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# The Social Responsibility of Directors: Dangerous and Harmful, though maybe not Irrelevant

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The question of how fiduciary duties should be allocated within the public corporation has been the subject of intense interest recently. This holds not only in today's US but also in other economies including Japan. Indeed, it has bee a constant refrain since the 1960s. But, as Professor Friedman argued, there is one and only one social responsibility of business -- to use its resources and engage in activities designed to increase its profits so long as it stays within rules of the game, which is to say, engages in open and free competition, without deception or fraud.

Upon the theoretical foundation of firms and organizations, the nexus of contract theory and the role of 'the controlling group', this paper first analyses the corporate governance in large Japanese firms in which the board of directors have fiduciary obligations only to shareholders. In most large Japanese firms, the controlling group is the body of employees, which is elected in shareholders meetings and must induce shareholders to be friendly and remain friendly. The dynamics of the market drive the controlling groups to act as if it had every other resource owners' interest at heart. As a result, for instance, many argue in Japan that because the board members elected among the body of employees so successfully maintain the support of shareholders, shareholders meeting have become ceremonious, and the management treats the interest of shareholders too lightly. The paper then proceeds to ask why and for whom should we ask 'social responsibility' to corporations, and to discuss its potential enforcement. Upon logical investigation and Japanese experience, it concludes: The corporate social responsibility argument, so long as it concerns only the choice among feasible alternatives under normal conditions, has at least only a limited and marginal influence on a director's behavior. As a result, even if such a responsibility were mandatory, it would have only a correspondingly marginal effect on firm performance. It is, however, the indirect effect of the argument that endangers our open and free market economy. If widely supported by the public, as has been the case until very recently in Japan, the argument would indirectly but seriously influence corporate behavior in general, and director's decision making in particular.

# The Social Responsibility of Directors: Dangerous and Harmful, though maybe not Irrelevant[1]

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'The view has been gaining widespread acceptance that corporate officials and labor leaders have a "social responsibility" that goes beyond serving the interest of their stockholders or their members. This view shows a fundamental misconception of the character and nature of a free economy. In such a economy, there is one and only one social responsibility of business -- to use its resources and engage in activities designed to increase its profits so long as it stays within rules of the game, which is to say, engages in open and free competition, without deception or fraud. Similarly, the "social responsibility" of labor leaders is to serve the interests of the members of their unions. It is the responsibility of the rest of us to establish a framework of law such that an individual in pursuing his own interest is, to quote Adam Smith again, "led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest, he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good"' (Milton Friedman, *Capitalism and Freedom*, 1962, The University of Chicago Press, p.133).

## I. Introduction

Professor Friedman's rebuttal to the social responsibility of directors came to mind when I received an invitation to this conference. I first encountered this argument in the late 1960s when I was an undergraduate and people in Japan were seriously suffering from environmental pollution. I was surprised at his argument, which I hated without understanding. Now, after three decades, I am on his side -- though his position is still a minority position in Japan. Let me first explain why I have changed my mind and then discuss the Japanese experience.

Whenever I encounter a 'social responsibility of corporation' argument in Japan, I quote:

'Few trends could so thoroughly undermine the very foundations of our free society as the

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acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible. This is a fundamentally subversive doctrine. If businessmen do have a social responsibility other than making maximum profits for stockholders, how are they to know what it is? Can self-selected private individuals decide what the social interest is? Can they decide how great a burden they are justified in placing on themselves or their stockholders to serve that social interest? Is it tolerable that these public functions of taxation, expenditure, and control be exercised by the people who happen at the moment be in charge of particular enterprises, chosen for those posts by strictly private groups?' (pp.133-34)

The question of how fiduciary duties should be allocated within the public corporation has been the subject of intense interest recently. Scholars and practitioners have attempted to resolve the question of whether corporate boards of directors have fiduciary obligations to corporate stakeholders other than shareholders by invoking vague, result-oriented conceptions of basic fairness and equity, as well as other, equally value-laden terms like economic efficiency and reliance' (Macey and Miller [1993, p.401]) . This holds not only in today's US but also in other economies including Japan. Indeed, it has been a constant refrain since the 1960s.

Corporate governance, and corporate directors' decision making behavior, depend on many factors, of which the legal framework is only a part. The legal framework varies not only over time but also across countries. So does its actual functioning, as well as the specific issues discussed, the conclusions drawn, and policy measures advocated. This paper focuses upon Japan, particularly corporate governance and directorial behavior in Japanese large firms, the Japanese legal framework, and the debates and actual experience concerning corporate 'social responsibility' and 'fiduciary duty' in Japan. I conclude that the corporate social responsibility argument is dangerous and harmful, though it might not be irrelevant. As shown below, my argument is based on the standard principles of economics. These were not invented to explain Japan or any particular society. Instead, they are basically technological, and apply to all economies. Therefore, the paper provides a case supporting the traditional doctrine that the directors of public corporations owe fiduciary duties to shareholders and to shareholders alone.

The corporate social responsibility argument, so long as it concerns only the choice among feasible alternatives under normal conditions, has at least directly only a limited and marginal influence on a director's behavior. As a result, even if such a responsibility were mandatory, it would have only a correspondingly marginal effect on firm performance. It is, however, the indirect effect of the argument that endangers our open and free market economy. If widely supported by the public, as has been the case until very recently in Japan, the argument would indirectly but seriously influence corporate behavior in general, and director's decision makings in particular.

In my view, the support for a corporate social responsibility argument has been much

stronger in Japan than in the US. As shown below in Section X, since the turn of the century Marxist economics has dominated discussions of the Japanese economy. This influenced not only academics in other fields of social sciences, but also those outside the university, such as journalists, politicians, lawyers, and bureaucrats. Partly because of this, since the prewar period, the support for a corporate social responsibility argument had been so strong in Japan that those who took the opposite position were almost non-existent and the controversy over this argument did not start, and it was in the second decade after the War that defining the role of the government in the market economy became a big political issue.

In this paper I study Japanese firms alone, but I do not argue that they are different in any sense from firms in other countries. As I argued elsewhere (Miwa [1996, p.8]), talk about today's Japanese economy is full of misconceptions, upon which not only political debate but also academic works heavily depends.[3] Firms, corporate behaviors, and underlying legal framework in Japan are not as different as is widely believed from those in other countries including the US. Corporate law in Japan is basically the same as that in the US. Similarly, as a nexus of contracts among rational agents, a Japanese firm as much the same as an American firm and generally behaves rationally. Firms in Japan, America or any other country are never badly managed to any extreme. The reason is straightforward: most poorly managed firms either fire their managers, improve management performance, or go out of business. 'Elementary notions of comparative advantage suggest that some firms in any country will always be uncompetitive compared to firms in the same industry elsewhere' (Ramseyer, 1993, p.2020). The nature or the basic logic underlying the discussion in this paper—that the fundamental factor which determines the form, character and workings of organizations is organization-specific human capital found in the body of employees—is technological and therefore not peculiar to any one country. Therefore, even when a crucial difference is observed between economies, it is not caused by some difference in the underlying basic mechanism.

Reader may wonder why I talk about Japanese experience now, when most people are disappointed at the Japanese firms, Japanese management, the Japanese government, and the Japanese economy as a whole. However, if I had come here ten years ago, I would have presented almost the same paper and the reaction of the audience would be different. Those who think that corporate governance in large Japanese is fatally defective should note that such successful firms as Toyota, SONY, Honda, Panasonic, ORIX, and Seven-Eleven Japan were born, grew, and make decisions under the so-called 'the Japanese system'. They should note also that Japan's historically remarkable postwar industrial success was achieved under this 'system'. There have been failures under 'the Japanese System', to be sure, but unless observers are intentionally closing their eyes,

[3] A reader happy enough not to have any such misconceptions and to believe so should read Section 1.3 of Miwa [1996] entitled 'Five Misconceptions of the Japanese Economy', written as a beginner's guide to studying today's Japanese economy. The world is full of talks and articles based , often unconsciously, on these misconceptions, and this happy reader like little Red Riding Hood has no way to defend herself against them.

they will find similar failures under 'the American system' as well.

