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# What Will Become of the Japanese Corporation?

**By Katsuhito Iwai**

## 1. INTRODUCTION

There have been at least two conflicting views on the objectives of business corporations in a capitalistic world. On one hand is the “shareholder-oriented view” that insists that the major objective of business corporations is to maximize the returns to its shareholders, and on the other, is the “organization-oriented view” (or “employee-oriented view”) that claims that the chief concern of the managers of business corporations is the survival and growth of the corporation as an organizational entity comprised of employees and other stakeholders. The U.S. business corporations tend to uphold the shareholder-oriented view and the Japanese business corporations the organization-orientated view.

There is no doubt that the above dichotomy is a simplification. There is a wide disparity as well as a wide fluctuation in corporate objectives both within the U.S. and Japan. And yet, this is a simplification, not an oversimplification. Notwithstanding large variations within each country, we still find it a useful working hypothesis to assume that U.S. managers are generally expected to maximize their returns to shareholders and that Japanese managers are generally expected to emphasize the survival and growth of the corporation as an organizational entity.

These expectations give rise to further thought. In spite of the wide difference in attitudes towards the objectives of business corporations, both the U.S. and Japan are full-fledged capitalistic economies. Not only U.S. corporations but also Japanese corporations are organized in accordance with “corporate law” that is based firmly on the system of private property. In fact, the current Japanese corporate law can be regarded as an amalgam of German law and U.S. law. There thus emerges a theoretical puzzle to be solved: How can the same legal framework of private property allow these seemingly contradictory systems of business corporations to co-exist in this world? One of this paper’s main theses is that it is the very legal concept of "corporation" that is responsible for the co-existence of two seemingly contradictory forms of a corporate systems.

## 2. Varieties of Corporate Systems

Table 1 reports the results of a 1988 survey that asked managers of large business corporations in the U.S., Japan, and Europe to pick out the three most important goals of their management policies. We can see from the entries in the first column that answers given by the U.S. corporate managers were consistent with the traditional assumption in economics and law that the whole purpose of the business corporation is to maximize returns to its shareholders. They ranked ROI (the rate of return on investment) at the top (78.1%) and capital gains of shareholders second (63.0%). In stark contrast to American counterparts, the Japanese corporate managers placed capital gains of shareholders at the very bottom of their ranking (2.7%). It is true, that they ranked ROI third, but the points it gets are not so high (35.5%). Instead, they put the ratio of new products and new operations at the top (60.8%) and ranked market share second (50.6%).[i] These goals are more or less related to the survival and growth of the business corporation as an organizational entity. The answers given by European corporate managers, however, were somewhat murky due to the diversity of the countries in this category.

**<Table 1: Important Corporate Goals among U.S., Japanese and European Managers in 1988>**

| (%) | America | Japan | Europe |
|---|---|---|---|
| Sustenance & Improvement of ROI | 78.1 | 35.6 | 64.2 |
| Capital Gains of Shareholders | 63.0 | 2.7 | 10.6 |
| Maintenance & Expansion of Market Share | 53.4 | 50.6 | 61.8 |
| Improvement of Product Portfolio | 28.8 | 11.5 | 26.0 |
| Maximization of Sales Volume | 15.1 | 27.9 | 17.9 |
| Increase in Own Capital Ratio | 13.7 | 21.8 | 18.7 |
| Rationalization of Production & Distribution Systems | 13.7 | 27.0 | 27.6 |
| Reinforcement of Global Strategy | 12.3 | 32.8 | 30.9 |
| Expansion of New Products & New Operations Ratio | 11.0 | 60.8 | 14.6 |
| Improvement of Corporate Social Image | 6.8 | 18.6 | 18.7 |
| Retention of Employees | 1.4 | 3.8 | 6.5 |
| Improvement of Employees' Benefits | 0 | 7.7 | 0.8 |

*Source*: Keizai Doyu Kai, *Showa 63 nendo Kigyou Hakusho* (*1988 White Paper on Corporations)*, (1988).

*Note*: Number of corporations responding to questionnaire: 73 in America, 724 in Japan and 123 in Europe (58 in Italy, 33 in Germany, 18 in France and 14 in Great Britain).

This study was conducted more than 20 years ago. Indeed, the 1980s was the decade of Japan. Buoyed by the 1979 publication of Ezra Vogel's "Japan as Number One," the Japanese-style business corporation took center stage in the capitalist world, hailed as the model of the future -- it was stable, egalitarian, and super-productive. With the collapse of the stock market and land market bubbles in 1991, however, the stage suddenly went dark and the Japanese economy fell into “the lost decade.” In sharp contrast, the 1990s became the decade of the United States. Riding on the wave of globalization, the U.S. economy stood at the forefront of both the IT revolution and financial liberalization, and sustained a high productivity growth throughout the decade. The shareholder-oriented model of U.S. corporations then appeared to have established itself as “the global standard” to which all corporations in the world must converge sooner or later, and the sooner the better. In 2000, Henry Hansmann and Reinier Kraakman, two of the leading scholars on law and economics, claimed in their widely quoted article that “the basic law of corporate governance -- indeed, most of corporate law -- has achieved a high degree of uniformity across “advanced capitalist countries” and “there is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.”[ii]

Despite such wide-spread belief in the universality of the shareholder-orientation model of the business corporation, and despite the rapid integration of financial markets and competitive pressure from globalized markets, all the comparative studies on corporate objectives and management practices (as far as the author is aware) suggest that there still remains, between the U.S. and Japan, a large difference in the way business corporations are structured and governed.[iii] Table 2, taken from Jacoby, Nason and Saguchi [2005], reports the executive values of human resource managers both in Japan and in the U.S. in 2001-2, together with the values expressed by Japanese directors in 1993. There were certainly signs of movement towards shareholder-orientation in Japan from 1993 to 2001, but more important is the fact that in spite of such movement, Japanese corporate managers still emphasize the job security of their employees (for that matter the autonomy of corporate organization) far greater than their U.S. counterparts do. This is again confirmed by Table 3 that summarizes the results of the 2005 study by Tanaka [2006] who asked Japanese managers to scale their answers from 1 (Yes) to 7 (No) to such questions as (1) “Should the share value be maximized?” (2) “Should shareholders be the sole power holder of the corporation?” and (3) “Are employees mere inputs to production?” The managers were also asked: “What would have been your or your predecessor’s answer 10 years ago?” If we look at the column for the total, we can again discern a trend in the direction of shareholder-orientation in contemporary Japan. (The average score is 3.7 in 2005, but it was 4.5 ten years ago.) Yet, the study has also shown that those managers who were relatively employee-oriented in 2005, on average expressed their belief that they had become even more so in the last 10 years. (Their score is 5.1 in 2005, but was 4.9 ten years ago.)

