

The Corporate Governance Model of Japan:

Shareholders are not Rulers

Franklin Allen  
University of Pennsylvania

and

Mengxin Zhao  
Bentley College

May 13, 2007

**Abstract**

In the U.S. and U.K. corporate governance is concerned with the narrow goal of ensuring that firms maximize the wealth of shareholders. In Japan and some other countries, firms are concerned with a broader group of stakeholders, including employees, suppliers, customers and others as well as shareholders. This article contrasts the Anglo-American system of corporate governance with that in Japan and elsewhere. If markets and institutions are well developed and competitive, Anglo-American corporate governance ensures an efficient allocation of resources. In other circumstances, focusing on a wider range of stakeholders as the Japanese do can be more efficient.

In the U.S. and U.K. corporate governance is concerned with ensuring the firm is run in the interests of shareholders and its objective is to create wealth for them. Underlying this view of corporate governance is Adam Smith's notion of the invisible hand of the market that he laid out in his seminal book *The Wealth of Nations*. If firms maximize the wealth of their shareholders and individuals pursue their own interests then the allocation of resources is efficient in the sense that nobody can be made better off without making somebody else worse off. In this view of the world the role of the firm in society is precisely to create wealth for shareholders. This fundamental idea is embodied in the legal framework in the U.S. and U.K. In these countries managers have a fiduciary (i.e. very strong) duty to act in the interests of shareholders.

Much of research in economics in the more than two centuries since the publication of *The Wealth of Nations* in 1776 has been concerned with understanding when the invisible hand of the market works and when it does not. The requirements for it to work are strong. These include perfect and complete markets so that there are no transactions costs or other similar frictions. There must be no missing markets or externalities such as those arising from pollution. Everybody must have the same information so that nobody has an unfair advantage over others. Markets must be perfectly competitive. These are strong requirements and are unlikely to hold in most economies. The key question is whether such deviations are sufficient to invalidate the basic insight of the invisible hand of the market. In the U.S. and U.K. it is widely agreed that this is not the case and it is accepted that firms' objective should be to create wealth for shareholders.

In many other countries there is no such consensus. Japan is perhaps the most extreme example. Instead of focusing on the narrow view that firms' should concentrate on creating wealth for their owners, corporate governance has traditionally been concerned with a broader view. One way of articulating this view is that corporate governance is concerned with ensuring that firms are run in such a way that society's resources are used efficiently by taking into account a range of stakeholders such as employees, suppliers, and customers, in addition to shareholders.

With imperfect markets this broad objective can potentially make everybody better off compared to just focusing on the shareholders' interests (see Allen and Gale, 2000). For example, if there are externalities such as pollution then maximizing the value of the firm is well known to cause a misallocation of resources. If firms were instead to use the broader view above, they would change their behavior and produce the socially optimal level of pollution. In general, although it may not be possible to obtain efficiency it may be possible to achieve a better allocation of resources with the broad view than with the narrow one (see Allen and Gale, 2000, and Allen, 2005).

In countries such as Japan, Germany and France, it is this broad view that is often stressed. Rather than being concerned only with shareholders a wider set of stakeholders including employees and customers as well as shareholders are considered. In fact in Germany the legal system is quite explicit that firms do not have a sole duty to pursue the interests of shareholders. This is the system of *codetermination*. In large corporations employees have an equal number of seats on the supervisory board of the company which is ultimately responsible for the strategic decisions of the company. In Japan, managers do not have a fiduciary responsibility to shareholders. The legal obligation of directors is

such that they may be liable for gross negligence in performance of their duties, including the duty to supervise (Scott, 1998). In practice it is widely accepted that they pursue the interests of a variety of stakeholders (see, for example, Allen and Gale, 2000).

### *Examples of Corporate Philosophies in Japan*

Table 1 contains a typical statement of corporate philosophy for a Japanese firm. It is for Asahi Breweries, a well-known Japanese firm. Very little attention is paid to shareholders. In fact they are not even mentioned until Section 6 and then only briefly: “We at Asahi, through securing and expanding the base of our operations, desire to fulfill our responsibilities to stockholders and the local communities in which we operate.” Table 1 illustrates the perspective on the role of the corporation in society that underlies the broad definition of corporate governance given above.

