COMMENT: PAPERS ON EMPLOYEES AND CORPORATE GOVERNANCE

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I. INTRODUCTION

It is interesting to compare the different stances of the three papers: Sadowski, Junkes and Lindenthal address the question of whether Germany's co-determination system is Pareto-efficient (and they cite a surprisingly large body of literature on the question). They reveal only towards the end that they favor the system, but clearly they believe that it could not be justified if it proved to be inefficient or to inhibit flexibly dynamic adaptation to change. Marleen O'Connor, on the other hand, defines herself as a member of the body of "progressive" scholars, characterized presumably by the normative belief that labor should have greater power than it presently has within the United States' economic system. She is concerned with ways in which that might come about—through extension of fiduciary law, through arguments about employees' investments in specific human capital and through wielding shareholder power via pension funds. Takashi Araki, in his surprise that the Legislative Council of the Ministry of Justice should have adopted the "Americanization" recommendations of Japan's Corporate Governance Forum, reflects the uncertainty, not to say bewilderment, of much of the Japanese academic community. These Japanese scholars are caught between a slowly changing reality, with which they are on the whole satisfied, and a predominant rhetoric in the media in favor of a shift from a conventionally employee-favoring "stakeholder firm" towards clear shareholder-sovereignty "a l'americaine."

Yet, nobody argues what seems to me the obvious "social justice" case for subordinate-employee power. Perhaps it is most obvious here in Britain where, last year, executive compensation (not including stock options) rose by 15% while average salaries rose by 5%. Britain

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may still be behind the United States, to judge from the figures O'Connor cites, but it is well on the way. By contrast, Araki points out the relative compression of differentials in Japan. One might add that in the hard times of recent years, surveys suggest even greater compression: Executive pay has risen by smaller amounts than average pay.

II. SOCIAL JUSTICE

The "social justice" argument goes like this: Of course, modern industrial societies and post-industrial societies have to be meritocracies and, in meritocracies, people who are lucky enough to acquire the scarcest abilities inevitably have greater power. Hierarchical power relationships become a more and more necessary concomitant of the division of labor, the more formidably complex the material and social technology that is used in production becomes. Direct democracy in a business firm is as absurd a proposition as direct democracy in national government where increasingly complex technical problems have to be mastered for sensible decision making. I do not believe as Maureen O'Connor does that labor-shareholder activism or anything else can "destroy the perception created under Taylorism that workers are not competent to take strategic business decisions." Workers can make judgments on the fairness of the division of tasks, rewards and opportunities (given their society's conventional notions of justice) and the honesty of managers who try to convince the employees that decisions management makes on those distributions are fair. It has always seemed to me that advocates of greater worker participation should be working towards a structure that divides organizations for production cooperation, on the one hand, from something one might call a Fairness Council,[1] but not collective bargaining institutions manned by adversarial maximizers.

So inequality of power is inevitable. Yet, the normative "social justice" argument, i.e. there "ought" to be devices (like co-determination[2] and the conventions of the Japanese firm), which prevent those who have power from arrogating to themselves so much

1. RONALD DORE, TAKING JAPAN SERIOUSLY Ch. 8 (1987).

2. The fact that the head of IG Metall, in his capacity as member of the Mannesmann supervisory board's remuneration committee, is under investigation by the German prosecutors for his role in approving, by German standards outrageously large, bonuses to departing managers, possibly as a result of a corrupt deal, may cast doubt on the effectiveness of this curb. Bertrand Benoit et al., *Mannesmann Defence Stepped Up*, FIN. TIMES, Aug. 22, 2001, at 17. The amounts involved, however, as a *Financial Times* leader commented the next day, "were tame by British and American standards."

of the good things of life—especially those that money can buy—that material inequality goes way beyond anything necessary to provide reasonable incentives for effort. This is directly opposed to an alternative social justice "ought," which says that rewards should be based on purely objective criteria and the only objective criterion available is market price. People should get what the market is willing to pay them. If the market lets the winners take all, then all is what they "ought" to have.

Choice between the two "oughts" is a matter of personal values, though those who, like myself, viscerally incline to the first can try to win over those on the other side by asking them questions like the following: If the price you have to pay for enjoying your yachts and ranches is to surround yourself with electronic fencing and never to be able to stroll through city streets of an evening without fear, would you still insist? Are you not attracted by the idea of a society with enough solidarity and enough similarity in material conditions for people of all income levels to treat each other as equal in dignity and citizenship?