**<Table 2: Important Executive Values: Japan and U.S. in 2001—2; Japan in 1993 >**

| "What is important to you in your job?" 1=not important, 4= most important | | | |
|---|---|---|---|
| | Japanese Directors 1993 | Japanese Human Resource Executives 2001 | U.S. Human Resource Executives 2001-2 |
| Share Price | 2.0 | 2.3 | 3.3 |
| Safeguard employees' jobs | 3.3 | 3.2 | 2.1 |
| Source: Jacoby, Nason and Saguchi [2005]。 | | | |

**<Table 3: Important Executive Values: Japan 2005 and 1995>**

·Should Share-value be Maximized? Yes 1 ←-→ 7 No

·Should Shareholders be the Sole Power holder? Yes 1 ←-→ 7 No

·Are Employees Mere Inputs to Production ? Yes 1 ←-→ 7 No

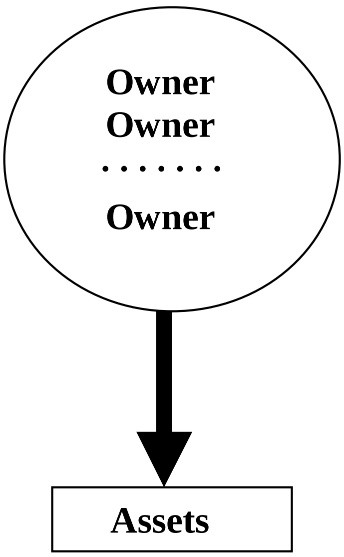
| Average Score | Total | Shareholder-Orientated | Intermediate | Employee-Orientated |
|---|---|---|---|---|
| Present | 3.7 | 2.9 | 3.9 | 5.1 |
| | ↑ | ↑ | ↑ | ↑ |
| 10 Yrs Ago | 4.5 | 4.4 | 4.8 | 4.9 |
| Frequency | 231 | 64 | 110 | 57 |
| Source: Kazuhiro Tanaka [30] | | | | |

### 3. What is a Business Corporation?

What is a business corporation? The simplest definition is that it is a firm that is set up as a corporation. In the first place, a business corporation is a firm. In this sense there is no difference between a "mom and pop" grocery shop around the corner and Toyota Motor Corporation. As depicted in any textbook of economics, both the grocery store and Toyota are organizational entities that supply goods to markets for profit. Of course, there is a huge difference in their size – while our grocery store around the corner is owned and run by a good-natured couple with little capital of their own, Toyota has capital of about 400 billion yen (5 billion dollars), generates sales of over 25 trillion yen (30 billion dollars), and hires more than 300,000 employees. Their differences, however, cannot be reduced solely to size; Toyota is set up as a corporation but our grocery shop is not.

Suppose you are an owner of a mom and pop grocery shop. Whenever you feel hungry, you can pick up an apple from the shelf and eat it right away. That apple is your property, and the only thing you have to worry about is the wrath of your spouse -- your co-owner. As Fig. 1 shows, a firm consists of a single ownership relationship between an owner, in the case of a single proprietorship firm, or a group of owners in the case of a partnership firm, and assets such as apples and oranges on the shelf of the grocery store. However, as soon as a firm is set up as a "corporation" and become a "business corporation," its ownership structure undergoes a fundamental change.

**<Fig. 1: Single Ownership Structure of a Classical Firm>**

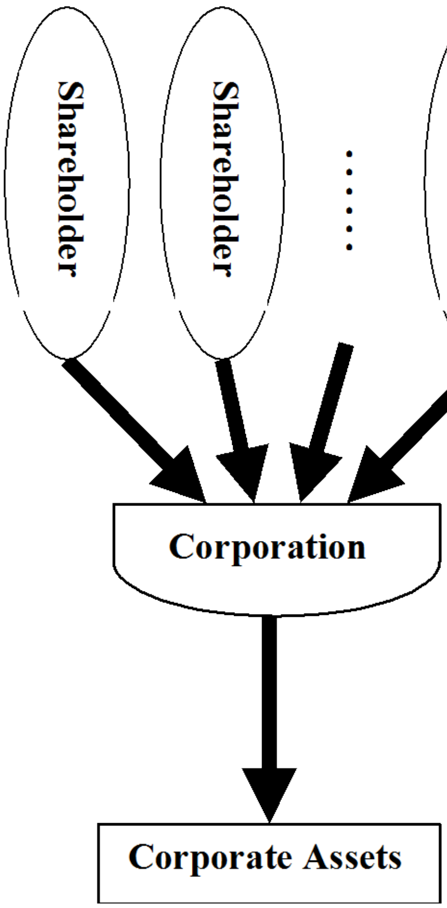



Suppose now that you are a shareholder of a business corporation, e.g., a big supermarket chain. You feel hungry and on your way home you enter one of the stores in the chain, grab an apple from its shelf and eat it right away. What will happen to you? You will be arrested as a thief, even if you are a shareholder! Why? It is because a corporate shareholder is not the legal owner of the corporate assets. Who, then, is the owner of those corporate assets? The corporation as a "legal person" is. Then, what is a legal person? The law treats a corporation as the subject of property rights, capable of owning real property, entering into contracts, suing and being sued, all in its own name, separate and distinct from its shareholders.[iv] A corporation is, in other words, a "thing" that is treated legally as a "person." And it is the corporation as a legal person that is the owner of the corporate assets. You were arrested as a thief simply because you took the property of another "person."

Who, then, are corporate shareholders? The answer is that they are the owners of the corporation. Corporate shareholders are literally the holders of a corporate share -- a bundle of rights that includes the right to vote on issues affecting the corporation as a whole, the right to share in the residual assets when the corporation is liquidated, and the right to receive dividends the corporation generates. These three rights in fact correspond to the three basic rights of property ownership -- *ius utendi* (the exclusive right to use one's property), *ius abutendi* (the exclusive right to alienate one's property), and *ius fruendi* (the exclusive right to enjoy the whole fruits from the use and from the alienation of her property).[v] Holding these rights against the corporation can thus be regarded as owning the corporation as a "thing," *i.e.*, as an object of property rights. A corporate shareholder is thus an owner of a share or a fraction of the corporation as a "thing," separate and distinct from the underlying corporate assets. Indeed, we can buy and sell a corporate share freely just as any other "thing," and in the case of a publicly-held corporation, a centralized market, called the stock market, is organized for daily transactions of its shares.

This observation leads us to the most crucial characteristic of the business corporation. In contrast to a single ownership firm or a partnership firm, an incorporated firm, or what we have called a business corporation, is composed of not one but TWO ownership relations: the shareholders own the corporation, and the corporation in turn owns the corporate assets, as is shown in Fig.2. Indeed, in this two-tier ownership structure there is a division of labor between the person-side and the thing-side of the corporation. In regard to things (corporate assets), a corporation acts legally as a person, as a subject of property rights; and in regard to persons (shareholders), a corporation is acted upon legally as a thing, as an object of property rights.