The Japanese company Toyota provides an even stronger illustration of the idea that if companies pursue the interests of all stakeholders then a superior allocation of resources can be achieved. On August 1, 2001 the *Financial Times* reported details of the annual meeting of the International Corporate Governance Network which was held in Tokyo that year.

“Hiroshi Okuda, chairman of Toyota Motor Corporation and of the Japan Federation of Employers' Associations, told the assembled money managers that it would be irresponsible to run Japanese companies primarily in the interests of shareholders. His manner of doing so left no doubt about the remaining depth of Japanese exceptionalism in corporate governance.

...Mr Okuda made his point by telling guests what Japanese junior high school textbooks say about corporate social responsibility. Under Japanese company law, they explain, shareholders are the owners of the corporation. But if corporations are run exclusively in the interests of shareholders, the business will be driven to pursue short-term profit at the expense of employment and spending on research and development.

To be sustainable, children are told, corporations must nurture relationships with stakeholders such as suppliers, employees and the local community. So whatever the legal position, the textbooks declare, the corporation does not belong to its owners.

No matter that all the research shows that stock markets respond favourably to higher research and development spending. Nor that the audience consisted chiefly of long-term investors, such as pension funds. The chasm between Japanese and Anglo-American views on what companies are for and whose interests they serve could not have been clearer. "In Japan's case," said Mr Okuda, "it is not enough to serve shareholders."

Despite this focus on all stakeholders, Toyota has done very well for its shareholders. Figure 1 shows the return from buying stock in Toyota, Ford, General Motors and the S&P 500 index in 1972 and holding this investment with reinvestment of dividends until the end of 2006. Even though it does not focus on the creation of wealth for shareholders, it has done vastly better for its owners than General Motors where this has been the focus. Ford is another interesting example. It is effectively a family owned firm since the Ford family controls about 40% of the voting rights. This concentrated ownership means the owners have strong incentives to oversee management effectively and ensure they create wealth for shareholders. Ford briefly outperformed Toyota in terms of wealth creation in the late 1990's but this period was very short. Over the long run, Toyota has again done considerably better.

*How widespread are these Philosophies?*

Of course, Asahi and Toyota are just two companies. How representative are they of companies in Japan and elsewhere? The view that Japanese corporations have relatively little responsibility towards their shareholders is confirmed in surveys of managers. Figure 2 shows the choices of senior managers at a sample of major

corporations in the five countries, Japan, Germany, France, the U.S., and the U.K., between the following two alternatives:

(a) A company exists for the interest of all stakeholders (dark bar).

(b) Shareholder interest should be given the first priority (light bar).

In Japan the overwhelming response by 97% of those asked was that all stakeholders were important. Only 3% thought shareholders' interests should be put first. Germany and France are more like Japan in that 83% and 78%, respectively, viewed the firm as being for all stakeholders. At the other end of the spectrum, managers in the U.S. and U.K., by majorities of 76% and 71% respectively, stated that shareholders' interests should be given priority.

The same survey also asked the managers what their priorities were with regard to dividends and employee layoffs. The specific alternatives they were asked to choose between were:

(a) Executives should maintain dividend payments, even if they must lay off a number of employees (dark bar).

(b) Executives should maintain stable employment, even if they must reduce dividends (light bar).

Figure 3 shows the results. There is again a sharp difference between Japan, Germany and France and the U.S. and U.K.

The evidence on managers' views of the role of the firm is upheld by the way that wages are structured in the different countries. In the U.S. and U.K. wages are based on the nature of the job done. Employees' personal circumstances generally have no effect on their compensation. In Japan and Germany it is common for people to be granted

family allowances and special allowances for small children. In France vacation allowances based on family are common. These differences underline the fact that in the U.S. and U.K. the firm is designed to create wealth for shareholders whereas in Japan, Germany and France the firm is a group of people working together for their common benefit.

### *Corporate Governance Differences in Practice*

So far we have argued that the philosophy underlying corporate governance in the U.S. and U.K. differs from that in Japan. We next go on to consider how these differences in philosophy manifest themselves in corporate governance mechanisms.