Section II explains the theoretical foundation of firms and organizations, the nexus of contract theory and the role of 'the controlling group'. Section III is a brief introduction to the relevant part of Japanese Commercial Code. Section IV explains the roles of directors and friendly shareholders (*antei kabunushi*). Section V discusses why employees constitute the controlling group in large Japanese firms. Section VI explains why friendly shareholders remain friendly. Supposing that we reach an agreement to ask corporations to bear 'social responsibility', Section VII discusses how we should enforce it and at what cost, and concludes that the argument is dangerous and harmful. Section VIII examines what the movement is trying to achieve and asks whether it could effectively achieve the alleged objective. It answers in the negative. Taking concrete examples, Section IX shows how richly shareholders, the residual claimant, of large Japanese firms have been rewarded. Upon the Japanese experience, Section X illustrates how dangerous and harmful is the corporate social responsibility argument, taking three episodes. Section XI concludes.[4]

## II. The Nexus of Contract Theory and the Role of 'the Controlling Group'

My argument in this paper begins with the nexus of contract theory associated with Jensen and Mechling (1976). The central dilemma for most organizational issues is, using Simon's (1976) words, who is 'the controlling group' -- in other words, who 'has the power to set the terms of membership for all the participants' (p.119).With the importance of employees' investment in organization-specific human capital formation, the body of employees takes this key position, and selects directors to be its representatives. Other stakeholders, such as friendly shareholders and friendly lenders, rationally defer to the controlling group.[5]

The view one takes of firms and organizations is apt to depend on one's assumption of 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 to establish the governance structure that is most beneficial to investors, net of the costs of maintaining the structure. People who seek

[4] In order to explain the foundation of my view of firms and organizations, and corporate governance in large Japanese firms, this paper heavily depends on Chapter 11 of Miwa [1996] entitled 'Corporate Governance in Japanese Firms: The Body of Employees as the Controlling Group and Friendly Shareholders'.
[5] This is not the place for explaining my argument in detail, for which see Chapter 11 instead.

resources to control will have to deliver more returns to investors. Those who promise the highest returns... will obtain the largest investments.'

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

The basic issues are who are the founders of the corporation and who take their position when the firm grows larger. The fundamental question is, who makes up 'the controlling group'? Employees are the most important stakeholders in most large Japanese firms, which means that the controlling group will be 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 employees' interest.

The view of organizations underlying my discussion does not depend on the legal definition of a firm. As Tirole [1988, p.16] points out, the economist's 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, recognize in their decision making that the legal boundary of a firm is only one of many constraints. But this legal boundary is not necessarily critically chosen by the controlling group. Accordingly, defining a formal organization by using the legal definition becomes inappropriate, as it can easily misidentify 'the effective boundaries of the organization' (Milgrom and Roberts [1992, p.20]).[6]

The question is why and how the body of employees, as the controlling group, can secure their interest and defend themselves from other stakeholders, especially shareholders. Before going into the details of this point, however, we must briefly review Japanese corporate law and understand that the legal framework for corporations in Japan is not different in any key aspect from other industrialized countries including America.

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[6] Since a firm in the real world is just a legal fiction, the legal boundary of any given firm usually does not coincide with the boundary used by the controlling group in their decision making. A firm, for Coase in particular and economic analysis in general, is a set of activities and/or agents within the boundaries, given by the controlling group, which hereafter will be referred to as the effective boundary.

The basic factor which determines an organization's controlling group is not capital ownership (shareholdings) or corporate financing (loans, bonds, and so on) or its representative directors. Rather it is the organization-specific human capital accumulated in the body of employees. Once we realize this, many economic phenomena related to the organization must be re-examined, such as the predominance of small business and the slimness of large firms in the Japanese economy. For this controlling group the legal boundary is only one of many constraints in the decision-making process, and may not significantly affect the intra-firm organization or inter-firm relationship. The inside-outside characterization of a firm, as described by Coase, depends on transaction costs. Here again the legal definition does not necessarily affect the economic definition of a firm. In this view, even for a firm owner-manager it is in their interest to be friendly to the body of employees. Therefore the question of whether the management is separated form control is irrelevant.

## III. The Outline of the Japanese Commercial Code

The Japanese Diet enacted the Commercial Code [*Sho-ho*], part of which was the core of corporation law, just before the turn of the century. Although it based that Code on Prussian law, under the Occupation after the World War II it revised the Commercial Code to track American models more closely. It remains, however, more detailed and less flexible than its statutory counterparts in the US.

The public corporation (*kabushiki kaisha*) form is the most popular form for large, and for many small, enterprises in Japan. The fundamental features of the public corporation are similar to those of the corporation forms prevailing in the U.S.[7] Shareholders of public corporations are liable only to the extent of their capital contributions, and can usually recover their investment only by selling their shares. Each shareholder is generally entitled to one vote per share held. Shareholders exercise their influence over the management of the company through the shareholder meetings, which must be held at least annually. It may also be held at any time as determined by the board of directors, or, with court permission, upon demand of shareholders holding at least three percent of the issued shares. Shareholder resolutions are passed by a majority vote of shares, unless otherwise specified in the Commercial Code or the company's articles of incorporation.

To manage the company, the shareholders elect directors. Each director is elected as a member of the board of directors, and it is the board that makes the company's management decisions. The board has to monitor each director's business, and is not allowed to delegate key decision making listed in Section 260-(2) to a director. The directors must appoint one or more 'representative directors', who will have actual authority to bind the corporation on certain specified issues. Each director's relationship to the company is governed by a duty of care and a duty of loyalty, and shareholders can sue directors for damages due to breach of these fiduciary duties.[8] Shareholders are also allowed to ask the court to stop a director's action when an irreparable damage to the company is about to occur.

Directors are elected at shareholder meetings and serve terms of office of two years or less, and the shareholders can also dismiss a director during his terms of office. The board of directors is granted broad statutory powers to 'manage' the corporation. Japanese boards do not delegate so much their management powers to corporate 'officers' as they commonly do in the US. The American concept of corporate 'officers' does not apply in Japan. So many who would be considered 'senior management' by American standards occupy places on the board of directors.

The board has other enumerated obligations including: convocation of general meetings of shareholders; approval of transactions between a director and the company; and submission of

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[7] Yanagida et als. [1994, p.271]

[8] Shareholders suit of the existing character, representative suit or derivative suit, was introduced in the 1950 *Sho-ho* [the Commercial Code] amendment, which, however, is odd enough not to include a clause to ask whether the litigant is 'fairly and appropriately' representing the shareholders' interest. On this point see Miwa[1998c].

certain financial reports to the auditors prior to each ordinary general meeting of shareholders and then again to the shareholders at the general meeting, and so forth.

## IV. Directors and Friendly Shareholders

How do employees, as the controlling group, secure their interest and defend themselves from other stakeholders, especially shareholders? Most basically their control generally benefits other stakeholders. An additional reason points to 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 hostile shareholders, especially during takeover bids. So many are fond of talking about *mochiai* [mutual shareholdings] and *keiretsu* as a key to understanding corporate behaviors in Japan, like Dore (1992, p.20) stating, '[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'. Yet the real puzzles here are two: why they are friendly? And will they remain friendly even on rainy days and in the storm?

Let me begin the discussion by examining certain characteristics of large firms' shareholdings. To illustrate my point, I use data on large firms in the transport equipment industry listed on the Tokyo Stock Exchange, such as cars, car parts, shipbuilding, railway vehicles, and so on. From this data two points immediately become clear. First, for most large Japanese firms, a large part of the equity is in the hands of a small number of shareholders. The average concentration ratio of the ten largest shareholders of 11 firms with over 10000 employees in 1990 (Group A) was 35.03 per cent in 1980 and 36.49 per cent in 1990. This figure ranges from 26.20 per cent (Mitsubishi Heavy Industries) to 59.50 per cent (Isuzu) in 1990. The corresponding figures for 29 firms with employees between 2000 and 10000 in 1990 (Group B) were 55.70 per cent in 1980 and 54.53 per cent in 1990.

