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An Evaluation of Japan's Stakeholder Capitalism

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Not much more than a decade ago, Japanese capitalism seemed to have triumphed in apparent defiance of the tenets of neo-classical economics. Almost as impressive as its economic achievements, Japan appeared to have invented a more humane form of capitalism without having to sacrifice efficiency and productivity. Many Americans looked to Japan for an alternative to the raw capitalism practiced in the United States and liked what they saw. Ronald Dore (1986: 250) said that Japan had seen the shape of the future and made it work.

In particular, the Japanese company seemed to contrast favorably with its U.S. counterpart. Apart from its competitive success, what most impressed outsiders was the Japanese company's loyalty to its employees and its freedom from the short-termism and obsession with pleasing Wall Street that afflicted American companies.

Many scholars discerned in the Japanese company—or imagined they discerned in it—many of the attributes of a "stakeholder company." According to Carl Kester (1991: 79), "Japanese managers are agents of the entire coalition of stakeholders rather than the shareholders or any other single group." For Eric Orts (1992: 129), the Japanese company is "a coalition of stakeholders—suppliers, lenders, customers, shareholders—holding a complex blend of senior and junior, short-term and long-term, conditional and unconditional, implicit and explicit claims against the company." Sanford Jacoby (2000: 6) describes the Japanese variant of capitalism as one that "balance[s] the interests of multiple stakeholders: employers, creditors, trading partners, and finally, shareholders." Ronald Dore (2000:10) says that in Japan, the "rights of owners ... are seen to be very properly circumscribed by the rights of other stakeholders—employees, customers, suppliers and subcontractors, creditors, local communities, etc." These examples could be multiplied.[1]

The Basis of Japan's Stakeholder Capitalism

The basic building block of Japan's stakeholder economy is the long-term relationship in both workplace and marketplace. Japan's economy is a dense network of such relationships. The term "relational contracting" was coined to contrast Japanese trust relationships with arm's length contractual relationships or spot market transactions allegedly typical in America. In discussing the labor market in Japan, Hiroshi Ono (2002: 1) distinguishes between social exchanges (characteristic of Japan) and economic exchanges (characteristic of the United States): "Labor market transactions in Japan are embedded in an intricate web of social relations or social exchanges. Economic

[1]Other examples include the following: The Japanese company is "a coalition of the body of stockholders and the body of employees, integrated and mediated by management, which acts to strike a balance between the interests of both sides" (Aoki, 1988, 154). The Japanese "variant of capitalism balance[s] the interests of multiple stakeholders: employers, creditors, trading partners, and finally, shareholders" (Ahmadjian and Robbins, 2003). Japan's "stakeholder system embodies a community of fate, a social context diligently supported by Japanese legal practice and courts" (Robert Ballon and Kekichi Honda, 2000). The Japanese company is a "[m]ulti-stakeholder" organization (O'Connor, 1993: 1562). Other scholars refer to the Japanese company as a communitarian corporation (see Thurow, 1992: 32). Sony's legendary chairman Akio Morita would have agreed with these assessments. He wrote that "Japanese company employees know that they are members of a community bound together by a mutual fate for which they bear the hardships of today in anticipation of a better future" (Ishihara & Morita, 1989).

exchanges are characterized by short-lasting impersonal transactions between anonymous actors. In contrast, there is an implicit understanding and trust in social exchanges that the relationship will be long-lasting, and transactions will lead to a deepening of the social relationship."

The best-known example of relational contracting is, of course, the lifetime employment guarantee given by companies in return for the loyalty of their employees. But long-term relationships are ubiquitous in Japan. Another example is the country's web of interlocking shareholdings: "An implicit agreement is made between two companies to hold ownership in the other partners' stock, usually around one percent by nonfinancial firms and up to five percent by banks. Each company makes the same type of implicit agreements with, for example, twenty companies. Consequently, a spider web of mutual stockholding among inside shareholders is created, thereby stabilizing majority stock ownership" (Shishido, 2000: 210-11). Similar ties of mutual obligation bind companies to their "main banks" and their suppliers and vice versa. The resulting stability of supplier relations is suggested by the fact that of 60 or so members of Toyota's first-line suppliers' club in 1990, only two or three had not been members in 1970, and only two or three of the names that figured in the earlier list had disappeared (Dore, 2000: 36).