**<Fig. 2: Two-Tier Ownership Structure of a Business Corporation>**




## 4. The Corporate Personality Controversy and the Comparative Corporate System

For many centuries, legal scholars and legal philosophers have debated heatedly as to what constitutes the “essence” of the corporation. This is called the “corporate personality controversy” – one of the most celebrated controversies in legal theory and legal philosophy. In this age-old controversy, two competing legal theories have emerged advancing opposing answers --- “corporate nominalism” and “corporate realism.” Corporate nominalism asserts that the corporation is a contractual association of individuals, whose legal personality is no more than an abbreviated way of writing their names together. Corporate realism, in opposition, claims that the corporation is a full-fledged entity whose legal personality is no more than an external expression of its real personality in society. (And both claim to have superseded the "fiction theory" or the "concession theory" -- the traditional doctrine since the twelfth century, which maintained that the corporation is a separate and distinct social entity but that its legal personality is a mere fiction conceded by the state or created by law.)[vi]

The corporate personality controversy is not something of the past. The rivalry between corporate nominalism and corporate realism has continued until the present. On one hand, the contractual theory of the firm, whether it is an agency-theory version or a transactions costs economics version, is a direct descendent of corporate nominalism.[vii] On the other hand, the evolutionary theory of the firm, variously known as the resource-base view or the core-competence view or the organizational capability model, can be interpreted as a modern representative of corporate realism.[viii] The former regards "private corporations" as "simply legal fictions which serve as a nexus for a set of contracting relationships among individuals." (Jensen and Meckling [1976], p. 310.) The latter posits corporate firms as "organizations that know how to do things, .... while individual members come and go." (Winter [1988], p. 136.) The corporate personality controversy is far from a relic of the past.

It is not hard to see that the age-old controversy between corporate nominalism and corporate realism and the more recent rivalry between the contractual theory of the firm and the evolutionary theory of the firm more or less correspond to the difference between the U.S. corporate system and the Japanese corporate system.

What I would like to do now is to "end" this long-standing controversy between corporate nominalism and corporate realism once and for all. It is, however, not by declaring victory for one side or the other. It is rather by declaring victory for both sides by elucidating two legal mechanisms through which the legal concept of the corporation is capable of generating two seemingly contradictory corporate structures ----- one approximating corporate nominalism and the other approximating corporate realism.

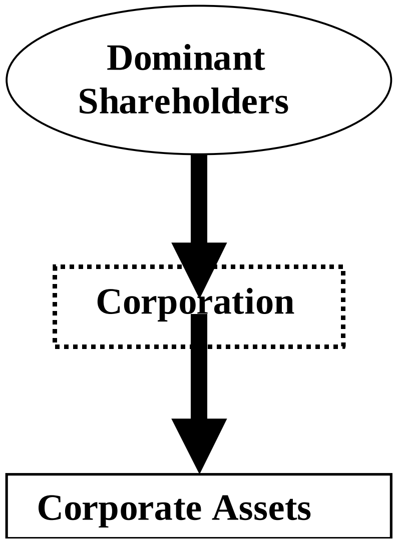
If we only look at the upper tier of the two-tier ownership structure depicted in Fig. 2, the corporation appears as something owned and controlled by shareholders, and we draw near to the position of corporate nominalists and that of U.S. corporate system. If, on the other hand, we look only at the lower tier, the corporation appears as a person owning and managing corporate assets, and we draw near to the position of corporate realists and that of the Japanese corporate system.

We can go further. What I am going to demonstrate is that there are even ways to eliminate both personality and "thingness" from the corporation, thereby turning it into a mere "thing" or a full "person," respectively.

### 5. How to Make a "Nominalistic" Corporation

The way to eliminate the personality from a corporation is simple and well-known; it is to have someone own more than fifty percent of its shares. That someone then acquires absolute control over the corporation. The corporation is deprived of its subjectivity and turned into a mere object of property rights. Legally speaking, the corporation is still the sole owner of the corporate assets, but in practice it is the dominant shareholder who can exercise ultimate control over these assets. We are certainly in the world of the corporate nominalists here.

**<Fig. 3: A 'Nominalistic' Corporation>**




This is of course common sense, but I now argue that the so-called corporate raiders are daily putting this legal mechanism into practice in the real economy.

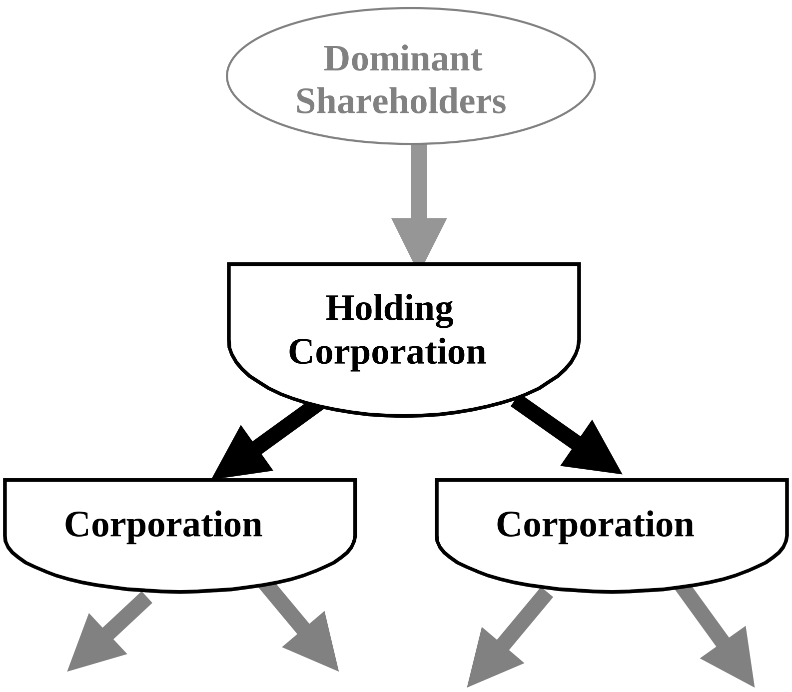
That a business corporation consists of a two-tier ownership relationship implies that it contains two kinds of "things" — the corporate assets and the corporation itself. This fact immediately implies that there are also two kinds of values residing in a business corporation. They are, respectively, the value of corporate assets and the value of the corporation as a thing. The former can be defined as the present discounted value of the future profit stream that would accrue from the most efficient use of these assets. This can also be called the "fundamental" value of the corporation. The latter can be identified as the total share price of the corporation in the stock market. The business of corporate raiders is to exploit the potential difference between these two values by buying corporations whose stock market values are lower than the fundamental value of the underlying assets. In the process, they become dominant shareholders and turn the target corporation into a purely "nominalistic" corporation.