Second, the largest shareholders are corporations, mainly financial institutions and trade partners. In 1990, for every firm in Group A, the ten largest shareholders were corporate shareholders. Of these 11 firms in group A, financial institutions were the ten largest shareholders in two cases, nine in eight cases, and eight only in one case. Non-corporate shareholders, including employees' shareholding associations, appeared on the ten largest shareholder's list in only three of 29 Group B cases in 1990. In the same year the average number of financial institution in the list was 7.6.[9]

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[9] At the end of March 1990, the ten largest shareholders of Nissan and Honda were all financial institutions. In many cases, the largest shareholder was a non-financial corporation and the others were financial institutions such as Mazda (Ford held 24 per cent), Daihatsu (Toyota, 14.19 per cent), Fuji Heavy Industries (Nissan, 4.24 per cent), Aichi Machine (Nissan, 32.10 per cent) and Yamaha Motor (Yamaha, 33.42 per cent). Of the ten largest shareholders of Toyota, nine were financial institutions. Toyoda Automatic Loom, from which Toyota originally spun off, was the fourth largest shareholder with 4.35 per cent of Toyota's total equity.

The term *antei-kabunushi* is widely used, but ill-defined. *Antei* [literally, stable] here has a dual meaning, 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 its English translation. The position of large shareholders remained stable for a long time. Of the ten largest shareholders in 1990 of the 11 Group A firms, on average seven to eight were also on the top ten list in 1980. Most large shareholders new to the list in 1990 were financial institutions which in 1980 were listed in the top 11 to 20 shareholders. There were only two non-financial institutions new to the top ten list in these 11 Group A firms, Ford as the largest shareholder of Mazda with 24 per cent and GM as the third largest of Suzuki with 3.6 per cent .

The stability of large shareholders is symbolized in the case of Koito, a car-parts manufacturer. In 1989 to 1991, Koito was the target of a take over attempt by Boone Pickens, a well-known corporate raider from the USA. Pickens was Koito's largest shareholder, owning 26.43 per cent of the total issued shares at the end of March 1990.[10] While the share price had stayed at around 500 yen per share, prices rose dramatically to 5,470 yen on 31 March 1989. However, what is most striking is the stable behavior of large shareholders. Between March 1980 and March 1990, only three dropped out or the list of the 20 largest shareholders. None of the remaining 17 shareholders decreased their shareholdings and 14 actually increased their ownership. Of the three which disappeared from the list in 1990, not one was a top ten shareholder in 1980 and the combined holding of the three shareholders was only 3.24 per cent of the total shares issued in 1980. Apart from the Boone company, both of the two new large shareholders appearing on the top 20 list in 1990 were mutual life insurance companies, whose combined holding was only 2.17 per cent of ownership. In 1980, the ten largest shareholders had 50.78 per cent ownership and the 20 largest had 61.71 per cent ownership.

In most large Japanese firms, the controlling group is the body of employees. In such firms, the director and managers are selected from among the firm's employees and are almost always able to expect strong support from the majority of employees, as long as their actions are generally consistent with the interests of these employees. Large shareholders remain as such and faithfully support existing management. They maintain the right as large shareholders under the present corporate law and legal system to deprive the existing management of their leadership in the firm. However, we are in a world of exchange by agreement rather than by coercion. Therefore these shareholders have no incentive to unite or this purpose: otherwise, nothing prevents them from uniting in order to realize the benefits. It such a situation were to occur, the positions of directors and managers would not be stable. Thus they are friendly to the existing management and called friendly shareholders (*antei-kabunushi*). Recall that usually a small number, say 10 or 20, of the largest

[10] I am not sure Pickens ever really wanted to take over Koito. There were rumors that it was just a greenmail attempt from the start and that in the end he obtained secret payoffs from the firm.

shareholders as a group possess the majority of a company's stocks, suggesting that for such largest shareholders it is easy to control the shareholders' meeting for their interest, including election of directors.

In the large Japanese firm most members of the board of directors are selected from among employees. For instance, all 55 directors of Toyota in June 1993 were former employees. The same was true for 31 of 33 director of Honda in March 1993. Of the two remaining seats, one was occupied by a former high official of the Ministry of Foreign Affairs and the other by an interlocking directorate of the chairman of Mitsubishi Bank. All 35 directors except one of Nihon Denso in December 1993 (with 41996 employees), of which Toyota owned 23.07 per cent of the equity and Toyoda Automatic Loom 7.28 per cent , were former employees. The only exception involved an interlocking directorate of the chairman of Toyota. Almost the same was true for Aisin Seiki (employees: 10935), 21.67 per cent of whose equity was owned by Toyota in March 1993. Here 25 of 28 directors were former employees and the remaining three were all form Toyota, one of them with an interlocking directorate serving as a Toyota vice-president.

The same picture applies to smaller firms. In March 1993 all 24 directors of NOK, a car-parts manufacturer with 3790 employees, were former employees. Of NOK's entire equity, 22.55 per cent was owned by Freutenberg of Germany and 4.04 per cent by Toyota, the fourth largest shareholder. Of the 21 directors of Kayaba, another car-parts manufacturer with 4480 employees, 19 were former employees in March 1993. The largest shareholder of Kayaba was Toyota, with 9.12 per cent, followed by Nissan, with 8.73 per cent. The remaining two directors were both former managers of Fuji Bank, the third largest shareholder. Finally, there is Koito. In March 1990, 16 of Koito's 20 directors were former employees. Of the remaining seats three were held by former managers of Toyota and one involved an interlocking directorate, a vice-president of Matsushita, the third largest shareholder.

Table 1 shows the average age of director appointment in major Japanese companies in 1966, 1981 and 1996, with the number of directors. Recently, on average, an employee/manager is elected to be a director in his or her early fifties. A director stays on the board on average for six to seven years. For instance, in 1993, most directors of Toyota had first become members when they were between 50 and 53 years old. Unless they resigned, on average these new directors were promoted four years later to a higher position, such as managing director, executive managing director, vice-president or president. Of Toyota's 55 directors, 23 held a higher position and ten were newly selected at the general meeting of shareholders in September 1993. Three facts are important. First, every year new directors are selected from among the employees to fill the seats of resigning board members. Second, directors chosen from the body of employees continuously dominate the board. Finally, the large shareholders, individually and as a group, continuously support, with the selection of board members from among company employees, the resulting employee-dominated

board itself.

------------------ Table 1 ----------------

Figure 1 displays the average number of board members, classifying those on a position higher than and equal to *jomu* [managing director] from others, and auditors in five major Japanese automobile producers in 1960-1996.[11] The pattern is quite similar in other industries, revealing no clear difference between those with rapid growth and those with slow growth or decline.[12] Note also that the directors are split into a hierarchy of several ranks. Seniority usually determines ranking. The lower ranking directors tend to be salaried employees, such as department chiefs, which are commonly recognized as higher positions in the company promotion ladder, prepared for representatives of employees.

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**V. The Body of Employees as the Controlling Group**

Why is the body of employees the controlling group and why do large shareholders support this group? 'Today the essential task for a firm is not to carry out routine work steadily but through interaction of agents to create information, to search for new business opportunities, and to develop an accumulation process for continual innovation' (Imai, 1989, p.141). To survive and grow, a firm has to accumulate a stock of human capital with which it establishes an organization suitable for its task. This accumulation process takes a long time and requires a guarantee that in the foreseeable future nothing will drastically devalue the accumulated human capital. This requires friendly shareholders.