One would have thought, apropos the discussion in the German paper of the Jensen/Meckling question, "If co-determination is so efficient, why do managers not choose it voluntarily," that the Freeman/Lazear answer was blindingly obvious. Co-determination may make for a bigger cake, but owners end up getting less of it. I was surprised to find that all the literature cited in their paper as bearing on the efficiency of co-determination depended on regression analyses within Germany, comparing more and less co-determined firms. The authors cite no external comparisons, do not mention the famous high-road/low-road argument about German diversified quality production, nor analyze any studies of the strength of German firms in foreign markets in competition with management-determined Anglo-Saxon firms. One piece of work is very relevant indeed to the Freeman/Lazear thesis: de Jong's analysis of the share-out of value added in Europe's hundred biggest firms[3]. He specifically compared the German and the British firms in his sample. The former had, on average, a higher value added per employee ratio, but the shares of that revenue going respectively to capital and to labor were strikingly different—something like 20:65 in Britain and 7:85 in Germany. What equalized returns to equity in the two countries was the fact that for

3. Henk de Jong, *European Capitalism Between Freedom and Social Justice*, 10 REV. INDUS. ORG. 410 (1995); Henk de Jong, *The Governance Structure and Performance of Large European Corporations*, 1 J. MGMT. & GOVERNANCE 5 (1997).

two firms producing the same total net value added, the market valuation of the British firm would be close to three times that of the German.

III. UNDERLYING PARADIGMS: WHO IS AN EMPLOYEE?

What is striking about all three papers is the strength of established paradigms. The first paradigm is the image of the firm which informs most such discussions as a large mass production factory predominantly manned by blue-collar workers. So much so, that O'Connor does not admit CalPERS and TIAA-CREF to the status of labor-shareholders on par with the Teamsters and UNITE. But this is to ignore the transformation in employment relations, in the United States especially, brought by the steady decline in employment of easily substitutable blue-collar workers and the concomitant increase in the proportion of staff whose specific human capital is of obvious value to the employer. The consequent increasing use of share distribution and share options as a means of remuneration clearly blurs, or shifts, the employer-employee dividing line. The growth of stock option remuneration (the 13% of total issued stock which O'Connor quotes is a formidable figure), surely explains a large part of the shift she describes from a manager/labor coalition against owners in the 1960s, to a manager/shareholder coalition against labor in the 1990s. (That is precisely what the device intended, after all.) Perhaps a change in the taxation regime for share options—towards more punitive treatment—as well as a change in the accounting requirements for them, would do more than anything to bring about a reversal in the decline in labor's power vis-à-vis management. Araki's paper makes clear how important it is for the structure of Japanese firms that even top managers see no objection to being put in the same category as the production worker as "employees"—employees, not of their shareholder principals, but of "the firm."

There is a more general point, however, about the tendency to equate "employee power" with the power of labor unions (which was the fatal flaw in the proposals for industrial democracy drafted, but never enacted in Britain by the Labour Government of the mid-1970s). It ignores the enormously important—and increasingly important—stratum of junior and middle managers. They see themselves as remote from the center of power and, as such, they are closer to and able to identify with, other subordinate employees. At the same time, they are the most likely to have the expertise to challenge top management's decisions. As I argue below, apropos of the "capillary controls" over top management in Japan, the role of the younger people on management tracks in keeping top management efficiently on its toes cannot be underestimated. They should not be left out of any schemes for employee power in corporate governance. In the German co-determination system, they are explicitly not left out. In Japan, however, the few faint voices raised in favor of formal employee representation in corporate governance seem mostly to have in mind legal status for the existing type of Union-Management Consultation Committees—which would indeed leave out middle managers.

IV. UNDERLYING PARADIGMS AND CULTURAL HEGEMONY

The other underlying paradigm is, of course, the neo-classical economist's assumptions about property laws and about maximizing behavior. I was astonished to learn from the German paper of Jensen and Mecklen's counter-positioning of the legal compulsion of co-determination with the voluntary adoption of co-determination—as if the "voluntary" behavior of the owners of property had nothing to do with law, and it was not in any sense a function of the powers conferred on them by the laws of property, contract and corporate law. The salience in both the American and the German paper of the "specific human capital" argument for greater employee rights is another instance of the strength of the paradigm, appealing as it does to the methodological individualism of neo-classical economics and the "matrix of contracts" vision of the firm.