Corporate raiders thus help to realize the idea of corporate nominalism in this world. It is claimed that even if they are not raiding corporations on a daily basis, the mere perception that they may at any time enter the scene works as an effective threat to incumbent managers, steering them away from management policies that may fail to realize the corporate assets' fundamental value. If this is the case, the stock market is said to function as the "market for corporate control."[ix]

**6. How to Make a “Realistic” Corporation (1)**

We know that as a legal person a corporation can own things and that as a legal thing a corporation can be owned by persons. This at once suggests that a corporation as a person can, in principle, own another corporation as a thing. In fact, since the state of New Jersey in the United States legalized “holding” corporations in 1889, corporations all over the world have been buying and holding the shares of other corporations. A holding corporation is a corporation that is created solely for the purpose of owning other corporations, as is shown in Fig. 4. It acts as a person in regard to the corporations it owns.

**<Fig. 4: A Holding Corporation and a Pyramidal Ownership Structure.>**

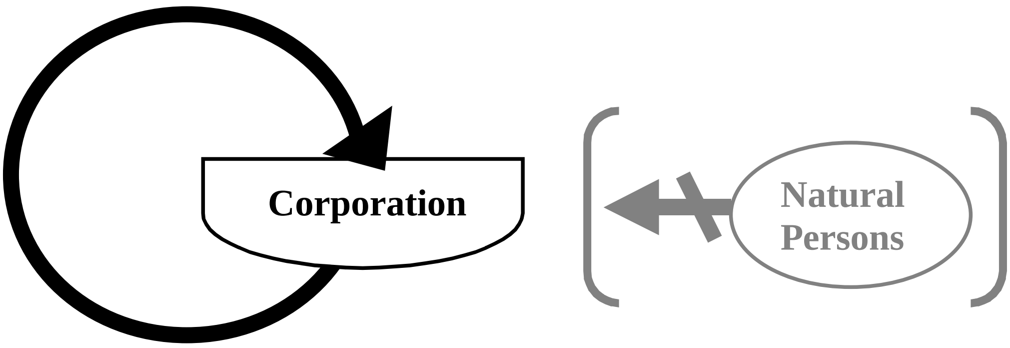



The holding corporation has paved the way to an important organizational innovation--the pyramidal system of ownership and control. At the top is a group of capitalists or a Zaibatsu family that owns a corporation as a thing, but that corporation can also, as a legal person, own another corporation as a thing, which again as a legal person can own another corporation as a thing, and so on. Such ownership hierarchy can extend *ad infinitum*. This is not the whole picture because you do not have to own all the shares to control a publicly-held corporation. As long as minority shares are sufficiently diffused among passive investors in the stock market, only a share slightly greater than *50%* is sufficient for control. This implies that one unit of capital can in principle control almost two units of capital, if each half buys a bare majority of the shares of a corporation with a capital close to one unit. It then follows that, as more and more layers are added to the ownership hierarchy, a group of capitalists at the top can multiply the controlling power of their capital by the order close to $2^n$, where $n$ is the number of hierarchical layers beneath.[x] One can regard the pre-war Japanese Zaibatsu and present-day Italian family empires and Korean Chaebols as typical examples of this pyramidal system of ownership and control.

**7.How to Make a "Realistic" Corporation (2)**

Nevertheless, a holding corporation still falls short of shedding its "thingness" entirely because it has its own dominant shareholders watching over it. One can, however, go a step further at least in theory. A corporation as a person can own itself as a thing. Indeed, nothing prevents us from imagining a corporation that becomes its own controlling shareholder by holding a majority block of its own shares under its own name, as is shown in Fig. 5. If this were possible, that corporation would be free from any control by real human beings (natural persons) and become a self-determining subject. It would thus acquire a full personality in the province of law.

**<Fig. 5：A (Hypothetical) Self-Owning Corporation>**

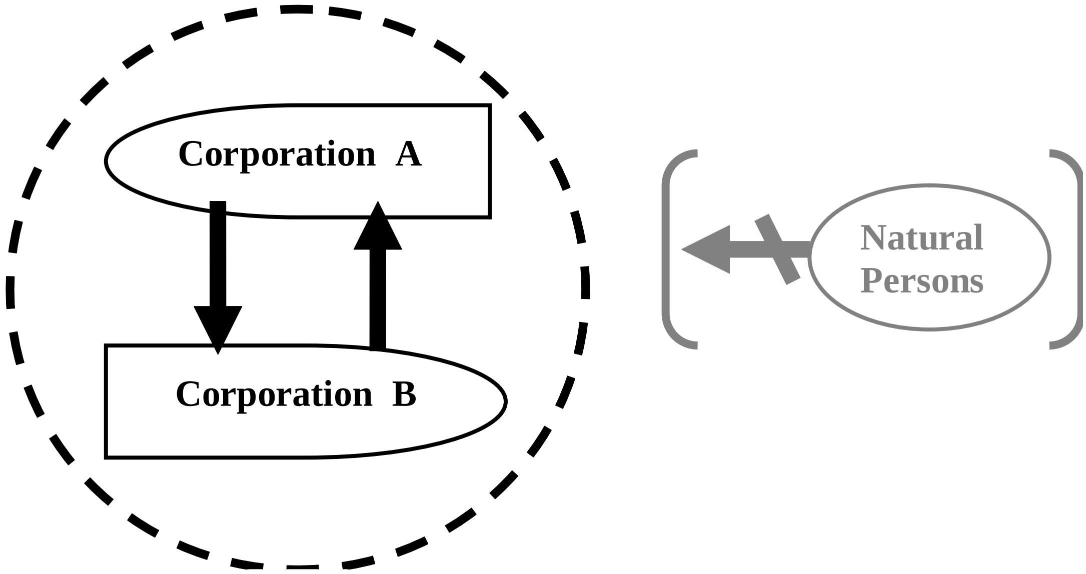



One might dismiss all this as idle speculation. Some countries prohibit a corporation from repurchasing its outstanding shares. And, in many other countries that allow share repurchases, the repurchased shares usually lose their voting rights in shareholders' meetings. In the real economy, therefore, it appears impossible for the corporation to become its own owner.

There is, however, an important leeway. Imagine a situation where two corporations, A and B, hold a majority of each other's shares. Corporation A as a person own corporation B as a thing, and corporation B as a person in turn owns corporation A as a thing. As is shown in Fig. 6, even though each corporation does not own itself directly, it does indirectly through the intermediacy of the other corporation. One might still object to the practical possibility of this leeway by pointing out that some countries impose legal limits on the extent of cross-shareholdings between corporations.

Yet, it is possible to circumvent even these limits. Suppose that twelve corporations get together and that each holds 5 percent of each of the other's shares. Then, simple arithmetic ((12 - 1) x5% = 55%) tells us that a majority block of each corporation's shares could be effectively sealed off from real human-beings without violating legal restrictions on cross-shareholding in any of advanced capitalistic countries. These twelve corporations would indeed become their own owners at least as a group, as is depicted in Fig. 7. It is therefore practically impossible to prevent corporations from becoming their own owners, if they so wish. We have now reached the paradigm of corporate realism – through extensive cross-shareholding, corporations can eliminate their “thingness” and become self-determining subjects in the system of law.