This process, when effective, has four characteristics. First, it requires each participant's long-term investment in his or her own human capital. Second, the required investment is more or less specific to the particular organization; that is, the skill is organization-specific. Third, it is used in the team production process described by Alchian and Demsetz (1972, pp.782-83), in that the product is not a sum of the separable outputs of each cooperating resource, and that not all the resources used in the team production belong to any one person. Fourth, with long-term investment each participant acquires 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 with the organization. Quitting the organization will devalue the skill gained since it is organization-specific. When the

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[11] Toyota, Nissan, Honda, Mazda, and Isuzu.
[12] See Miwa [1998b].

stability of the organizational structure is uncertain -- when there remains the possibility of change in the incentive system, such as economic rewards and promotion, and in the basic corporate strategy -- participants hesitate to invest in the formation of the required skill. This results in the firm's low performance, discouraging talented young candidates from joining the firm. When only some participants are confident in the organization's stability, the value of a confident worker's skill will be lower than otherwise because of the lower skill of less confident workers. Thus, by making the stability of the organization certain, the body of employees can make the best use of their resources.

Besides securing large, stable shareholders supportive of the existing management, the selection of employees as directors and top managers is an indication of the organization's stability. A director who was a former employee, say for 30 years, has already made a long-term organization-specific investment which allows him to understand the firm's core assets and the firm's business nature. This director also understands the importance of the organization's stability to its prosperity. Moreover, once a *de facto* rule of selecting directors from the employees is established, every participant is confident of the organization's stability since directors unfamiliar with or hostile to the existing nature and structure of the firm are generally avoided or can be easily removed.

Recall that those directors are elected at the shareholders meeting, where a small number of the largest shareholders as a group can easily take concerted action in their own interest. Neither directors nor those shareholders are obliged to bear and actually have any 'social responsibility' for stakeholders like 'employees' other than shareholders. The economic organization through which resource owners cooperate will make better use of their comparative advantages to the extent that this facilitates the payment of rewards based on productivity. This applies to every resource owner. Investors, for instance, part with their money willingly, putting it in equities rather than other investment alternatives because they believe the returns to equities are relatively more attractive. The same analysis is true in determining investment alternatives in the case of firms. Once owning, the equity of a firm, the investor realizes the importance of the organization's stability and wants to be a friendly, but profitable, shareholder. An investor can recover the investment and receive his reward by selling the equity. He can also decrease the risk of investment by diversifying his or her portfolio. Neither option is feasible, however, for an employee investing in organization-specific skill.

Note two points. First, as this observation is a result in a world of exchange by agreement rather than by coercion, who 'controls' the firm is a matter of definition, so any attempt to answer such a question in general is futile. 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 below. Second, one may agree with the literature regarding the 'discretionary' power held by managers of large firms and apply it to firms where the controlling group is the employees. How does it happen that shareholders willingly allow directors to act contrary to their interests, since the rewards for their investment largely depend on the performance

of the directors?

## VI. Why does a Friendly Shareholder Remain Friendly?

The basic reason why the body of employees is able to secure its stability and defend itself from attacks from other stakeholders is that such attacks generally do not benefit other stakeholders. An additional reason is the role played by friendly shareholders. Why does a friendly shareholder remain friendly? In a world of exchange by agreement, a shareholder agrees to be friendly and stays friendly because the expected rewards from being friendly are higher than would otherwise be the case. The controlling group of a firm has to deliver rewards large enough to attract suppliers of other resources. In order to induce a large shareholder to be friendly and remain friendly, the controlling group has not only never to make management decisions against the interest of shareholders but also to offer additional incentives beyond those available to an ordinary shareholder. Otherwise, those who hold rather pessimistic expectations of the firm's future prospects relative to the market will cease to be friendly.

Three types of incentives are popular. First, cross-holding equity ensures the stability of both organizations, functioning as mutual hostages between friendly shareholders. Second, trade partners often benefit from other organizations' stability and are willing to pay a premium for this benefit. Since stability is the basis of the firm's prosperity, contributions to its stability increase the seller's profits and enable it to provide better products at lower prices to a buyer. It also serves the buyer as a guarantee that the supply of products will not cease either at the supplier's will or as the result of an invasion, such as take-over, by a buyer's rival. Third, a firm can offer additional incentives through allocating profitable business opportunities.[13]

With the understanding that the controlling group is the body of employees and that it has the implied power to select the friendly shareholders and to choose the sources of corporate funds, we can draw three logical conclusions all of which are contrary to the conventional view of the Japanese economy. First, 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 (for example, among 'corporate group' firms)[14] are the result of such voluntary selection.

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[13] For more details of the argument, see Miwa[1996, pp.207-9]. Mutual insurance companies, some of which are the largest shareholders in Japan, are typical of the third type of beneficiary. Since they are not corporations but mutual companies, cross-shareholding is not possible. Usually they are neither big purchasers of the manufacturing firms they own nor do they have much interest in the stability of the manufacturing firm's organization. We observe, however, both loan transactions and insurer-customer relationships between life insurance companies and their shareholding firms.

[14] That popular Japanese 'corporate group' or *keiretsu* talks are flatly false. See Chapter 7 of Miwa [1996].

Second, sources of corporate funds, including banks, are selected on the basis of the lender's support of the present body of directors. Therefore, when once friendly large lenders, such as main banks, become hostile to the present management, the directors change their source of funding.[15] The phenomenon that the largest lender has a large share of the borrower's stock is only one result of such voluntary selection.

Third, members of the board of directors and top managers are selected on the basis of their support of the present directors and employees. Even directors who are supposed to represent the interests of other stakeholders are friendly to the present body of directors, and they remain in such a position unless they became troublesome. The structure of the board of directors is a result of this

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[15] Readers familiar with popular Japanese main bank(s) argument may wonder the connection of my argument with the role of 'main banks'. This view is compatible with Dore's second feature of the Japanese economy (1990, p.20), for instance. 'One of the banks is generally considered a firm's lead bank. It may provide only marginally more loan capital then 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 main bank, has significant power and even controls the borrower's management. However, why does the controlling group continue to choose a certain main bank? As shown in Miwa[1996, Chapter 6], I am quite skeptical on the current flood of literature on the Japanese main bank system which, instead of assuming a competitive market, implicitly assumes the existence of a tight cartel among Japanese financial institutions and its dominance in the Japanese capital market. Often 'main banks' run away before the borrowers fall into financial trouble. Before this observation, it is irrational for non-main-bank lenders to save monitoring cost by 'delegating' monitoring function to main banks. Why does a main bank not run away, using effectively their advantageous informational position, if, as argued, 'main bank' both has magnificent monitoring capability and possesses borrower's information better than other banks?

Readers may ask, 'Have Japanese banks "magnificent monitoring capability", which are recently suffering from a flood of bad loans with threatens both individual bank's existence and the stability of Japan's financial system? At least have they ever had it?' My view and explanation of the flood is as follows. Since the financial crisis in the 1920's (*kin'yu kyoko*) in particular, Japanese banks have adopted as a common principle in making loans and purchasing corporate bonds, particularly in making long-term loans, to take security (and/or a guarantor). This caused a shift of focus in bank's examination and monitoring for making loans, from the proposed project's profitability and borrower's management to value and safety of the security and guarantor. No change in this principle has occurred at least until very recently. During the 'Japan's Bubble Years' in the second half of the 1980s', most loan security (and guarantor in substance, too) was land, which, with a collapse of land market, 'a land-bubble crash' since 1990, resulted straight in the flood of bad loans. Many argue that at the final stage of the Bubble banks were 'bubbly' enough to overvalue securities, making their damages bigger. Thus Japanese banks magnificent monitoring capability, if any, is to examine the value and safety of security and guarantor, not to examine and evaluate the project's profitability and borrower's management. On these points, see Miwa[1996, pp.120-22].