There are five that we shall focus on.

- (i) The Board of Directors
- (ii) Executive Compensation
- (iii) The Managerial Organization of Corporations
- (iv) The Market for Corporate Control
- (v) Concentrated Holdings and Monitoring by Financial Institutions

In the U.S. and U.K. the board of directors is elected by the shareholders. It consists of a mix of outside directors and inside directors who are the top executives in the firm. Once elected the board of directors specifies the business policies to be pursued by the firm. The role of management is to implement the policies determined by the board. Shareholders have very little say beyond electing directors.

Except in unusual circumstances, such as a proxy fight, the outside directors are nominated by the incumbent management and thus typically owe their allegiance to the

CEO. Table 2 shows the total number of directors and for the U.S., U.K. and Japan (in parentheses) the number of outside directors for a typical sample of large firms in each of the countries. The size of boards is roughly the same in the U.S. and the U.K. and is usually around 10-15 people. In the U.S. a majority are typically from outside the firm while in the U.K. a minority is external.

Japan resembles the U.S. in terms of the legal form of corporations because of the heavy influence of the U.S. Occupation Forces on the legal system and the structure of institutions after the Second World War. Some important differences do exist, however. The rights of Japanese shareholders are in theory greater than those of shareholders in the U.S. and U.K. For example, in Japan it is easier for shareholders to directly nominate directors and elect them. Also management remuneration must be decided at general meetings of shareholders.

Despite these differences in shareholders' rights, the structure of Japanese boards of directors is such that shareholders do not in fact have much influence. It can be seen from Table 2 that the size of Japanese boards is much larger than in other countries. There are a handful of outside directors but they have very little influence. The overwhelming majority of directors are from inside the company. Their number is such that they include many people in addition to the most senior members of management. The nominations of individuals for positions as a director are essentially controlled by the company's CEO. This together with the unwieldy size of the board and its composition means CEOs hold tremendous power. Provided the financial position of a Japanese corporation is sound it is essentially the CEO and those closest to him who control the company's affairs. The structure of many Japanese companies' boards has changed in



recent years. In response to the forces of globalization a number of firms have reformed their boards to reduce their size and bring them more in line with U.S. and U.K. boards.

One of the most important corporate governance mechanisms is the structure of senior executives' compensation. Provided investors have an incentive to gather information and stock market prices partially reflect this, incentives can be provided by making managers' compensation depend on the company's stock price. Examples of the form which this dependence can take are direct ownership of shares, stock options and bonuses dependent on share price. Provided stock prices contain enough information about the anticipated future profitability of the firm fairly effective automatic incentive systems to ensure managers maximize shareholder wealth can in theory be designed. In addition to stock prices accounting based performance measures are also frequently used. The advantage of stock prices is that they cannot be as easily manipulated by management as accounting data.

Another motivating force for managers is the possibility of dismissal for bad performance. If other firms perceive that the performance was due to incompetence the manager may find it difficult to find another job and so may bear a large penalty. On the other hand, managers who perform extremely well may be bid away at higher compensation levels to other companies. The managerial labor market thus also plays an important part in providing incentives to managers.

One of the most important differences between the U.S. and other countries is the level and structure of executive compensation. Executives in the U.S. are paid much more on average and a greater proportion of their compensation is performance related. This is true even relative to the U.K. and particularly relative to Japan. Senior executives

in Japan are among the lowest paid in the world and relatively little is tied to the stock price of the company (see, for example, Figure 12.1 in Brealey, Myers, and Allen, 2006).

Although there has been an enormous amount of effort devoted to understanding the operation of the U.S. and U.K. system where firms pursue shareholders' interests, or Anglo-American capitalism as we shall call it, there has been relatively little devoted to stakeholder capitalism where firms pursue the interests of a variety of stakeholders. However, to the extent that there is such a literature it mainly focuses on the managerial organization of corporations. Aoki and his co-authors have made great progress in understanding the main differences between Japanese and U.S. firms. Aoki (1990) contains an excellent survey of this literature. He contrasts the traditional U.S. hierarchical firm, the "H-mode", with the Japanese firm structure, the "J-mode". The H-mode is characterized by (i) hierarchical separation between planning and implemental operation and (ii) an emphasis on economies of specialization. The J-mode stresses (i) horizontal coordination among operating units based on (ii) the sharing of ex post on-site information. It is suggested that among other things "lifetime employment", "seniority advancement" and management discipline through competition over ranking by corporate profits are important. Also the fact that management decisions of Japanese corporations are subject to the influence of employees as well as owners is stressed. Aoki stresses that the structure of corporations' organization has an important influence on the efficient use of its resources.