**<Fig. 6: Mutually Holding Corporations>**




**<Fig. 7: Cross-Shareholding Among 12 Corporations>**

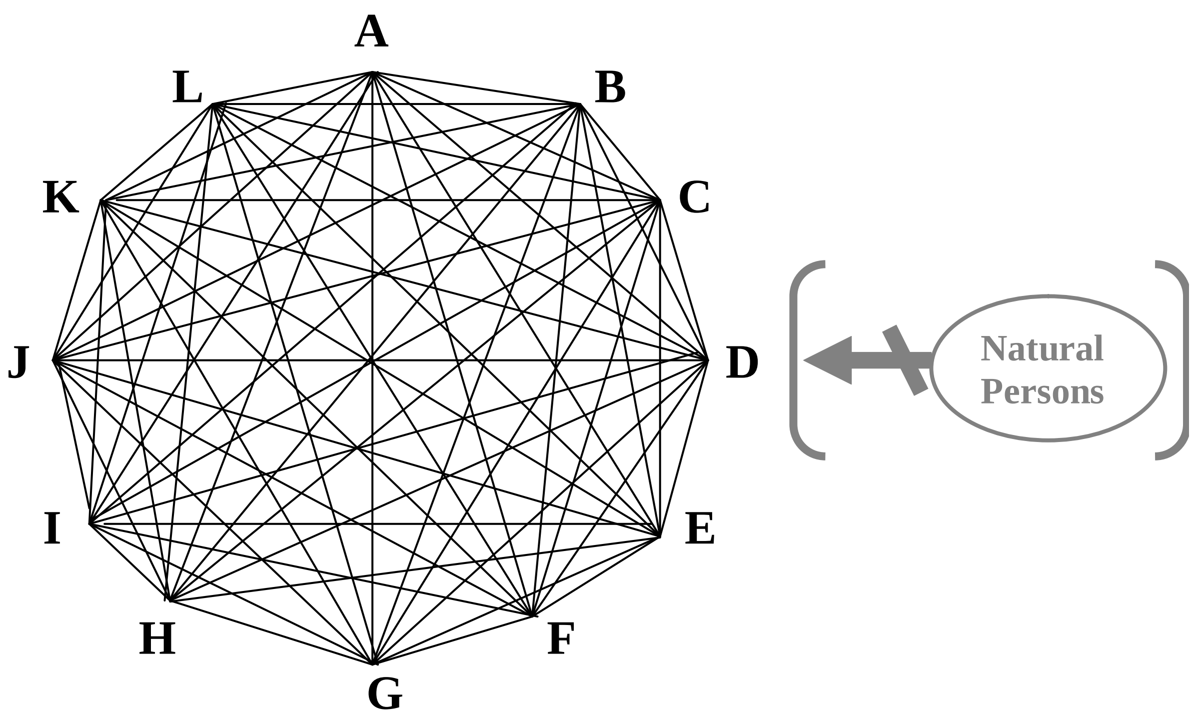


Fig. 7 is not a mere doodle of an armchair theorist. One can see how such a doodle was "realized" in Table 4. It is well-known that one of the distinguished features of the post-WWII Japanese economy was the extensive cross-shareholding among large corporations. Table 4 summarizes cross-shareholding among 20 corporations of the Sumitomo group in 1993. Indeed, Japan used to have six major corporate groups (Mitsubishi, Mitsui, Sumitomo, Daiichi-Kan-Gin, Fuji, and Sanwa), each of which was clustered around a main bank, extended over the whole industry, and connected through mutual holdings of shares and mutual exchanges of directors. The percentage of cross-shareholdings reached as high as 32.9% of the total shareholdings of publicly-held corporations in 1990.

**<Table 4: Cross-Shareholding among Core 20 Corporations of Sumitomo Group, 1993>**

<Table 2: Cross-Shareholdings among Core 20 Corporations of Sumitomo Group, 1993>

