's choice and causes the conflict of interest among friendly shareholders. Also many argue that, unless the firm will pay the required minimum dividend, it may allow shareholders as a part of the reward voice to the management. The above case suggests, however, that the conflict of interest remains potential, and that each may have a chance to voice for the common interest on the stable dividend payment, which is not always observed.

## 11-8. Organization as a Decision Unit and Firm as a Legal Fiction

The view of organizations underlying the above discussion does not depend on the legal definition of a firm. As Tirole[1988, p.16] pointed out, the economists' contractual view of a long-run arrangement of its units has relatively little to do with the legal definition of a firm. The controlling group, the body of employees and the existing directors supported by them, thereby, recognize in their decision making the legal

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[27] See 4 June 1994 issue of Weekly Toyo Keizai, p.18. 6 June 1994 of Nihon Keizai Shimbun reports that the total of this extra payment by Nippon Steel is ¥60 billion (nearly US$ 600 million) this year. Needless to say, it can pay the money because of the huge retained profits, and impossible otherwise. I do not intend to argue that life time employment is prevalent in Japan.

boundary of a firm drawn from this definition only as one of the constraints. But it is not necessarily critically binding.[28] Once our focus becomes the elements of organizational architecture which the controlling group chooses and creates, defining a formal organization by the legal definition becomes quite inappropriate because it can easily misidentify "the effective boundaries of the organization" (Milgrom and Roberts [1992, p.20]). Thus, unless the issue depends on the actual boundary of the firm as a legal entity, it makes little or no sense to distinguish the "inside" of the firm from the "outside."

Large Japanese firms are relatively small. But it is about the size of firm as a legal entity, and the story about the size of organization within an effective boundary may be different. The same applies also to the predominance of small business. It is the effective boundaries of the organization that are crucial for understanding the working mechanism of the economy. In discussing interfirm relationships in the next chapter, I will focus on "the effective boundaries" as relevant and critically important to the decision-making of the controlling group.

The controlling group is often a union of several groups, each of which does not necessarily exercise an equal bargaining power. Employees are a collection of different groups of workers and one or some of them form the controlling group. Thus, the preceding discussion does not imply that employees in a firm are strongly united and form the controlling

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[28] For instance, Jensen and Mechling [1976, p.311, fn.14] emphasize the important role which the legal system and the law play in social organizations, especially, the organization of economic activity:

> Statutory laws sets bounds on the kinds of contracts into which individuals and organizations may enter without risking criminal prosecution.... The courts adjudicate conflicts between contracting parties and establish precedents which form the body of common law. All of these government activities affect both the kinds of contracts executed and the extent to which contracting is relied upon. This in turn determines the usefulness, productivity, prfitability and viability of various forms of organization.

Besides, technology, demand, competition, and "transaction costs" are on the list as the examples of constraints and variables which affect the effective boundaries.

group. Other groups stay in a relatively weak position. As a result, in a R&D oriented firm, for instance, the body of personnel in the R&D field often forms a part of the controlling group, and their representatives are selected as board members, which functions as a guarantee for high return on investment in organization specific R&D skill formation.

This view also suggests that the legal definition of a firm is much larger than the bounds for decision making by the controlling group; in some case, a firm can be better understood as a collection of independent decision units, each of which has own controlling group that is a part of the union. Each group belongs not necessarily to one such union, some of which are inside the firm while others outside. The tie between groups is strong in some while relatively weak in others.[29]

Therefore, not only an inside-outside distinction with the legal definition of a firm makes little or no sense, but also that with an effective boundary whatever is the definition does not necessarily make sense. Any effective boundary cannot be the only one which affect the behavior of a controlling group or a body of some resource owners joining the group as a part. Concerning with this, note two points. First, an activity or a decision unit is often both inside the boundary with one definition and outside with another both of which the controlling group is the same. Second, an activity or a decision unit is inside the boundary of an organization whose controlling group is X does not imply that it is outside the boundary of another organization whose controlling group is in

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[29] For example, though with another concept, in the field of marketing the same kind of mechanism is discussed as in Stern and El-Ansary [1988, p.410]:

> The ability of a channel member to exercise control stems from his access to power reserves. ...the accrual of such power generating resources to a channel leader may be the result of the specific characteristics, experience, or history of the firm and its management. Alternatively, power sources (or their absence) may reflect particular characteristics of the environmental forces impinging upon the channel (demand, technology, competition, legal constraints, etc.) and the channel member's ability to capitalize on these forces. Therefore, the power of a channel leader may reflect both the characteristics of his environment and his own characteristics.

keen rivalry with X.[30] For instance, Toyota and Nissan are arch-rivals, but both have maintained long-term close relationships with the same suppliers, which can be regarded as inside the boundary of these two organizations and often called keiretsu.[31] I call these relationships "long-term relationships with non-exclusiveness," and will study them closely in the next chapter, since its prevalence is one of the most striking peculiarities of Japanese industrial organization.