In the U.S. and U.K. it is widely argued that an active market for corporate control is essential for the efficient operation of capitalist economies. It allows able management teams to gain control of large amounts of resources in a small amount of

time. Inefficient managers are removed and replaced with people who are better able to do the job. The existence of a market for corporate control also provides one means of disciplining managers. If a firm is pursuing policies which do not maximize shareholders' wealth it can be taken over and the managers replaced.

There are three ways in which the market for corporate control can operate. These are proxy contests, friendly mergers and hostile takeovers. Proxy contests involve a group of shareholders trying to persuade the remaining shareholders to act in concert with them and unseat the existing board of directors. For example, if somebody wishes to change a firm's policies, one way that she can do it is to have her and others with similar views voted onto the board of directors at a shareholders meeting. In order to do this she solicits proxies from other shareholders which allows her to vote their shares. Proxy fights are usually difficult to win because holdings are often spread among many people. As a result they do not occur very frequently in most countries.

Friendly mergers occur when both firms agree that combining them would be value creating. In this case there are a number of ways that the transaction can occur. There may be an exchange of stock or one firm may make a tender offer for the other firm's stock. Friendly mergers and takeovers occur in all the countries under consideration and account for most of the transaction volume that occurs.

The third way in which the market for corporate control can operate is through hostile takeovers. These occur when there is conflict between the acquirors and acquirees over the price that should be paid, the effectiveness of the policies that will be implemented and so forth. Hostile tender offers allow the acquirors to go over the heads

of the target management and appeal directly to their shareholders. This mechanism is potentially very important in ensuring an efficient allocation of resources.

A very significant difference between U.S. and U.K. on the one hand and Japan on the other is that hostile takeovers are almost unheard of in Japan whereas they are common in the U.S. and U.K. Historically, cross-shareholdings were put in place by many Japanese companies to prevent hostile takeovers. Although these cross-shareholdings have been reduced significantly in recent years, they remain a formidable barrier. The recent case where Oji Paper, Japan's largest paper company, attempted to take over Hokuetsu Paper, illustrates other difficulties (see *The Economist*, September 7, 2006). The Japanese paper industry had significant overcapacity. Oji Paper felt that industry rationalization would best be served if it acquired Hokuetsu with its new plants rather than build its own new plants. However, Hokuetsu feared the impact of such a takeover on its stakeholders and with the help of the industry number two, Nippon Paper, fended off the bid.

The importance of equity ownership by financial institutions in Japan and Germany, and the lack of a market for corporate control in these countries have led to the suggestion that the agency problem in these countries is solved by financial institutions acting as outside monitors for large corporations. In Japan, this system of monitoring is known as the main bank system. The characteristics of this system are the long-term relationship between a bank and its client firm, the holding of both debt and equity by the bank, and the active intervention of the bank should its client become financially distressed. It has been widely argued that this main bank relationship ensures the bank acts as delegated monitor and helps to overcome the agency problem between managers and the firm. However, the empirical evidence on the effectiveness of the main bank

system is mixed (see, for example, Hoshi, Kashyap and Scharfstein, 1991, and Aoki and Patrick, 1994). Overall, the main bank system appears important in times of financial distress, but less important when a firm is doing well.

This review of the five mechanisms of corporate governance and their operation in the U.S. and U.K. compared to Japan shows how fundamentally different the two systems are. Not only do the philosophies underlying the two systems differ but their means of implementation are also very different.

### *Conclusions*

For countries such as China that are reforming their corporate governance systems, the Anglo-American model provided by the U.S. and U.K. provides one possible direction to go in. These countries' corporate governance systems are based on a narrow view of the role of the corporation in the economy. This is that firms' focus should be on creating wealth for shareholders. This system can lead to an efficient allocation of resources provided, among other things, that markets and institutions are well developed and competitive.