| HOLDER | S. | S. | S. | S. | S. | S. | S. | S. | S. | S. | Jap | S. | S. | S. | S. | S. | S. | NEC | S. | S. | TOT |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| % % | Bank | Trus | Life | Mar | Corp | Coal | Cons | Fore | Che | Bake | Glas | Cem | Meta | Meta | Ligh | Elect | Heav | | Real | Stor | AL |
| S. Bank | ---- | 2.8 | 6.1 | 1.8 | 1.7 | 0.0 | 0.0 | 0.1 | 1.1 | 0.2 | 1.1 | 0.2 | 1.3 | 0.4 | ---- | 0.9 | 0.2 | 1.1 | 0.1 | 0.2 | 19.3 |
| S. Trust Bank | 3.3 | ---- | 4.2 | 1.5 | 2.5 | 0.0 | 0.0 | 0.2 | 1.2 | 0.5 | 1.4 | 0.5 | 2.3 | 1.2 | 0.0 | 1.7 | 0.4 | 2.8 | ---- | 1.5 | 25.3 |
| S. Life | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- | ---- |
| S. Marine Ins. | 4.4 | 6.3 | 4.6 | ---- | 2.3 | 0.1 | 0.1 | 0.1 | 1.2 | 0.3 | 1.2 | 0.3 | 1.0 | 1.0 | ---- | 0.9 | 0.6 | 1.8 | 0.1 | 0.8 | 27.1 |
| S. Corporation | 4.8 | 5.8 | 5.1 | 2.9 | ---- | 0.1 | 0.0 | 0.3 | 1.6 | 0.3 | 1.0 | 0.4 | 2.7 | 1.7 | ---- | 1.0 | 0.8 | 3.7 | 0.1 | 0.4 | 32.8 |
| S.Coal Mining | 4.8 | 4.0 | 2.5 | 2.4 | 3.4 | ---- | 0.8 | ---- | 2.5 | ---- | 0.4 | 1.0 | 4.9 | 2.1 | ---- | ---- | 1.7 | 4.2 | ---- | 0.2 | 34.8 |
| S.Construct' | 4.4 | 2.9 | 5.8 | 1.4 | ---- | 3.1 | ---- | 0.6 | 1.1 | ---- | 0.6 | 2.3 | ---- | 3.3 | ---- | 1.0 | ---- | ---- | 0.4 | 0.2 | 27.0 |
| S. Forestry | 4.3 | 7.0 | 7.2 | ---- | 2.6 | 0.1 | 0.4 | ---- | ---- | 0.4 | ---- | 0.3 | ---- | 7.3 | ---- | ---- | 0.2 | 1.4 | ---- | ---- | 31.1 |
| S. Chemical | 4.7 | 5.3 | 8.9 | 1.4 | 1.3 | 0.0 | 0.1 | 0.1 | ---- | 0.1 | 0.4 | 0.3 | ---- | 0.2 | ---- | 0.3 | 0.2 | 0.5 | 0.0 | 0.2 | 23.9 |
| S. Bakelite | 4.8 | 7.1 | 5.9 | 1.3 | 2.1 | ---- | 0.3 | 0.4 | 21.6 | ---- | 0.3 | 0.5 | 0.9 | ---- | ---- | 0.3 | ---- | 1.3 | 0.4 | 0.1 | 48.2 |
| Japan Glass | 5.0 | 6.8 | 5.5 | 2.3 | 1.6 | ---- | 0.1 | 0.1 | 1.2 | 0.5 | ---- | 0.8 | ---- | 0.3 | ---- | ---- | 0.6 | ---- | 0.5 | 0.2 | 25.6 |
| S. Cement | 4.6 | 5.4 | 8.5 | 1.0 | 2.3 | 1.9 | 0.6 | 0.4 | 1.1 | 0.4 | 0.8 | ---- | 1.0 | 1.1 | ---- | 0.3 | 2.2 | 0.8 | 0.2 | ---- | 32.8 |
| S. Metals | 4.0 | 6.2 | 5.5 | ---- | 1.6 | 0.1 | 0.0 | ---- | ---- | 0.1 | 0.1 | 0.1 | ---- | 0.5 | ---- | 0.3 | 0.2 | 0.6 | 0.0 | 0.1 | 19.2 |
| S.Metal Min'g | 4.6 | 10.0 | 4.8 | 1.5 | 2.5 | 0.1 | 0.2 | 0.3 | ---- | ---- | 0.3 | 0.7 | 0.8 | ---- | ---- | 1.0 | 0.3 | 2.4 | 0.1 | 0.1 | 29.6 |
| S.LightMetals | 4.7 | 5.8 | 4.0 | 1.4 | 4.0 | ---- | ---- | ---- | 1.3 | ---- | ---- | 0.4 | 23.3 | 0.9 | ---- | 0.8 | 0.6 | 0.8 | ---- | 0.2 | 48.2 |
| S. Electrics | 3.8 | 5.4 | 7.0 | ---- | 0.8 | 0.0 | 0.0 | ---- | ---- | ---- | ---- | 0.1 | ---- | 0.8 | ---- | ---- | 0.1 | 2.4 | ---- | 0.1 | 20.6 |
| S. Heavy Ind. | 4.6 | 6.4 | 7.8 | 2.5 | 3.0 | 0.1 | 0.1 | 0.1 | ---- | ---- | 0.5 | 1.3 | ---- | 0.7 | ---- | 0.7 | ---- | ---- | ---- | 0.3 | 27.9 |
| NEC | 5.0 | 4.8 | 6.8 | 2.6 | 2.2 | 0.0 | 0.0 | 0.1 | 0.4 | 0.1 | 0.2 | 0.1 | 0.7 | 1.0 | ---- | 2.2 | 0.1 | ---- | 0.0 | 0.2 | 26.4 |
| S. Real Estate | 3.4 | 5.1 | 2.3 | 1.6 | 0.5 | 0.0 | 0.2 | ---- | 0.4 | 0.2 | 0.7 | 0.1 | 0.5 | 0.3 | ---- | 0.5 | ---- | 0.7 | ---- | 0.5 | 17.2 |
| S. Storage | 4.7 | 6.7 | 8.4 | 5.4 | 2.4 | ---- | 0.3 | ---- | 1.5 | 0.1 | 0.8 | | 2.2 | ---- | ---- | 0.9 | 0.9 | 3.9 | 0.3 | ---- | 38.5 |

*Sources*: Toyo Keizai, *Kigyo Keiretsu Soran '95 (Survey on Corporate Groups, '95)*, (Toyo Keizai Shinpo Sha, 1995).

*Note*: '0.0' means a very small percentage, and '**----**' means no holding.

## 8. Traditions and Corporate Systems

I now believe I have succeeded in "ending" the age-old controversy on the essence of the corporations in corporate nominalism and in corporate realism. There should also be a clearer understanding about the more recent rivalry concerning the nature of the firm according to contractual theory and the nature of the firm with respect to evolutionary/resource-base/core-competence/organizational capability theory. It is indeed the very legal concept of the corporation that is capable of eliminating either personality or thingness from the person-cum-thing corporation, thereby turning it into a mere "thing" or a full "person," respectively. I also believe I have provided a resolution to the real-life opposition between the shareholder-oriented U.S. corporate system and the organization-oriented Japanese corporate system. The U.S. and the Japanese system are but two extreme forms of the genus "corporation." Each society can choose any position along an extensive spectrum that runs from a purely "nominalistic" structure to a purely "realistic" structure, on the basis of or at least under the influence of, economic efficiency, political interests, ideological forces, cultural traditions, historical evolution and other extra-legal factors. My contention is that in the long history of their capitalistic development, the U.S. economy and the Japanese economy have both chosen from this long legal menu, the position close to the "nominalistic" end as their dominant corporate structure, respectively.

It appears, however, that traditional Japanese-style management has completed its historical mission. The stock market and property market bubbles burst in the late 1980s. The financial markets were belatedly but rapidly liberalized in the 1990s. And the wave of globalization began to expose Japanese corporations to mega-competition in the world markets. All these movements have weakened the traditional ties between major banks and industrial corporations and loosened the tight network of corporate cross-shareholdings. In fact, the percentage of cross-shareholdings declined to 12.0% in 2006, and the six major corporate groups are now consolidated into three (Mitsubishi-Tokyo-UFJ, Mitsui-Sumitomo, and Mizuho).

Do these facts mean that the long-run tide of the Japanese corporate system is flowing in the 'nominalistic' direction? Is there a "convergence" towards the U.S. corporate system?

The answer is "no!" Indeed, I am also discerning another tide that is moving strongly in the opposite direction. It is a tide brought about by the transition of the advanced capitalistic economies from the stage of 'industrial' capitalism to the stage of 'post-industrial' capitalism

## 9. Two Sources of Inefficiency in Corporate Organizations

In order to explain this, we must re-examine the nominalism/realism dichotomy of corporate forms from the standpoint of economic efficiency, leaving the consideration of cultural, political, and ideological factors to another time. We have learned from the recent literature in economics of imperfect information that two of the most important sources of inefficiency in economic organizations are "moral hazard problems" and "hold-up problems" -- both related to the management of human capital, especially knowledge-orientated human capital, endowed in organizations.[xi]

First, the moral hazard problem refers to the inefficiency caused by the separation of control and ownership in corporate organizations. Insiders of an organization, such as workers, engineers, researchers, and managers, may take advantage of the shareholders' weak monitoring of their performances and covertly pursue their private interests at the expense of those of shareholders. For instance, managers may accumulate perks, researchers may seek academic reputation, engineers may indulge in creating experimental designs, and workers may simply be lazy.