Scholars who find the profit motive distasteful or even immoral have been heartened by the successes of the Japanese economy. A recurrent theme in the scholarly literature is that Japan has somehow succeeded in transcending self-interest and the narrow focus on profitability and maximizing stockholder wealth characteristic of corporate America. Japan's success allegedly calls into question the assumption that modern economies have to rely on the motive force of profits to be effective. Amartya Sen says the West has to come to terms with the fact that "the most successful capitalist nation in the world flourishes economically with a motivation structure that departs firmly—and often explicitly—from the pursuit of self-interest, which is meant to be the bedrock of capitalism" (Sen, 1993: 50).[2]

Other observers, too, interpret the Japanese company as a community "whose members are willing to subordinate their private interests for the sake of larger goals of the community" (Fukuyama, 1995: 309; see also Thurow, 1992: 32). Another says that Japanese employees are not motivated by profit (Bowie, 1991). According to William G. Ouchi (1984), employees of Japanese companies feel they have an obligation beyond the simple exchange of labor for salary. The gifted observer of Japan, Ronald Dore, claims that Japanese employees share a sense "of being engaged in a shared national enterprise to make Japan powerful and respected member of the comity of nations" (Dore, 1986: 251).

It is not just employment relations that seem to be driven by more than simple self-interest or the profit motive. Other business and work relationships appear to have more complex motivations too. Thus, companies don't hold shares in one another with a view to making a profit, but rather as a means of cementing business relationships. Rodney Clark (1979:102) says that "institutional shareholders ... have bought their shares [in a company] not so much for dividends as to ensure the cooperation of the company as a borrower, customer or supplier." The main bank rescues affiliated companies on the brink of bankruptcy "less for profit than from obligation..." (Dore, 2000: 34). A company's supplier "has a right not to be simply abandoned [just] because ... another supplier offers a better deal [so long as it is doing its best]" (Dore, 2000: 36). Contrast this with what Dore calls the Anglo-American norm: "Switch without compunction if you find a better combination of quality and price…" (Dore 2000: 35-6).

[2] Sen is fond of quoting the *Wall Street Journal's* tongue-in-cheek claim that Japan is the "only communist nation that works" (Sen, 1993: 50). The chairman of Mitsubishi Heavy Industries has declared that "profit maximization is inappropriate for manufacturing industry" (*Economist*, 1998: 15).

However, that is not to say that self-interest has been entirely banished. As Dore himself points out, while loyalty to business partners is "an essential part of being a good citizen, ... [the Japanese] believe that in the long run it is also the best policy." He illustrates this coincidence of duty and enlightened self-interest by means of a hypothetical case: "Suppose that a supplier is in trouble. For a couple of years, you go on buying from him in spite of having to pay him higher prices that are being offered by the firm around the corner in order to keep him out of the bankruptcy courts. It will pay off in the end. He'll be so morally indebted ... that you'll be able to squeeze him when you're in trouble" (Dore, 1986: 2).

In stark contrast to the carnage of U.S. bust-up mergers and acquisitions and leveraged buy-outs, Japanese business is remarkably stable. In part, this may be due to a taboo against hostile takeovers. It is plain to see why hostile takeovers would be disapproved of. They disrupt established relationships nurtured over years. They may result in new management expropriating workers by disregarding implicit contracts with the workforce of the acquired company (Shleifer and Summers, 1988). Also for some critics, hostile takeovers involve a form of commodification of the company's employees. Many Americans might agree that buying a company seems immoral–like buying a person. Lester Thurow (1992: 137) is an example. He says that, in the United States, "[c]ompany divisions, including the employees, are bought and sold or restructured in a manner reminiscent of kings buying and selling provinces in medieval Europe ... [As a consequence] employees are chattel serfs who are not consulted on whether they want to have different masters. Not much corporate loyalty can be expected if one can be expected to be treated as a slave and sold to the highest bidder." It has been pointed out that, in Japan, the words used to describe hostile takeovers suggest this cultural aversion: *miurisuru* (to sell one's body), *baishu* (bribery), and *nottori* (hijack) (Bradley, et al., 1999: 59). Shishido (2000: 208) says that the use of hostile takeovers is limited in Japan because of a norm labeling such activities as "nearly criminal."