Many readers both at home and abroad would reply that where there is smoke, there is fire. Most non-Japanese Japanologists love this reply, since they first were interested in Japan because of her 'singularities'. Here I quote two parts from a section entitled 'A Prior Rejoinder' in the 'Introduction and Summary' Chapter of Miwa[1996]. 'I would like to mention a Japanese proverb coming originally from China: "One dog barks at a shadow, and a hundred dogs at the voice" (an approximate equivalent in English may be "Much ado about nothing") and ask them to recall what the wrong dual-structure view was and what the fire was. My work on the corporate group model ... is analogous to examine the validity of the existence of UFOs' (pp.27-28). 'Readers may comment, "why so much discussion and new literature on Japan's main banks and industrial policy?" My answer is threefold. First, many ignore the *post hoc, ergo proper hoc* fallacy. Second, strong demand for the discussion and literature exists among politicians, government officials, journalists and academics, particularly in the former socialist economies. It creates the supply, which the politicians and government officials in Japan support enthusiastically both on the belief of the effectiveness of government policy and for their own self-justification. Third, as is usually the case, the authors of the literature on main banks, for example, are only those who are interested in them. Thus, there now exist the "main bank literature industry" and the "Japan's industrial policy literature industry"' (p.28).

I take the view of Stigler [1988, pp. 111-12], concerning with Gardiner Means's doctrines, that: 'It is fair to say that Mean's doctrines are much less widely held in economics than they were in the Great Depression, but their persistence is a remarkable tribute to their palatability to ruling political thought. Once an idea is widely accepted, it is guaranteed a measure of immortality. Its decline in popularity is more often due to changing interests than to contrary evidence, no matter how powerful that evidence may be.'

voluntary selection.

When the body of employees establishes its controlling group position within a firm and is supported by friendly shareholders, it is costly for large shareholders to unite in order to deprive the existing management of their leadership in the firm. Management is strongly supported by the body of employees. New management, whether invited from outside or selected from inside among employees, intent on changing the nature of the organization or corporate policy will face strong resistance from the body of employees since its accumulated human capital is organization-specific. Moreover, as a result of the prevalence of such firms, the external market for managers is not well developed. It is difficult to find a new body of management capable of improving the firm's performance for shareholders. When a bank with a large share of a firm's equity appoints its manager as the president of the firm, there is unlikely to be any significant change in the firm. Unless accepted by the body of employees as its representative, the director cannot change corporate policy. Hence appointing a leading director from outside is rarely effective in improving the firm's performance.

## VII. Implementing Director's 'Social Responsibility'

Since the time of Adam Smith, the separation of ownership and management, or the separation of management from control, within a large modern corporation has gathered wide attention. Berle and Means [1932] further provoked public interest in the firm's form of social control.[16] In postwar Japan the same argument has prevailed, and many have insisted that the separation was even more clearly realized in Japan than in the US.

My above argument presents a different view of this ownership-management separation. The classical view states that each shareholder is so small that the cost of uniting is prohibitive, limiting the effective control of management. In Japan, however, a small number of large shareholders own the dominant portion of equity, for whom the cost of uniting is not high. They support the existing management as friendly shareholders, since it is more profitable for them to do so than to manage the firm by themselves or replace the management. Here, the separation of ownership and management, and that of management from control, is not a serious social problem.[17][18]

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[16] Coupled with fear and/or hatred, often vague and ill-defined, for big business, this interest is strongly connected with interest in 'social responsibility' of corporations.

[17] Surely it is a matter of definition whether reader should call those shareholders 'institutional investors'.

[18] Thus far I have focused on only large firms like those listed on the Tokyo Stock Exchange. The same logic also applies to large unlisted firms, and even to small unlisted firms. What would happen if an owner of a large unlisted firm, where the body of employees is the controlling group, made a decision against the interests of this group, for instance suggesting selling the organization to some other firm in ten years? Such a firm can neither attract young talent nor induce employees to invest in organization-specific skill formation, resulting in the firm's poor performance. Thus an owner-manager chooses to be friendly to the body of employees, and the non-separation, or non-dispersion,

Before going to discuss, 'why and for whom should we ask "social responsibility" to corporations, or to corporate directors?', let us examine its potential enforcement. Suppose we reach an agreement to ask corporations to bear 'social responsibility'. How should we implement it? (1) Simple persuasion has no effect, as the present state is already the result of voluntary exchange among rational decision making units. Suppose some firms take the persuasion seriously, which the others are left uninfluenced. Such choices handicap the former group of firms, and the market will select the latter, which makes the long-run effect of persuasion impossible. (2) What will happen if we enforce, for instance by law, certain types of choices on directors? What would we require? Contribution to charities or education and academic research? Then, isn't it better to collect the money as tax and to ask the legislature to decide where to allocate it, rather than to ask self-selected private individuals to make the decisions? 'Is it tolerable that these public functions of taxation, expenditure, and control be exercised by the people who happen at the moment be in charge of particular enterprises, chosen for those posts by strictly private groups?' (Friedman, 1962, p.134) (3) Suppose we change the rules regarding derivative suits in order to prevent shareholders from challenging directors who decide to follow their notion of 'social responsibility'. What challenges would we prevent? Would we also modify the business judgement rule? Could shareholders contract around this new rule?[19] Directors are elected at shareholders meetings and serve terms of office of two years or less, and the shareholders can also dismiss a director during his terms of office. Would directors make decision against the interest of shareholders? Would such directors be elected? Shareholders meetings determine director compensation, too. (4) What would happen if the law imposes restrictions on the shareholders' director election? In some cases shareholders by themselves become directors, in another they select directors from among candidates in the narrower set, and in the other founders choose other form of business organization. In either case, the choice set of shareholders will be restricted, making the expected rate of return on investment worse, which discourages business investment, and distorting the resource allocation of the economy.[20] This conclusion applies also to the above (1) to (3). Thereby, 'social responsibility' movement, some of which seems to be a reflection of anti-business tradition long-lived in the society, if effective, makes the society poor.

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of ownership does not affect the firm's basic decisions. The same holds true for small businesses. In order to survive and grow, even an owner-manager of a small business has to follow the same path.

[19] The rules that are identified as "mandatory" in practice have very little in common with the ordinary understanding of that term. They are either easily -- and legally -- stepped, or they pose nonbinding constraints because there is no burning demand to deviate from them'. The history of corporation codes suggests that when a mandatory rule's constraint becomes binding (that is, when a sufficient number of firms desire to deviate from the rule), then the code is invariably revamped in the direction of less restrictive (more optional) terms' (Romano [1989, pp.1599, 1601]).

[20] We have to note, however, that, upon these cost, what the society would gain might not be great. As Kay [1996, p.118] argues, 'any governance structure -- political or corporate, democratic or authoritarian, American or Japanese -- has a natural tendency to embrace those who share the basic values of those who currently operate it, or reject those who do not. Moreover, such behaviour is easy to defend; is it not better to confine involvement to those who understand the business?'

The more strongly the 'social responsibility' requirement is enforced, the larger the cost society would have to pay in decreased income. Suppose the requirement is vague and the enforcement ambiguous. If the effect would be in fact discriminatory, placing focus upon well known established companies, listed big companies for example, particularly such public utilities as electricity, gas, and telecommunication, transportation, distribution, and financial institutions including banks, another distortion emerges. If the effect would be heavy on those with a good heart, the 'bad money would drive out the good'. Even if the requirement includes nothing new, signifies virtually nothing, for the moment, when society is calm and stable, the trend and atmosphere friendly to this requirement would steadily undermines the very foundations of our free society. It potentially and decisively influence the whole social system, when society loses its calmness and prudence, as Japan did just before and during the World War II. I will go back to this point in X, but such a situation is not unique to the wartime Japan. So, the argument is dangerous and harmful, of course, not only to Japan but also any other society.

## VIII. Effectiveness in Achieving 'Social' Objectives

Thus, even when the society would reach an agreement that corporate officials have a 'social responsibility' that goes beyond serving the interest of their shareholders, we have to solve many difficult problems: what actually should we require them to do?, who should determine the content of the requirement?, how should we implement and realize it?, and what would happen if directors neglect of the requirement and who would punish them? In addition, of course, we have to pay the cost for this requirement, which might be great.