But it was Takashi Araki's paper that most made me reflect on paradigms and on how difficult it is for Japanese, whether scholars or businessmen, to think outside the paradigm set by our current cultural hegemony. (I was about to say, not "current," but "the twenty-first century's"—but we have a long way to go yet.) Take, for instance, Araki's sentence, explaining why a number of Japanese companies have cut down the size of their Board of Directors. "Excessive size has been cited as a key cause of board dysfunction." Dysfunction? If "the" function of a board of directors is to hammer out policy in uninhibited debate, then to expect that of a board of 50 senior executives is clearly to expect the impossible. Yet, because that is a major function of the smaller boards of American companies, there is no reason why it has to be "the" function that entities bearing a title translatable as "Board of Directors" have to perform everywhere.

Of course, these large boards (like Japanese cabinet meetings) simply rubber stamp decisions already made before their meetings, and, of course, the "function" of making those decisions has to be performed elsewhere—usually (but after prolonged threshing in committees and private consensus-building conversations) in a small group, informally constituted (i.e., having no status in company law) of 3 to 10 top executives—the president, vice-presidents and senior managing directors (to use the translations of the titles which Araki gives in Figure 4). They meet regularly and much more frequently than the formal board. So why should a company have a Board of Directors at all? Because the law prescribes it and because it has acquired other functions, for example:

> (a) information diffusion and concomitant commitment-reinforcement. The directors of a large board, nearly all of whom head one or another department of the firm, are authoritative sources of information for their departments about decisions made or about to be made. By putting the decisions they have rubber-stamped in the best light, they can reinforce their department's commitment to carrying them out. Their status as board members gives an extra edge of authority to their exhortations.
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> (b) tension-defusing, resentment-reducing expression of sectional interests. A board member whose department has lost out in an internal struggle over policy can, when offering his rubber stamp at the board meeting, nevertheless express his reservations and in effect say: "OK, but you owe us one. Remember that next time."
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> (c) middle-management motivator. As Araki says, "board membership is . . . a final stage of promotion . . . the crowning success of [a] career as an employee." But for the prospect of that glittering reward (usually at ages 50-55) to be effective in motivating the 30- and 40-year old high-flyers, the success ratio needs to be significantly different from zero. In companies that recruited several hundred 23-year-olds onto management tracks in a single year of the 1960s, a board of 50 members, recruiting (and retiring) five or six a year is not too large.

V. OUTSIDER/INSIDER CONTROL AND WHITHER CHINA

I ended my own review of the debates about corporate governance in Japan[4] by suggesting that their outcome would depend on (a) whether America's glamorous "new economy" had a hard or a soft landing when the bubble burst, and (b) whether China ends up

4. RONALD DORE, STOCK MARKET CAPITALISM, WELFARE CAPITALISM: JAPAN AND GERMANY VERSUS THE ANGLO-SAXONS (2000).

with corporate governance norms closer to those of Japan than of the United States.

What I had not expected was that Enron and WorldCom would obscure the "landing" in such a cloud of dust, not merely taking the shine off the new economy, but also impugning the "transparency" which the Japanese preachers of "reform" had declared to be the great American corporate virtue. This is having a dramatic effect, not only on opinion in Japan, but also on the direction of Chinese reformist thinking and raising doubts generally about the efficacy of external controls.

The basic Anglo-Saxon starting-point for corporate governance prescriptions is a two-fold proposition: First, the efficiency of an enterprise is measured by the return it gives to its owners; secondly, managers will not be efficient unless they are subject to control—external control—by those owners. "Insiderism" can only lead to slackness, or even corrupt abuse of managerial power. Hence the enormous economics literature, employing sophisticated games-theory techniques, on agency theory—the institutional devices that can ensure that manager agents act on behalf of owner principals. Hence also the belief that where companies are quoted on the stock exchange and have multiple owners, absolute transparency of company accounting is necessary so that the "market" as a whole can provide the necessary external control.

The way that control by the stock exchange is supposed to work is as follows: If investors can make accurate and informed judgment of the performance and the value of a company, the stock exchange will price its shares accordingly. If management is inefficient and the share price falls, the shareholders will pressure managers to improve. Alternatively, because the company will become cheap to buy, a better management will organize a takeover and the inefficient managers will be punished by dismissal.