Additionally, many Japanese (as well as Americans) view the wave of hostile takeovers and LBOs in the United States in the 1980s as an essentially sterile, unproductive activity. Sony's Morita (Ishihara and Morita, 1989) deplored them as "money games" and "simply moving money back and forth"—as opposed to attending to the real business of an economy which consists in making things.

However, as will be discussed later, the use of hostile takeovers is practically impossible because of structural factors as well. The Japanese system of interlocking shareholdings presents an almost insuperable barrier to such takeovers.[3] Since long-term allies usually hold a controlling bloc of shares in each company, interlopers like T. Boone Pickens (who unsuccessfully tried to get a seat on the board of a Toyota supplier, Koito Manufacturing, on the strength of his shareholdings in the company) aren't likely to get a foot in the door.

Flexible Rigidities: The Theory of Japanese Stakeholder Capitalism

To skeptics, the Japanese system of stakeholder capitalism might work in practice, but it can never work in theory. The story the skeptics tell is that because Japanese companies are so enmeshed in long-term relationships that they lack the flexibility to adjust to change. They cannot lay off employees when they don't need them, and they cannot rapidly hire experienced workers when they do need them. They are not free to cancel orders to suppliers who fail to meet delivery dates or quality requirements or to cut off distributors who don't make the grade. They are protected from the consequences of their mismanagement by their base of stable shareholders and by main banks that are obligated to come to their rescue if they fail. Overall, the

[3] Additionally, under Japanese law, a merger requires the unanimous consent of a company's board.

Japanese system seems designed to block the process of Schumpeterian "creative destruction" by which an economy renews itself.

Up to the 1980s, Japanese companies triumphantly defied the skeptics. It was hard to argue with Japan's success. Japanese companies had taken over industry after industry, from textiles and shipbuilding to autos; and, with their victory in memory chips or D-RAMS, they appeared poised to dominate high-tech. As Michael Borrus later remarked, "it looked like just a matter of time before the Japanese owned the global electronics industry" (Schlesinger, 1992). Ronald Dore (1986: 250) dared the skeptics head-on by claiming that Japan worked because of its rigidities: "Japan has grown to be the second biggest western economy by incorporating precisely these features which are deplored elsewhere. . . ."

How did Japan transmute its rigidities into flexibilities? According to Dore, the source of Japan's flexibility is an implicit contract or bargain between companies and their employees. In return for job security, employees grant managers flexibility in the workplace.

> [Companies accept] a wide range of constraints on their freedom of action—lifetime employment guarantees, tight seniority constraints on promotion, acceptance of the need to engineer consent, to maintain close consultation with employees or their unions [in exchange for] a 'commitment' on the part of employees which greatly facilitates the firm's 'flexible' adaptation to technologies and new market opportunities.

Dore says that "'[c]ommitted' employees, not fearful of dismissal, are more willing to accept a complete change of job function when new technology makes their former job obsolete, more willing to undergo the necessary training; less likely to leave the firm and take with them the investment the firm has made in their training; more willing to accept wage restraint when the firm faces temporary difficulties, etc."

(Dore, 1996, 8).[4] Dore refers to these payoffs from employee job security as "gains from trust and cooperation."