What then is the movement going to achieve? It may sound obvious from the following statement: corporate officials have a 'social responsibility' that goes beyond serving the interest of their shareholders. In a world of exchange, however, a shop master primarily serving his own interest will recognize only those customers who think his shop is the best place to spend their money. Likewise, every resource owner will join a company and remain only when it is best to do so given the alternatives. The controlling group of a firm must deliver rewards large enough to attract suppliers of other resources. The controlling group of a firm, in my view the body of employees in most Japanese large firms, is elected in shareholders meetings and must induce shareholders, large shareholders in particular, to be friendly and remain friendly. The dynamics of the market drive the controlling group to act as if it had every other resource owners' interest at heart, 'led by an invisible hand to promote an end which was no part of his intention' (Adam Smith).[21] The problem here is to

[21] Note that a minority shareholder does not vote for the decisions at shareholder meetings. Even a shareholder who votes for the resolution might do so only because it is the best choice under the given constraints including the majority decision making rule.

which direction and to what degree 'social responsibility' requires a deviation of resource allocation.

Recall the reason why the body of employees becomes the controlling group, upon the support of other stakeholders. To survive and grow, a firm must accumulate a stock of human capital with which it establishes an organization suitable for its task. This accumulation process takes a long time and require the guarantee that in the foreseeable future nothing will drastically devalue the accumulated human capital. By making the stability of the organization certain that guarantee enables employees to make the best use of their resources. In Japan, this process has been widely realized but neither with any special emphasis upon 'social responsibility' nor with any specific policy intervention. The 'social responsibility' argument seems us to require to raise the relative position of 'employees', but I wonder to which direction and why. On the contrary, the dominant view seems to be the opposite. Many argue that because the board members elected among the body of employees so successfully maintain the support of large shareholders (*antei-kabunushi*, or friendly shareholders), shareholders meetings have become ceremonious (in Japanese, *keigai-ka* [a mere shell]), and the management treats the interest of shareholders too lightly.[22] Also, many people argue now that in the 1990s in particular, suffering from the too much stability in Japanese firm's organization, Japan has to restructure every kind of organizations, increasing their flexibility and mobility.[23]

The same applies to the position of trade-partners. Though the conventional wisdom about trade relationships is full of misconceptions, symbolized by the ill-defined *keiretsu*, trade relationships in many fields in Japan probably have a long-term character.[24] 'Social responsibility' argument seems also to require to raise the relative position of trade-partners, implying in Japan to increase the stability of *keiretsu* which has been criticized as too stable. The dominant trend of argument in Japan is the opposite, I believe, as is the case concerning the position of 'employees'.

I have never seen a view supporting 'social responsibility' requirement discussing precisely the details, at least in Japan. In Japan, 'social responsibility' is emphasized always in general terms, which simply reflects some people's strong fear or hostile sentiment toward free competition and the market mechanism.[25] So many have criticized the 'social responsibility' argument, like Friedman [1962], Macey [1989], and Macey and Miller [1993], I go back to Japanese experience and observations.

## IX. Rewards to the Shareholders, the Residual Claimant

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[22] I am talking about a popular sentiment, not mine. Here I do not argue that it is peculiar to Japan.
[23] Note that, in substance, my view has nothing to do with labor-managed firm. Employees are a collection of different groups of workers, and one group or a collection of groups of workers form the controlling group. My view does not imply that employees in a firm are strongly united and form the controlling group as a whole. On this point see Miwa [1996, pp.212-13].
[24] Note that long-term relationships are not necessarily exclusive. See Miwa [1996, p.15, and Chapter 12].
[25] See Section X below.

Those who are enthusiastic about the 'social responsibility' argument seem to insist that providing the right to elect corporate directors to shareholders alone is against equity, giving too much privilege to shareholders, though it may contribute to efficiency.[26] My argument against this view is obvious from the preceding discussion. In a world of exchange by agreement, who 'controls' the firm is a matter of definition. Recall that, instead of discussing 'who controls the firm?', I only refer to 'the controlling group, which holds the power to set the terms of membership for all participants and to select the basic value criteria that will be employed in the organization's decision making process. In this section I talk about what shareholders in Japan got in the past.

A simple observation symbolizes the situation of Japanese shareholders. By law shareholders can make a resolution at their meeting that they liquidate the company and share the residual value among them. Among companies listed on Japanese stock exchanges, no company's shareholders have ever received dividends in this way. [27]

Large firms usually do not increase their dividend payments even when there are large profits. Instead, firms expand their retained earnings and reinvest this profit into the organization mainly for the employees' benefit. Over a long periods of boom and depression, other stakeholders have stayed friendly unless circumstances change. For instance, with stable dividend payment of only 5 yen a year per share, many shareholders remain friendly.[28] Banks which are sure to recover their loan principal and promised interest payments will continue to support existing management. Once-prosperous firms, such as Toyobo, Toray, Mitsubishi Heavy Industries, and Nippon Steel, are the notable examples. For instance, Toray earned large profits in the 1960s when it enjoyed a monopoly in nylon production and was one of the pioneering suppliers of polyester. However, Toray's dividends increased slowly, reaching their peak at 8 yen per share per annum in FY1969. Dividends soon decreased to around 5 yen per year.

Large firms spend large sums of money on their employees in preparation for periods of hardship, such as a business depression. Many large firms begin to diversify in their heyday when they spend retained profits. Mergers and acquisitions are not popular for this objective, since the purpose is not profit itself through efficient use of internal funds but the creation of an expanded

[26] In Japan, those who emphasize 'fairness' and/or 'equity' often proceed even to challenge the majority decision rule of shareholders meetings. Suppliers of 'the same resource', investors, lenders, trade partners, and workers, differ greatly among themselves. Requesting their equal treatment, neglecting those difference, and at the same time the difference of their efforts and underlying incentives, is surely against the foundation of our society. Whether this point applies only to Japan is another question.

[27] One may argue that corporation is based on the corporate law which assigns as the claim on the residual to shareholders, who therefore obviously control the firm. However, as Komiya [1990, pp.168-69] argued, 'irrespective of a 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'. When shareholders cannot decide the residuals by themselves, the assigned residual claimants position does not make sense.

[28] Before 1990, at least, average rate of return on equity investment in Japan had been quite high, mostly realized as capital gain.

workplace for employees. Besides investments for diversification, large firms often pay extra money to employees working outside the firm. For instance, recently Japanese firms have suffered a serious slump, and many workers continue as employees, but work outside the firm. The reward is lower because their organization-specific skill is almost worthless outside the home company, which must pay extra to compensate for the difference in salary. In the case of Nippon Steel, the largest steel maker, the number of employees working outside the firm was more than 15,000 in 1993 (this number had been over 10,000 since 1989 until very recently) about 30% of Nippon Steel's total employment. This firm is said to pay compensation until these employees reach the retirement age of 60. This firm had paid the shareholders' annual dividend of 2.5 yen per share even when the business was seriously in the red. Other major steel makers ceased paying dividends when the business was seriously in the red, but even those firms also continue to pay extra payments to those employees working outside the firm. The last case demonstrates that shareholders cannot force the directors to refrain from decreasing dividends to zero, instead of continuing the extra payments.