Much of the talk in China recently about inefficiency and corruption on the Shanghai stock exchange has assumed that a well-informed and honest stock exchange, functioning according to the "effective discipline" model described above, would provide this essential form of external control over management. The stock exchange is therefore the key institution of a properly functioning economy, far superior to the other alternative means of channeling household and corporate savings into business investment—namely, through bank deposits and bank loans, taxation and government subsidy or the issue of fixed-interest bonds. If that "effective discipline" model corresponded to reality, that might indeed be true, but there is by now a vast literature demonstrating that it does not, even in the home of stock-market capitalism, the United States.[5]

Japanese corporations have based their institutions on a different two-fold proposition: First, the efficiency of an enterprise is measured by the returns it gives not just to the owners of capital, but also to customers, the local and national community and to its employees—especially to the latter, the body of *shain* ("members of the firm"), including managers and workers, who form something like a community. (Japanese corporations may not constitute communities quite to the extent that Chinese state-owned enterprises—the "work units," which provided "iron rice bowls"—once did, but yet they are something much more than a temporary collection of people hired on contract by managers to do what managers tell them to do.) Secondly, the external controls, which help to keep managers efficient, come more from product markets in the form of customer feedback than from financial markets. Thirdly, internal controls from within the organization are just as, if not more, important for efficiency.

What are those internal controls in Japan? First, there are the "capillary controls" over their immediate superiors of younger enthusiastic junior managers, who have to do the detailed work of preparing the papers for important decisions their superiors have to take. (Do not forget that this is a lifetime employment system: The junior managers are tomorrow's senior managers and are in—muted—competition for faster-than-average promotion to senior positions.) Sometimes there have been more formal and collective forms of this otherwise "capillary" control; for example, when junior managers set up their own informal study groups and write memoranda for senior management remonstrating against what they consider to be their mistakes. Second, there is the formal control over the president and his close advisors exercised by the large boards of directors (up to 50 members in large firms) made up of senior executives. Their functioning has already been described above. Third, there is the control exercised by a firm's labor union. In the typical large Japanese firm, the union is autonomous and confined to the enterprise. Every employee who is not defined in the 1946 Trade Union Law as "an agent of the employer" belongs to the union, which means, in practice, that junior managers are also members until they reach positions of line authority, usually when they are in their early

5. To cite two excellent analyses of the evidence (to which the newspapers continue daily to contribute): ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (2000) and MARY A. O'SULLIVAN, CONTESTS FOR CORPORATE CONTROL: CORPORATE GOVERNANCE AND ECONOMIC PERFORMANCE IN THE UNITED STATES AND GERMANY (2000).

to mid-thirties. (The reason for the "agent of the employer" formulation is that (as enshrined in current NLB practice, and under the same influence) the law was drafted on the assumption of a strongly adversarial employer/employee conflict. That was an accurate assumption about the late 1940s. Today, the union/non-union dividing line separates, rather, those who are closely involved in decision making about the firm's future and those who are on the receiving end of those decisions, but whose interests are deeply affected by the outcome—a line of division, which in the nature of the case, is never clear-cut.) The way the union exercises constraint on the authority of managers is predominantly through Union-Management Joint Consultative Committees, which meet regularly and have an agenda consisting of (a) items for report (of decisions managers have already taken), (b) items for joint consultation before decisions are taken and, (c) items for joint decision. What kind of decision comes in what category is established not by law as in the German co-determination system, but by a "constitutional" labor-management contract.

The Anglo-Saxon system of external controls works to keep managers honest and efficient by threatening punishment—punishment through takeover in the impersonal workings of the stock market or punishment through dismissal by a Board of Directors, dominated by external Directors, whose job is explicitly defined as representing the interests of capital-providing owners. The Japanese system of internal controls works through face-to-face, not impersonal, arm's length relationships by exerting moral pressure on managers' consciences. And what determines the sensitivity of those consciences? Top managers, after a lifetime of work in their firm, tend to be closely identified with it. The threat that their negligence or dishonesty might damage the reputation of the firm—or lead it into bankruptcy if it failed to conform to the "hard budget constraints," which economic reality imposes on it—can make those consciences sensitive indeed.