However, the Anglo-American model is not the only one. In many countries, and particularly in Japan, a broader view of corporate governance is taken. This requires that companies use resources efficiently by taking the interests of a range of stakeholders, not just shareholders, into account. In cases where markets and institutions are not perfect and competitive this view of corporate governance can lead to a superior allocation of resources than the narrow view.

## References

- Allen, F., (2005), "Corporate Governance in Emerging Markets," *Oxford Review of Economic Policy* 21, 164-177.
- Allen, F., and D. Gale, (2000), *Comparing Financial Systems*, MIT Press, Cambridge, MA.
- Aoki, M., (1990), "Toward an Economic Model of the Japanese Firm," *Journal of Economic Literature* 28, 1-27.
- Aoki, M., and H. Patrick (eds.), (1994), *The Japanese Main Bank System: Its Relevancy for Developing and Transforming Economies*, New York: Oxford University Press.
- Brealey, R., S. Myers, and F. Allen, (2006), *Principles of Corporate Finance*, 8th edition, New York: McGraw Hill.
- Hoshi, T., A. Kashyap, and D. Scharfstein (1991). "Corporate Structure, Liquidity and Investment: Evidence from Japanese Industrial Groups," *Quarterly Journal of Economics* 106, 33-60.
- Scott, K., (1998), The Role of Corporate Governance in South Korean Economic Reform, *Journal of Applied Corporate Finance* 10, 8-15.
- Smith, A. (1776). *An Inquiry into the Nature and Causes of the Wealth of Nations*, Dublin: Whitestone.

## **Table 1**

### **ASAHI BREWERIES, LTD.**

#### Corporate Philosophy of Asahi Breweries, Ltd.

We at Asahi Breweries, Ltd., through our business activities including alcoholic and nonalcoholic beverages, food and pharmaceuticals, wish to contribute to the health and well-being of people the world over. By thus contributing to society as a whole, the company seeks to attain the trust and confidence of the consumer and develop still further.

#### 1. Consumer Orientation

Identifying the best interests of consumers, we endeavor to meet their demands by creating products suited for contemporary tastes and lifestyles.

#### 2. Quality First

Open to consumer opinion of our products, we consistently enhance quality level and extend technological capabilities in order to market the finest products in the industry.

#### 3. Respect for Human Values

Our Company firmly believes that human beings are the core of the business, and follows the principle of human values through developing human resources and implementing fair personnel management. Each employee is encouraged to fully utilize his or her own potential, and work to realize an open, positive thinking corporate culture.

#### 4. True Partnership Between Labor and Management

Our Company aims to strengthen harmonious relations between labor and management based on mutual understanding and trust. Both parties work hand in hand for corporate development as well as the welfare of all employees.

#### 5. Cooperation with Business Associates

We seek to build strong relations with all our business associates and affiliates in a spirit of co-existence and co-prosperity based in mutual trust. At the same time, we are determined to accept and fulfil our responsibilities as the core of the Asahi group of companies.

#### 6. Social Responsibilities

We at Asahi, through securing and expanding the base of our operations, desire to fulfill our responsibilities to stockholders and the local communities in which we operate. Also in carrying out business activities, we sincerely observe the moral principles of management based on social standards.

Source: Asahi Breweries, Ltd. Case, 1989, Harvard Business School, 9-389-114.

**Table 2**

## Number of Members on Boards of Directors

	U.S. <sup>1</sup>	U.K. <sup>1</sup>	Japan <sup>1</sup>
Ford	15 (10)	Glaxo 16 (7)	Toyota 60 (1)
IBM	14 (11)	Hanson 19 (8)	Hitachi 36 (3)
Exxon	12 (9)	Guinness 10 (6)	Matsushita 37 (6)
Mobil	16 (10)	British Airways 10 (6)	Nissan 49 (5)
Philip Morris	16 (4)	Allied Domecq 12 (4)	Toshiba 40 (3)
RJR Nabisco	9 (6)	Grand Metropolitan 14 (1)	Honda 37 (3)
Texaco	13 (11)	BTR 10 (4)	Sony 41 (6)
Johnson & Johnson	14 (12)	Associated British Foods 7 (1)	NEC 42 (5)
GAP	11 (8)	British Steel 8 (0)	Fujitsu 36 (7)
			Mitsubishi Electric 37 (3)
			Mitsubishi Motors 43 (4)
			Mitsubishi Heavy Industries 43 (3)
			Nippon Steel 53 (1)
			Mazda 45 (8)
			Nippon Oil 22 (0)