The recent decision of NKK, the second largest steel maker in Japan, to liquidate Toa Steel, its subsidiary company listed on the Tokyo Stock Exchange, with 1400 employees and annual sales of 130 billion yen, also illustrates the situation. On 3 September 1998 NKK announced that Toa Steel would be liquidated at the end of March 1999, and that they would prepare a receiving company that would inherit all the assets and debts, with employees. At the end of March 1998 NKK held 51.58% of Toa's stocks. The business of Toa has long been seriously in the red and this company paid no dividend to shareholders. Toa has long been a subsidiary of NKK, and with additional contribution of 5.2 billion yen this February NKK raised the stock share from 36.54% to the present level, when the stock price was more than 100 yen per share. The total value of debt NKK inherits from Toa is said to be 250 billion yen. Shareholders of NKK recently receive annual dividend of 2.5 yen per share, after a long time of no dividend.[29][30]

## X. How Dangerous and Harmful is the 'Social Responsibility' Argument in Japan

At least potentially, the support in Japan for the 'corporate director's social responsibility' argument is, at least, as strong as in the US. This support is a part of an economic thought or a social doctrine that

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[29] Why NKK chose this is another question. Why NKK's shareholders are silent is the other. An obvious fact is that Toa's shareholders lost their whole investment.

[30] By definition, under the present legal framework the body of shareholders are the residual claimant, the primary reason for which is, as Macey [1989, p.175] argues, that 'shareholders retain the ultimate right to control corporations because they value this right more than do other groups and because it is therefore efficient for them to retain control '. This argument does not suggest in any sense that the shareholders can and actually do take anything they want at the sacrifice of other stakeholders. What could and would be left as residuals is determined in the same way as other management decisions, and observations shown in this section suggest two points. First, in large Japanese firms almost always nothing is left for the residual claimant when the company goes bankrupt and/or is liquidated. Second, the residual claimant should take 'residuals' for instance as dividend payment before the company goes bankrupt accordingly, but dividend payment to shareholders is not much, either.

has dominated Japan at least since the turn of the century. Only recently has its dominance diminished. The dominance and the persistence of this doctrine has been the greatest obstacle to deregulation in Japan, which only recently accelerated the speed,[31] reflecting the declining dominance. The continuing wide support to the doctrine is, like a dormant volcano, dangerous.

As I argue elsewhere (Miwa [1996, p.2]), it is only recently that many economists have begun to talk about the Japanese economy using the standard principles of economics, explaining the dominant pattern of economic phenomena. Prior to the change, before the 1970s, for instance, Marxist economics dominated discussions of the Japanese economy. Those subscribed to such theories failed to recognize that the economic phenomena could have occurred as a result of exchange by agreement, not by coercion. These theories influenced not only academics in other fields of social sciences but also those outside universities, such as journalists, politicians, lawyers, and bureaucrats. Even business leaders shared the view when they talked, not about their own business, but about the Japanese economy as a whole. Thus the Marxist theories have become so ingrained that they still permeate the conventional view of the Japanese economy. Even today most Japanese, particularly those who are over 40, strongly sympathize with those views.

Under the dominance of these theories, at least until very recently support for open and free competition led by an invisible hand has been weak in Japan, and large sectors of the economy like financial sectors, energy, and telecommunication have been put under strict government regulation. In addition to such chronic neglect of free market by the public and intervention by the government backed by the public's widespread fear of competition, quite often Japan has seriously suffered from intermittent attacks by these theories, of which I introduce below three episodes. With the remarkable postwar industrial success of the Japanese economy, through open and free competition led by an invisible hand typically in the manufacturing sector, the public's support to these theories have weakened step by step.[32] These theories, however, have become so ingrained that like a dormant volcano with a slight stimulus or by chance they might regain an explosive influence. Thereby the ongoing corporate social responsibility controversy is dangerous and harmful, though it might not be irrelevant as a process for the public to learn the danger and harm while the society is

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[31] On this see Miwa [1997].

[32] Readers may suffer from a vague belief like Krugman [1994, p.142] that: 'There is no question that before the early 1970s the Japanese system was heavily directed from the top, with the MITI and the Ministry of Finance influencing the allocation of credit and foreign exchange in an effort to push the economy where they liked.' Many Japanese as well share the view, like Okazaki and Okuno-Fujiwara [1993, p.12] who argue, referring to The Industry Stabilization Act (*tokuan-ho*) of 1978 and The Structural Improvement Act (*sanko-ho*) of 1983, as follows: 'Those policies for "competition control" and "planned resource allocation" are what the government inherited from the wartime plan-and-control system. The postwar industrial policy differs from the wartime control merely in the objective, economic independence and economic growth instead of wartime mobilization, and in the policy implementation system, decentralized inducing system with diversified soft-type methods instead of command-control system, making excessive competition visible.' As I discussed in Miwa [1998a], these views are flatly false. Not only in the postwar Japan before the early 1970s but also even under the wartime control what the government could and actually did achieve through intervention into the private business was small.

calm.[33]

The Japanese people experienced the most tragic attack during the World War II, under the wartime controls. Starting with *sangyo gohrika undo* [the industrial rationalization movement] symbolized with the establishment of *Rinji Sangyo Gohri-kyoku* [the Temporary Industrial Rationalization Agency],[34] the government intervention into the private sector expanded step by step with the progress of the war situation. In the process neglect of the open and free market reached its peak where almost every kind of business activities including entry and investment was strictly controlled, and the role and working of profit incentives were denied. Many business people resisted, and some of them argued that too strong intervention would hurt military production. In retrospect, Japan's wartime economy suffered from serious inefficiency and bad performance, at least partly because of ill-organized interventions and discouraged business incentives.[35]

The second decade after the War, following the decade of transition and recovery from war destruction, was a highlight of Japan's postwar industrial success story. The decade was also the time of a series of 'liberalizations' like trade liberalization. Throughout the decade in Japan the biggest policy issue was defining the role of the government in the market economy. The so-called Industrial Order Debate reached its peak when the Bill for the Act on Temporary Measures for the Promotion of Specified Manufacturing Industries was proposed to the Diet, which would allow the government to intervene into the private sector. The attempt of the government, the Ministry of International Trade and Industry in particular, which was again backed by the public's fear of competition, distrust on the market and trust in the state, emphasized the 'Industrial Order' to be maintained by the government intervention. Fortunately, the attempt failed, which symbolized the long-run trend toward open and free market, realized above all in the manufacturing sector.[36] Thereby, Japan enjoyed a remarkable industrial success not by effective industrial policy but in open and free market. A new law was not adopted, but the process took a long time and existing laws and other policy measures remained untouched even in the manufacturing sector. In the financial sector, for instance, the same type of controversy became serious in the 1980s.

At the beginning of the 1990s, people both at home and abroad found a new phrase '*kyosei*

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[33] Once the society, or the environmental factors around the business change drastically, or if the basic economic conditions worsens and the society loses calmness, the potentials supporting the argument might run recklessly. Thereby, we must pay more attention to those potential danger of the argument than their direct effects. It is my view, drawn from the Japanese experience, however, that controversy on to whom corporate directors should be fiduciary may not be irrelevant, so long as the participants would finally reach an agreement that it is to shareholders. It serves as an opportunity for the public to learn the danger of this argument. It functions also as an outlet for the energy feeding on hatred and criticism to non-such-social-responsibility argument and open and free market which would otherwise accumulate in the society. The controversy, however, might be dangerous when many call for the 'social responsibility' in a loud voice, revealing that the accumulated energy is exploding.

[34] The Agency, which existed from 2 June 1930 to 30 April 1937 and whose chief was the Commerce Ministry, was established to mobilize all the sections within the Commerce Ministry's jurisprudence.

[35] Whether the government effectively intervened into the private sector and could achieve their primary objective is another question. Placing focus upon 'the Competence of the State' under the wartime control Part I of Miwa [1998a] draws a negative conclusion on this point.

[literally, symbiosis]' proposed and emphasized by Japanese business leaders as an ideal both of their society and of their business behavior. People remember the phrase with the late Mr. Akio Morita, then the chairman of SONY and the vice-chairman of *keidanren* [the Federation of Trade Associations in Japan]. He as a representative of *keidanren* and of a much wider business world enthusiastically argued that beyond competition in open and free market they, Japanese firms, had to find a new way for co-existing, *kyosei*, with non-Japanese firms in the world market. Though in substance quite similar to the traditional cartelization and industry control doctrine, the argument gained immediate acceptance and '*kyosei*' became one of the most popular phrases of the time.[37] This view apparently struck a responsive chord in the public, particularly among senior business people and politicians and in the mass media, based on the traditional Marxist theories, now a dormant volcano.