The next issues are What determines the effective boundaries of the organization, relations between these boundaries, and their working mechanism? and How they work? Two basic facts of Japanese firms and industrial organization, namely the predominance of small business and the slimness of large firms, and also both intrafirm organizational structure and interfirm relationships in general, must be interrelated and should be explained by a manner discussed above. The basic mechanism underlying the above argument is technological in character, which therefore must be in common everywhere and is not peculiar to Japan. Environmental factors, such as constrains including the legal system for each decision unit, conditions both the skill formation process and the shape and function of the organization.

As mentioned in Section 11-2 quoting from Hart [1989], however, "neoclassical theory begs the question of what defines a given firm or what determines its boundaries," and "[m]ost formal models of the firm are extremely rudimentary, capable only of portraying hypothetical firms that bear little relation to the complex organizations we see in the world." Neither do I intend to present a new formal model nor do I have a clear

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[30] Thus, the significance of an inside-outside distinction, which is not a black-and-white affair, totally depends on the efficacy of its definition for the goal of the analysis. It therefore makes little or no sense to distinguish, like Williamson [1991], the third area between "market" and "hierarchy" and call it "hybrid." Like most actual markets locate between pure monopoly and perfect competition, which are polar cases hypothetically formalized for analysis, most actual organizations are "hybrid."

[31] On this point, recall the last part of Section 4-4, especially note 53.

idea to give a persuasive answer to the above issues. The study of interfirm relationships in the next chapter is for two objectives. First, the Japanese economy by itself worths close study, particularly because of its rapid growth and its size, and so the interfirm relationships which are one of its striking peculiarities. Second, it is a rich source of materials for studying general issues related to organization.

The basic logic used above in this chapter is exactly the same with that used in Chapter 4, therefore a bundle of interfirm relationships closely organized by an assembler such as Toyota and Nissan in the Japanese automobile industry is an organization. Each interfirm relationship is organized by the controlling group formed as a union of the controlling groups in each unit, which is long-term but non-exclusive. Here the fundamental factor which governs the relationships is the formation and maintenance of both organization and relation specific human capital.[32] The controlling group of the total system is that of the assembler, which has the power to set the terms of membership for all the participants, and selects the organization the basic value criteria in an organization. Beyond this, however, I have no idea to give a persuasive answer to such subtler questions as follow. First, why Toyota is so slim and uses market so widely as to buy a large portion, about 70%, of parts for their car production from the outside? Second, what affects the decision of assembler's make-or-buy decision? For instance, Toyota's own-make items are different from those of Nissan. Third, why Toyota established Hosei Brake in 1968 as a joint venture with Akebono Brake, the largest brake maker in Japan, besides buying brakes from Akebono, and how it coordinates the relationships? Most other Japanese assemblers purchase brakes from Akebono, but none has such joint venture. To answer such questions, at least we need a rough image of what happens in the relationships and what supports them, and a rough estimate of the cost for its formation and

[32] As mentioned above in this Chapter and in Chapter 4, none of other types of relationship based on such factors as shareholding, loans, and despatching directors is crucial.

maintenance. For other readers, how exclusive it functions for new comers and how harmful it is for competition in the market and economic efficiency may be of the primary concern. For all these points, see the next chapter.

## 11-9. Concluding Remarks

In Japan, organization specific human capital is the fundamental factor which governs the structure and function of the organizations, such as firms and interfirm relationships. They are so organized as to induce core employees to make investment in the organization specific skill formation and establish an stable organizational structure suitable for it. As a result, the body of employees is the controlling group, and most directors are selected from among employees as their representatives. A group of friendly shareholders, a group of friendly fund suppliers like banks, and directors from the outside support the existing directors. The slimness of Japanese large firms and the predominance of small business in the Japanese economy, with long-term but non-exclusive relationships among them, should be explained by such a manner. So are the absence of hostile takeovers and the uncommon mergers between well managed firms in Japan.