Notes: 1. Figures in parentheses:

U.S.: Outside directors

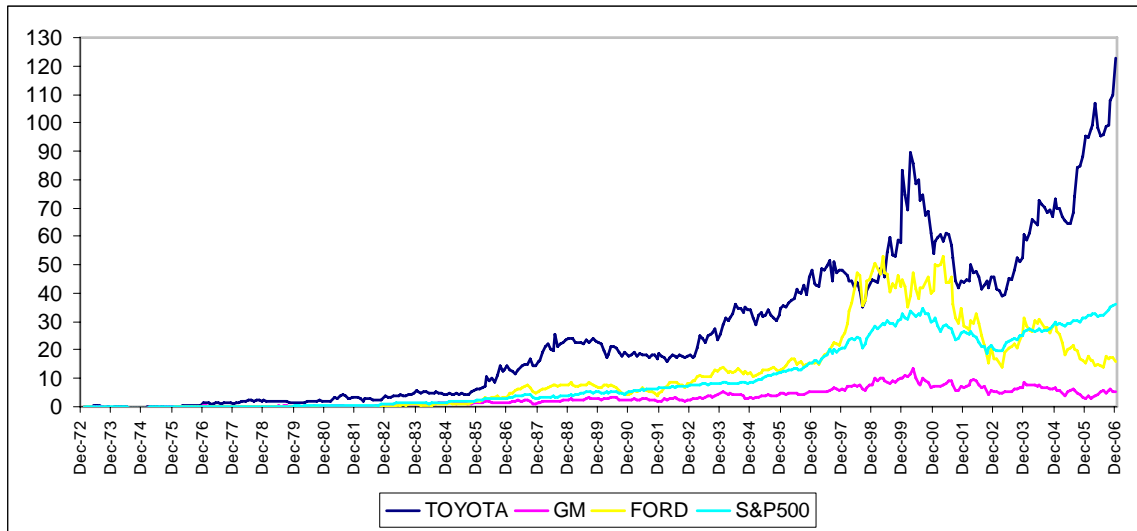
U.K.: Non-executive (outside) directors

Japan: Outside directors (including cross directorships)

Source: Institute of Fiscal and Monetary Policy (1996), Chart III-3-3, p.69.