One of the clearest gains from trust relates to the utilization of imported technology. In the West workers have often bitterly resisted the introduction of new technology. Thus in the U.K. (not coincidentally Dore's home country), employees would often see new technology as a threat to their jobs, pay and status in the workplace. Companies had to engage in protracted negotiations with employees with job control over so-called "productivity deals" in order to buy off employee opposition to innovation. But in Japan, workers had no reason to block new technologies or other improved efficiencies that might reduce the need for labor (Maitland, 1982 and Maitland, 1983).

In other ways, too, the rigidities of Japan's external labor market are compensated for by greater labor flexibility within the firm. One way that Japanese companies try to stabilize their workforces is by diversifying into new product lines. If faced with weakening demand for its company's product, it is considered to be "the task of management to increase demand or to find another product" (Abegglen and Stalk, 1985: 6).

Other sources of flexibility are more familiar. They include wage cuts in hard times that are possible because some of an employee's wage is in the form of a discretionary bonus. Companies may also lay off seasonal workers and so-called temporary workers who tend to be women or retired workers. Another uniquely Japanese practice is what Ono (2002, 8) calls "redundancies from above." Large companies farm out their surplus workers to their suppliers and affiliates (*shukko*). Additionally, Japanese companies rely on conventional techniques like

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[4]Dore (1986: 250) notes that a "skilled fitter would consider it entirely reasonable that if there is no fitting to be done, he should temporarily be asked to weed the flower beds beside the factory gates, or be sent off for two or three months to augment the external sales force."

hiring freezes, cutting overtime, early retirement programs, attrition and so on. However, Japanese companies have drawn the line at U.S.-style downsizings of large numbers of permanent employees.

In summary, the theory of Japan's stakeholder capitalism is that its apparent rigidities (like the prohibition on downsizing) have created a climate of trust in which employees are willing to accept significant changes in their jobs. These rigidities are the source of compensating flexibility in Japan's economy. That is why Dore calls them "flexible rigidities."

Did Stakeholder Capitalism Prolong Japan's Recession?

That is the theory of Japan's stakeholder capitalism. But Japan is coming off what some call a lost decade. In the 1990s Japan's annual increase in real GDP per capita barely exceeded one percent. That contrasts with the years of Japan's economic miracle of the 1960s when real annual growth approached the double-digit level (Alexander, 2000). Employment was no higher at the end of the 1990s than it had been in 1990. Part-time workers make up rising share of employment (24 percent in 1998 compared with 20 percent in 1990) (Lincoln, 1999).

Meanwhile, the U.S. economy has staged a comeback. Only a short decade ago, many in the United States and Japan appeared to have written off American high-tech industries—sometimes even the entire economy. Akio Morita (Ishihara and Morita, 1989) said "[t]here are few things [made in] the U.S. that Japanese want to buy." Quite a few Americans, too, shared Morita's pessimism. For example, former U.S. trade negotiator Clyde Prestowitz (1988, 28) had a lot of company[5] when he claimed that Japan's success in semiconductors marked the beginning of the end for U.S. electronics. In sepulchral tones, Prestowitz announced that the "story of . . . the semiconductor industry,

[5]See Maitland (1995) for examples.

invented in the United States and symbol of its dynamism, . . . is both a paradigm of the rise of Japan and the decline of the United States and one of the great dramas of the latter half of the twentieth century." He prophesied that, apart from a few custom chips, the Japanese would dominate every segment of the market worldwide by the early 1990s. "Nothing American industry can do will stop them."

Of course, Prestowitz and other American declinists proved to be false prophets. By the early 1990s, it was Japan's economy that was on the ropes. The U.S. economy showed surprising resilience. Therefore, the time seems right to take stock. Were Japan's skeptics belatedly proved right? Are the "flexible rigidities" that appear to have served Japan well in its catch-up phase hindrances now that Japan has caught up with the West? Are these arrangements only fair-weather ones that can withstand minor shocks to the economy but not a prolonged recession?

This paper assesses the viability of stakeholder capitalism in light of Japan's experience. This section considers whether the "stakeholder" elements of the Japanese economy prolonged its recession. The following section re-evaluates the practice of lifetime employment in light of how it has performed during the recession. And, lastly, the paper considers whether Japan's system of interlocking corporate shareholdings—without which its stakeholder capitalism would be impossible—is worth the price the Japanese pay for it.