The fear of being thought to be racist makes most social scientists shy away from using any concept of "culture" in the historical explanation of national differences, but I do not find it irrelevant to suggest that in this difference between external punition and internal pressure on conscience is due to the difference between a society based on the Mencian and Sung Confucianist doctrine that human nature is basically good, and one based on the more pessimistic view of human nature, which dominates the Western ethical tradition, especially in the form of Christianity's original sin. One characteristic of the political science, which developed in Confucian China and Confucian Japan, was an emphasis on good government as government by benevolence. One of the indexing characteristics of good government was that more use was made of rewards for virtue than of punishments for wrongdoing.

That Mencian/Sung Confucian tradition is one that Japan shares with China. I am not competent to say how relevant it is to contemporary debates about corporate governance in China today—how much that tradition enters into the "Chinese characteristics" of the socialism that China is seeking to build. But my first and major point is that the whole question of the balance between internal and external constraints is of extreme importance in any discussion of corporate governance. This difference is generally—and quite wrongly—neglected.

It is certainly neglected in the English-language literature about corporate governance in China,[6] which almost exclusively concentrates on the external controls exercised still partly by government and party agencies, and increasingly by banks, the stock exchange and the asset management companies. I find very little discussion about the staff and workers' councils or the careers and promotion system for management—which powerfully affects the sensitivity of managers' consciences to internal checks.

This neglect seems to me an example of the workings of cultural hegemony. Those who take part in the discussion are blinded by the shining salience of the American model and thus see only half the picture. I hope that the literature in Chinese, which I cannot read, is different.

VI. CONCLUSION: THE TRANSFORMATION OF CAPITAL

Japan has certainly moved further than China from its Confucian roots. It may be that if the Legislative Council's proposals that Araki describes are enacted, companies will indeed take the opportunity to revamp their formal governance structure along American lines. Of all the factors making such a change likely, it is not so much the decline in the capacity for company loyalty, changes in values and in the central life interests of younger generations, as the growth of foreign—mostly American—ownership of Japanese industry that is

6. *See, e.g.*, a paper sponsored by the OECD, Cyril Lin, *Private Vices in Public Places: Challenges in Corporate Governance Development in China*, mimeo (March 2000), or Li Jiange, *The Securities Market and Reform of State-Owned Enterprises*, 5 WORLD ECONOMY & CHINA 3 (2000).

probably the most important. Araki gives 18% of total market capitalization as the 1999 figure and it could well be higher now.

O'Connor considers the impact on American industrial relations of the growth of union-controlled pension funds, but the effects are also worldwide. American hegemony is not only geopolitical and cultural; it is also financial. It is an odd irony that the influx of new American savings (in a nation with an overall negative net savings ratio!), plus the inflow of foreign (including Japanese) savings, is of such proportions that having boosted price/earnings ratios on Wall Street to an absurd mid-20s average in recession America, the funds' search for a globally balanced portfolio takes them even to Japan where the ratio is still a good ten points higher. (Fixed and visible returns put a limit on the amount of money that can go into bond markets; only the equity and property markets with their "growth stock" myths can absorb this excess flow of capital. And it looks set to be swollen even further on a world scale by the finance industry's success in persuading politicians throughout the OECD world that pay-as-you-go state pensions are no longer viable and pensions have to be funded—preferably on an individual account basis.)

Whatever the financial mechanics, American funds are now deeply entrenched in Japan. The pilgrimage to meet investors in Wall Street is now part of the annual calendar for the CEOs of most Japanese major corporations. And the whole history of U.S.-Japan relations for the last fifty years serves to make the advice and remonstrance offered to them by an American fund manager—seven feet tall and booming with relaxed confidence—far more potent than when directed at a German manager. Araki does not mention that the Corporate Governance forum, source of the latest legislative reform proposals, has close links with CalPERS. Any story about the future of labor and capital in Japan has to take account of a transformation in the nature, not just of labor, but also of capital.

Who can predict whether the Anglo-Saxon face of capitalism will eventually transform Japan, whether the proposals for new forms of corporate governance will be rapidly adopted, whether the breach made by the Tokyo District Court in the protection of job security is gradually widened and whether Japanese managers take to down-sizing at the first sign of reduced sales to keep their profits up. Personally, I would prefer to wait until the current world recession has played itself out before I place my bets.