For Japan the 1990s has been basically the period of deregulation. With the progress of economic depression and financial disorder, however, this dormant volcano seems to be awakening. Recently the public and the mass-media increasingly demand government intervention into the private sector, asking for 'social responsibility' on the part of corporate officials, particularly those of financial institutions. This controversy is one of the revivals in substance of the same movement we witnessed at least several times after the World War II, which again is one of the movements based on the same foundation, distrust on the market and trust in the State.

## XI. Concluding Remarks

Markets fail quite often, and we have a list, a long list of market failures. As Stigler [1975, pp.113] argued, however, 'we may tell the society to jump out the market frying pan, but we have no basis for predicting whether it will land in the fire or a luxurious bed.' Likewise, contracts among participating agents for forming and maintaining a firm may be almost always incomplete, and like Hart [1993] it is possible upon the incomplete-contracting perspective to present 'arguments for and against a narrow interpretation of fiduciary duty'. The last paragraph of Hart, however, is as follows.

> 'I then considered the case for a mandatory rule (the prohibition of opting out). It seems to me that, although arguments can be made for a mandatory rule, they are not very robust; that is, in any particular situation, the adoption of a mandatory rule is as likely to do harm as good. My conclusion is that mandatory rules are probably a mistake' (p.313).

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[36] For the details of this event see Miwa [1996, Chapter 8].
[37] See Akio Morita [1992] and the special issue of *Monthly Keidanren*, December 1995. For their critical anatomy see Miwa [1997, Section 5-8].

In writing this paper, placing focus upon the Japanese history, I find and feel strongly that those who are for the 'social responsibility'- or 'fiduciary duty' argument place not only weaker trust upon the function of open and free market but also stronger trust upon the competence of the state than those who are against. We have to pay much more attention to the competence of the state, upon which I discussed extensively in Miwa[1998a], following Stigler [1965]. Professor Stigler, in his presidential address in December 1964 annual meeting of the American Economic Association, pointing that Adam Smith's distrust was primarily a distrust of the motives rather than the competence of the state, commented that Smith's argument was based on an undocumented assumption that the state was efficient in achieving mistaken ends. With this, Smith makes very little of inept governmental conduct, inefficient conduct in particular, and he gives no persuasive evidence that the state achieves the goals of its policies. The trend both in economics research and in the real economy's movement over the next three decades after Stigler [1965] strongly suggests that we have had a too optimistic view of the competence of the state.

I should emphasize here again that in this paper I study Japanese firms alone, but I do not argue they are different in any sense from firms in other countries. The nature of the basic logic underlying the discussion in this paper -- that the fundamental factor which determines the form, character and workings of organization is organization-specific human capital found in the body of employees -- is technological and therefore not peculiar to any one country. Therefore, even when a crucial difference is observed between economies, it is not caused by some difference in the underlying basic mechanism.

I conclude this paper with the last impressive paragraph of Fischel [1982], which came to my mind on the process. Reading 'the directors' decision making ignoring stakeholders' interests other than shareholders' for 'the divergence of the corporate managers and investors' captures my present feeling well.

> 'Despite the near consensus that improved corporate governance is necessary, critics have proffered no evidence to demonstrate that any problem exists. Many reformers, as their proposals reflect, either ignore or misunderstand the economics of the corporate form of firm organization and the market forces that limit the divergence of interest between managers and investors. It is difficult to escape the conclusion that the corporate governance movement, despite its durability and widely hed support, is much ado about nothing' (pp.1258-59).

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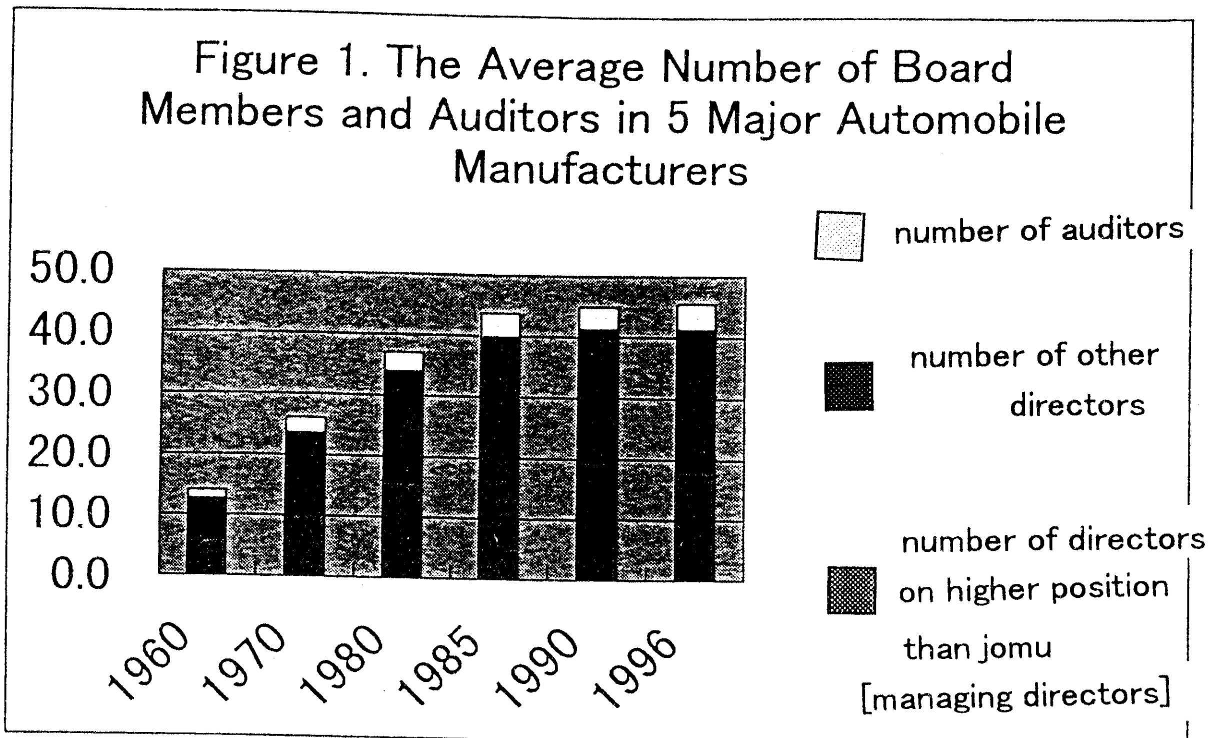
Table 1. Average Age of Director Appointment and the Number of Directors

| | 1966 | | 1981 | | 1996 | |
|---|---|---|---|---|---|---|
| | A | B | A | B | A | B |
| Panasonoic | 48.6 | 19 | 54 | 29 | 54.9 | 32 |
| SONY | 44.3 | 14 | 48.6 | 27 | 52.8 | 38 |
| Hitachi | 52.5 | 20 | 55 | 25 | 55.7 | 33 |
| Toyota | 45.6 | 18 | 50 | 35 | 52 | 55 |
| Honda | 43.3 | 11 | 46.7 | 32 | 49.6 | 35 |
| Fuji Bank | 48.2 | 19 | 50.3 | 30 | 50.6 | 36 |
| IBJ(*) | 48.2 | 19 | 51 | 34 | 51.5 | 37 |
| Nomura Securities | 42.8 | 33 | 44.5 | 40 | 45.7 | 43 |
| Tokyo Electric | 56 | 20 | 55.5 | 28 | 57.3 | 32 |

A: average age of director appointment
B: the number of directors
(*) Industrial Bank of Japan
Adopted from Miwa [1998b, Table 3]




Adopted from Miwa [1998b, Figure 4].