The hold-up problem, on the other hand, is concerned with another kind of inefficiency. For a corporate organization to survive and grow, its workers, engineers, researchers and managers have to develop skills, know-how, technologies, communication-networks, visions, leadership, etc. that are specialized for the organization. In economics, they are called "organization-specific human capital." These employees, however, are in a vulnerable position because the organization-specific human capital has, by definition, little value outside of the organization. Once these employees have invested their time and effort in organization-specific human capital, their vulnerable position may be taken advantage of by shareholders who are seeking only short-term returns. For instance, a corporate raider may buy out their corporation and then slash the funds for research and development in order to increase the dividend payout. For fear of such potential exploitation, these employees are reluctant to commit themselves to organization-specific human capital even if the accumulation would enhance the economic value of the corporation in the long-run. This is called the hold-up problem, and the so-called incomplete contract theory in economics explains this situation in detail.

I now maintain that there is a real trade-off between the two kinds of economic inefficiency – the one caused by moral hazard problems and the other due to hold-up problems, and that the choice of the legal form of corporation -- whether it is nominalistic or realistic -- depends very much on this trade-off.

It is evident that the nominalistic form of corporation has an advantage over the realistic form with respect to the moral hazard problem. It allows the shareholders to monitor the performance of managers and other core employees or it allows the stock market to pressure the managers to maximize returns to shareholders.[xii] In contrast, the realistic corporation has an advantage over the nominalistic corporation with respect to the hold-up problem. The realistic corporation can by its very nature shield corporate decisions from the pressures of often short-sighted shareholders, thereby protecting the organization-specific human capital from their hold-ups. It encourages those workers, engineers, researchers, and managers to commit themselves to investing in organization-specific human capital. The claim can then be made that the realistic corporation, with its long-term commitment to the survival and growth of its organization, can function as a *de facto* owner of organization-specific human capital.

## 10. Transition from Industrial Capitalism to Post-Industrial Capitalism

Let us now come back to what was referred to earlier -- the transition of capitalism from the industrial stage to the post-industrial stage. By the transition to post-industrial capitalism we mean a recent shift in the major source of profits, from economies of scale and scope of large factory systems, to skills, know-how, technologies, communication networks, visions, and leadership of workers, engineers, researchers, and managers. What is critical to the long-run competitiveness of business corporations is no longer physical capital, but human capital, especially knowledge-based human capital. There is a growing body of literature suggesting that the capital values of human capital and other “intangibles” have shown a phenomenal rise in recent years in the U. S. and other advanced capitalist economies.[xiii]

I maintain that it is the exhaustion of the ‘industrial reserve army’ -- the surplus population deposited in rural areas and supported by communal networks -- that is the ultimate cause of this massive phase-transition of capitalistic systems from ‘industrial’ to ‘post-industrial.’[xiv] The consequent rise in real wages of industrial workers relative to their marginal productivity has reduced the profit margins of the existing production facilities and distribution networks so that capitalist enterprises are able to reap profits only by undertaking what Schumpeter [1950] called “innovations.” By innovations Schumpeter designated a broad range of events which includes “the introduction of new commodities..., the technological change in the production of commodities already in use, the opening-up of new markets or of new sources of supply, Taylorization of work, improved handling of material, the setting-up of new business organizations … -- in short, any ‘doing things differently’ in the realm of economic life.” Obviously, in order to do things differently, capitalist enterprises need the ideas, know-how, coordinating skills, forecasting capabilities, strategic prowess, strong leadership, etc. of real human beings.

## 11. Inalienability of Human Capital and the Increasing Importance of Organization-specific Human Capital

We understand that knowledge-based human capital now occupies the central place in post-industrial capitalism. Does this mean, however, that any knowledge or any information can be the source of profits for business corporations? Even if one has a brilliant idea, if that idea can be accessed easily by others, or if that idea can be imitated easily by others, it has no or little economic value.

In the age of post-industrial capitalism only the differences matter! That is, only the knowledge that is within an organization and cannot be easily transferred to outside of the organization can generate positive profits for business corporations. This is precisely what is meant when we refer to organization-specific human capital.

What does this mean to our nominalism/realism dichotomy of corporate form?

The single most important characteristic of human capital is its inalienability. Money can buy factories, machines, offices, land, and other physical capital. Physical capital is alienable.

Money, however, cannot directly buy ideas, know-how, skills, human-networks, visions, and other human capital, because they all entail some form of knowledge stored inside human brains or gray cells. All money can do is to provide a variety of incentives that would encourage the workers, engineers, researchers, and managers to invest their time and efforts on human capital that is specific to the organizations in which they are working.

In the era of traditional industrial capitalism where the large factory system was the major source of profits, it was the shareholders who had the upper-hand in the balance of power within a business corporation because they were the ultimate suppliers of money that could buy factories and other productive facilities. Of course, a large force of workers has to be hired in order to operate factory systems, but their role within a corporate organization remains subordinate to physical capital, and hence subordinate to the shareholders.

In contrast, in this new era of post-industrial capitalism, the physical capital has surrendered its central position to the knowledge-based human capital that money can no longer buy and hence control directly. The balance of power within a business corporation is clearly tilting away from suppliers of money towards suppliers of knowledge-based human capital, especially to those who contribute to organization-specific human capital, that is, from shareholders to workers, engineers, researchers, and managers who have made a long-term commitment to the corporation.

Thus, we have seen that there are two fundamental sources of inefficiency in corporate organizations -- moral hazard problems and hold-up problems, and there is a trade-off between them.

The nominalistic corporate system is able to solve or at least mitigate the moral hazard problem, but only at the expense of the hold-up problem. Nominalistic corporations are thus better adapted to the stage of industrial capitalism, because its major source of profits is physical capital over which shareholders have direct control, whereas human capital is only a helping factor to run the physical capital efficiently.

On the other hand, the realistic corporate system has a comparative advantage in minimizing the hold up problem, but of course at the expense of moral hazard problems. To the extent that organization-specific human capital plays a central role in a corporation’s capability of generating profits, we expect many business corporations to adopt realistic forms in this new era of post-industrial capitalism.

## 12. The Future of the Japanese Corporate System

Global capitalism is now on a slow road to recovery from a global depression on a scale never seen since the Great Depression of 1930s. Since the onset of the 21st century, the U.S. economy has undergone a series of crises that have increasingly shaken the confidence in its corporate model – the collapse of the IT-boom-turned-IT-bubble in 2001, the Enron and other big corporate scandals during 2001-2002, and the subprime loan crisis that began in 2007 and ended up being what the former FED chairman Alan Greenspan called the "once in a hundred years" financial crisis. The shock triggered by the spectacular collapse of Lehman Brothers, the 4th largest U.S. securities corporation, on September 15, 2008 not only spread across the entire world instantaneously through tightly-knit international networks of financial markets, but also led to a sharp downturn in the real economy through extensive international trades of goods and services. As an almost reflexive reaction to the swiftness, breadth, and depth of the crisis, we have seen a sudden revival of large scale fiscal and monetary stimuli and a concerted effort to implement tighter financial regulations among advanced capitalist countries: initiatives which only a few years ago would have been summarily dismissed as harmful to the smooth working of the market system's "invisible hand." The lessons of the Great Depression have not been completely forgotten, and global capitalism will in all likelihood be saved from the catastrophe of the dimension of 1930s. Yet, the fact that the epicenter of this global economic crisis is the U.S. economy, above all, its financial sector has severely undermined the shareholder-orientated view of the corporate system – a view that had been championed as the "global standard."