Two points should be noted. First, the basic logic underlying the above argument on the formation and maintenance of organization specific human capital and its importance is fundamentally technological and must be in common everywhere, namely both at home and abroad. Therefore, the argument on Japanese organization in this chapter must apply also to organizations outside Japan. Some environmental factors may cause peculiar appearances to Japanese organization, but the basic mechanism is the same. So, Alchian and Demsetz [1972, p.789] argues on American firms that "[i]nstead of thinking of shareholders as joint owners, we can think of them as investors, like bondholders, except that the stockholders are more

optimistic than bondholders about the enterprise prospects."[33] Never I argue in this chapter that something is peculiar to Japan. When there is something peculiar in the organization in Japan or in some other economies, such as intrafirm organizational structure and interfirm relationships, it is not because of the fundamental role played by organization specific human capital but because of some environmental factors that affect and support the formation and maintenance of such human capital and organization suitable for it.

Second, each individual resource owner makes the best use of her own resource under given environments. When a group of human capital investors establishes an organization and takes its controlling group position everywhere, the prevalence of such organizations constitutes a part of environments surrounding each individual. Under such environments, individuals, organizations, and therefore industries make decisions and compete each other, which results, through the mechanism of comparative advantage, in the existing industrial structure of the economy and international division of labor. Therefore, the above argument may explain a part of the cause of the industrial success of the Japanese machinery industry, but it cannot be necessarily useful in explaining that of the overall Japanese economy. As will be shown in the next chapter, too extensive division of labor has hindered the coordination among participants in many industries, such as textile, which has resulted in high cost,

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[33] Many literature emphasize the importance of the discrepancy between actual behavior of corporate directors of American firms and assumptions embodied in American corporate law. See, for example, Mace [1971, 1979]. Also note the comment of Clark[1985, 56] that,

> [t]o an experienced corporate lawyer who has studied primary legal materials, the assertion that corporate managers are agents of investors, whether debtholders or stockholders, will seem odd or loose. The lawyer would make the following points: (1) corporate officers like the president and treasurer are agents of the corporation itself; (2) the board of directors is the ultimate decision-making body of the corporation...; (3) directors are not agents of the corporation but are sui generis; (4) neither officers nor directors are agents of the stockholders; but (5) both officers and directors are 'fiduciaries' with respect to the corporation and its stockholders.

low quality, low market responsiveness of the industries and made them comparatively disadvantaged. In some such industries we observe the same characteristics as the automobile industry, such as an extensive division of work, long-term close relationships among them with non-exclusiveness, directors as representatives of the body of employees, friendly shareholders, and friendly banks.

Most readers may notice that the above argument suggests the invalidity of the profit maximizing assumption of a firm. It is a logical consequence of the nexus of contract view of a firm, and not surprising at all. Not only that the existing firm is a legal fiction and not the basic unit for decision making, but also that the controlling group is not the body of shareholders whose target in the neoclassical view of the firm is profit maximization. Even when the controlling group maximizes the joint extra income (the sum of the parts greater than that obtainable in an outside opportunity) of all participants including shareholders, say, "profit in a wider sense," this target is different both from "profit" in the classical sense and from the figures in financial statements. Readers may ask, "Then how do you justify the argument in the previous Parts of this volume which heavily depends on the profit maximizing assumption of a firm, particularly in Part I?" Frankly, no perfect logical justification exists. There is no other choice and that is why I put this Part as the last one. But at the same time I believe with three reasons that it does not affect seriously the arguments in the first three Parts, thereby not decrease their value. First, though a "firm" is not profit maximizing, each resource owner makes the best use of her resource. Actually in Japan competition is fierce everywhere, not only in product markets, both for final goods, and intermediate goods and materials, but also in markets for factors such as capital, labor, and land. When such fierce competition prevails everywhere, the behavior of such an organization cannot but resemble to a profit maximizing firm. Second, the deviation form the profit maximizing behavior exists everywhere, irrespective of the firm size, and there is no reason to assume that it is greater, for instance, in larger

firms. I used profit rate data as a basic material in Part I not in their absolute values but in their relative position. Third, other arguments than the comparison of profit rate are invulnerable to the deviation. The number of new entrants did not specify who made entry decision, therefore can be reinterpreted as that of a "non-profit maximizing firm." The same is also true for the examination whether small business seriously handicapped under the Dual-Structure. Thus, and in general, the departure from the profit maximizing assumption of a firm will not greatly affect such type of arguments in the first three Parts, except for that in Chapter 7 on Corporate Groups where the role of shareholders is crucial.