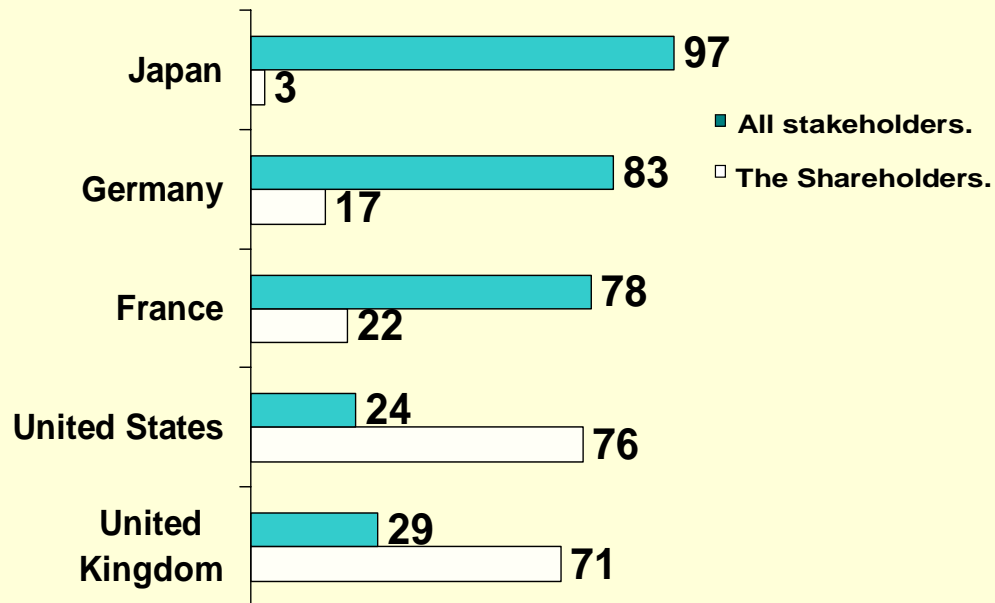


**Figure 1**



The buy-and-hold return from investing in Toyota, General Motors, Ford, and the S&P 500 in 1972 and holding with reinvestment of dividends until 2006.

**Figure 2: Whose Company Is It?**

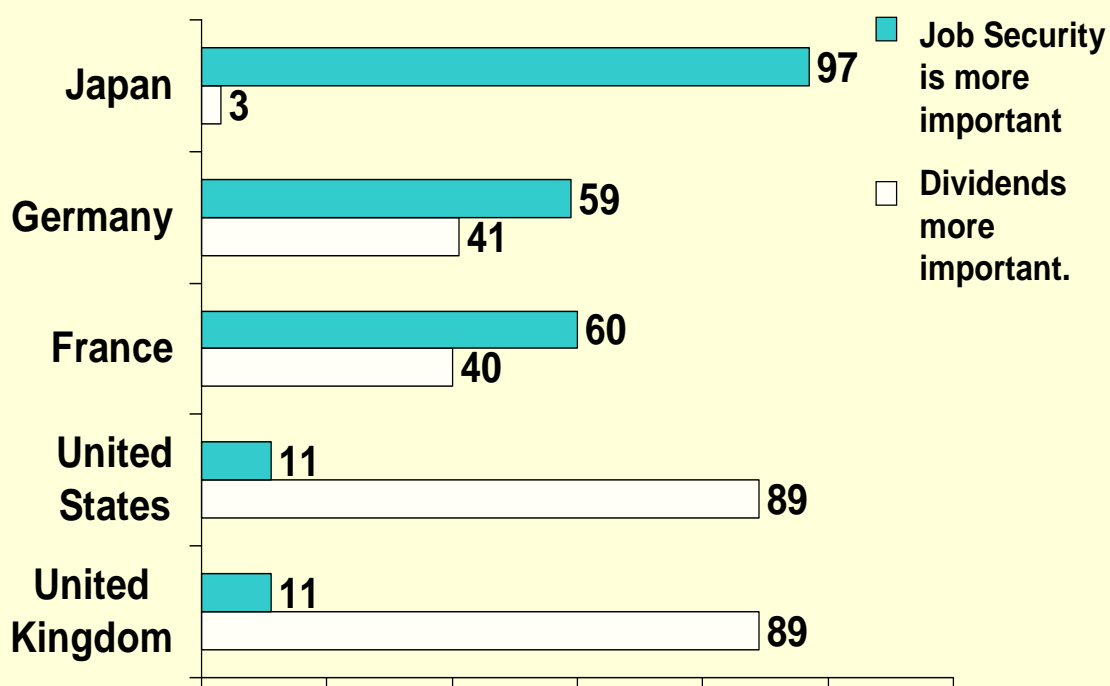


Number of firms surveyed: Japan, 68; United States, 82; United Kingdom, 78; Germany, 100; France, 50.

Source: Masaru Yoshimori, "Whose Company Is It? The Concept of the Corporation in Japan and the West." *Long Range Planning*, Vol. 28, No. 4, pp. 33-44, 1995

From: Institute of Fiscal and Monetary Policy (1996), Chart III-1-2, p. 57.

### Figure 3: Job Security or Dividends?



Number of firms surveyed: Japan, 68; United States, 83; United Kingdom, 75; Germany, 105; France 68

Source: Masaru Yoshimori, "Whose Company Is It? The Concept of the Corporation in Japan and the West." *Long Range Planning*, Vol. 28, No. 4, pp. 33-44, 1995

From: Institute of Fiscal and Monetary Policy (1996), Chart III-4-6, p. 84.