It is now widely agreed that one of the underlying causes of the speculative bubbles whose collapse led to the U.S. subprime loan crisis is the "excess liquidity" in the global financial markets. This is indeed the inevitable consequence of the transition of capitalism from the stage of "industrial" to the stage of "post-industrial" that has shifted the major source of profits for business corporations from physical capital that money can buy to human capital that money cannot buy. In this sense, this "once in a hundred years" financial crisis has marked the dramatic beginning of post-industrial capitalism that will bring about the eclipse of the nominalistic/shareholder-orientated model of corporate system.

Does this not suggest the revival of the Japanese-style corporate system?

On the basis of the two-tier nature of corporate structure, a theoretical possibility has been illustrated that a corporation can free itself from the control of outside shareholders and become purely realistic without violating any of the basic framework of corporate law. Indeed, the post-war Japanese corporate system not only demonstrated historically that such realistic corporate systems actually inhabited the capitalist world but also displayed empirically that they are even capable of outperforming the nominalistic corporate system for a considerable period of time. If there is indeed a tendency in the age of post-industrial capitalism for the leading corporate model to shift from the nominalistic to the realistic form, does this not suggest that the Japanese-style corporate system with its emphasis on the autonomy of organization will make a swift comeback in the future?

The answer is not as simple as the question might imply. It is true that extensive cross-shareholding has enabled the Japanese-style corporate system to minimize the influence of short-sighted shareholders, thereby providing employees, engineers, researchers, and managers with an organizational environment that is congenial to their in-house accumulation of skills and knowledge. Yet, in the era of industrial capitalism, even in its “late stage” where capital-intensive industries became dominant, the major source of profits was the scale and scope of economies of production facilities and distribution networks. The organization-specific human capital was subordinate to physical capital in that their contribution to corporate profits was only to coordinate the flow of inputs and outputs and maintain the efficient rate of capacity utilization. In contrast, in the era of post-industrial capitalism the large scale factory system takes a back seat and in its place the human organization itself, capable of doing things differently, plays the central role as the major source of profits. Even though both late-industrial capitalism and post-industrial capitalism require organization-specific human capital, the former requires the specificity to productive facilities and distributional networks fixed in factories and the latter the specificity to the human organization itself in each corporation. Needless to say, it is not an easy task to transform the skills and knowledge of workers, engineers, researchers, and managers from those specific to productive facilities and distributional networks fixed in corporate factories to those specific to the very human organization in which they are working.

My message for the future of Japanese corporate system is therefore a seemingly contradictory one: it does not have to change but it does have to change.

The Japanese corporate system does **not** have to change, because its history of distancing itself from the ideology of shareholder sovereignty may work as an advantage in the new era of post-industrial capitalism, in contradiction to the orthodox view in economics and law.

The Japanese corporate system **does** have to change, because its destiny in the new era of post-industrial capitalism hinges not on the designing of a corporate organization that assists the efficient use of the scale and scope of economies of physical capital but on the cultivation of the corporate organization itself that is able to inspire its employees, engineers and managers to generate different ways of doing things from others. The Japanese corporate system is poised and well-positioned for the future; we can only wait to see what unfolds.

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[i] One puzzle in this result is that "Retention of Employees" and "Improvement of Employees' Benefits" earned low scores even among Japanese managers. This is perhaps due to the fact that unless the corporation as a business organization would survive and grow it is not possible to secure the job of and

improve the benefits of employees. Note also that the more recent questionnaire study by Jacoby et all [2005] has shown a high mark for the job security in Japanese corporations.

[ii] Hansmann and Kraakman [2000] at 439.

[iii] See, for instance, Yoshimori [1998], Jacoby, Nason and Saguchi [2005], Tanaka [2006], Itami [2006], Japan Management Association [2009].

[iv] Sec. 3.02 of the American Bar Association's *Revised Model Business Corporation Act (RMBCA)* states that 'unless its articles of incorporation provide otherwise, every corporation ... has the same power as an individual to do things necessary or convenient to carry out its business and affairs, including without limitation power: (1) to sue and be sued, complain and defend in its corporate name;...(4) to purchase, receive, lease, or otherwise acquire, and own, hold, improve, use, and otherwise deal with, real or personal property, or any legal or equitable interest in property, wherever located; (5) to sell, convey, mortgage, pledge, lease, exchange, and otherwise dispose of all or any part of its property;....'

[v] Other rights are rights to inspect the records and books, rights to sue the directors and officers against their wrongful acts on the corporation, rights to share in the proceeds recovered when the corporation liquidates its assets, etc.

[vi] There is a huge body of writings on this controversy. Some of the best-known works available in English are Machen [1911], Maitland [1900], Dewey [1926], Radin [1932], Hart [1954], Hessen, [1979], Dan-Cohen [1986], Teubner [1988]. For a comprehensive review of various theories of corporate personality before 1930, see Hallis [1930]. In Iwai [1999] I have given an extensive discussion on this controversy. See also Iwai [2002].

[vii] See, for instance, Coase [1937], Alchian and Demsetz [1972], Jensen and Meckling [1976], Easterbrook and Fischel [1991], and Williamson [1985], Grossman and Hart [1986], Hart [1995].

[viii] See, for instance, Penrose [1959], Nelson and Winter [1982], Teece [1982], Wernerfelt [1984], Prahalad and Hamel [1990], and Chandler [1992].

[ix] For the notion of the market for corporate control, see Manne [1965].

[x] Moreover, if this hierarchical structure is combined with cross-shareholdings at each hierarchical layer, the capitalist family at the top can further enhance the leverage of their own capital.

[xi] The classic work that applies the moral hazard model to the theory of firm is Jensen and Meckling [1976]. For the hold-up problem, see, for instance, Hart [2005].

[xii] The traditional corporate governance theory, reviewed, for instance, by Schleifer and Vishny [1997], has been mostly concentrated on this problem.

[xiii] See, for instance, Hall [2000], Blair and Wallman [2001], and Corrado, Haltinger, and Sichel [2005].

[xiv] In fact, what I am maintaining is that the industrial capitalism is a form of capitalism that presupposes the dualistic structure *a là* Arthur Lewis [1954]. Kindleberger [1967], Ranis [2004] and Hayami and Godo [2005], chaps. 3-5 are the recent and insightful reviews on the relevance of the Lewis model. Note that all that is necessary for industrial capitalism to work as profit-generating mechanism is the persistence of wage difference between the industrialized urban sector and the traditional rural area.