A. *Overcapacity*

How far have the stakeholder features of Japan's economy deepened or prolonged the country's recession? Underlying Japan's decade-long recession has been a crisis of overcapacity. Estimates of excess employees run as high as six million. Over-investment in the bubble years of the 1980s depressed already low-productivity levels across Japanese industry. For example, McKinsey & Co. estimated that productivity of capital in Japan, across all industries, was 60 percent of that in the U.S., while labor productivity was about 70 percent

(Ahmadjian and Robbins, 2003). The Japanese auto industry had the capacity to produce 14 million vehicles but was making just 10.4 million cars (Strom, 1999).

Many observers lay some of the blame for Japan's persistent overcapacity on its system of lifetime employment. As the skeptics anticipated, labor has been tied up in less productive activities and hindered the creation of new jobs. According to Ono (2002: 2), for example, the lack of mobility in Japan's labor market (due in large part to companies' inability to lay off employees) is one of the causes of this overcapacity. Specifically, Ono faults "lack of exit of redundant workers [that] hinders job creation and impedes the entry of newcomers, such as new graduates and fresh recruits." Ono and Rebick (2003) estimate that barriers to the movement of labor between firms and to labor force participation by women cost Japan potential growth of one percent a year.

Although it has come under enormous strain, Japan's lifetime employment system is still mostly intact. Japanese companies have used a variety of techniques to try to reduce their workforces, but they have drawn the line at American-style layoffs (Dentzer, 1995). By 1996, according to Dore (1996: 14), "[n]o major firm [had] announced large-scale compulsory redundancies." More recently, work by Ono (2002: 8) confirms that "employee dismissal is still the last tactic used in Japanese firms in adjusting their employment levels."

The persistent overcapacity is evidence that, this time around, the traditional mechanisms Japanese companies have relied on to adjust payrolls have proved unequal to the task of adjusting to the severe recession of the 1990s. As Ono (2002: 8) says, Japanese companies have "run out of ways to adjust their employment levels."

We noted that one adjustment mechanism is intra-firm diversification. The risk here is that new projects adopted to keep the work force busy will become makework. If the *Economist* is right, these ventures have not paid off: Nippon Steel has come unstuck making laptop computers. Komatsu, which makes dump trucks, and Minebea, a ball-bearings company, tried and failed in semiconductors. Some of the big consumer-electronics companies now say they want to get into providing nursing care" (*Economist*, 1999). Another mechanism that has worked in milder recessions is large-scale voluntary retirement programs. These don't seem to have succeeded in making a perceptible dent in the this recession's labor surpluses.

B. *Technological Lag*

A second reason for Japan's lackluster record has been the disappointing performance of its technology sector. One of the strengths of the Japanese employment system has been that it facilitates the rapid introduction of new technology in the workplace. According to Dore, the guarantee of lifetime employment explains the readiness of employees to accept a complete change of job function when new technology makes their former job obsolete (Dore, 1996: 14). Certainly, a principal reason for Japan's rapid economic growth in the postwar years has been its capacity to absorb new technology.

However, in the past decade, that asset has become a liability. Lifetime employment appears to have handicapped Japanese companies in their attempt to leapfrog their U.S. rivals. Lifetime employment means that companies have to meet their needs for new skills by retraining their existing workforce. They don't have the option of going into the labor market to hire those skills. So long as Japan was playing technological catch-up, a work force of generalists who could be retrained to operate new technology, was an asset. Japan relied primarily on imported technology, so it had a road map to follow. In addition, Japanese companies focused their energies on improving manufacturing processes—in order to make established products better—and incremental product innovation.[6]

This formula did not work so well under the changed conditions of the 1990s. For one thing, Japan had largely caught up with the United States and had launched an ambitious program to overtake it (Maitland, 1995). But a disciplined work force of generalists willing to re-train in order to operate a new technology is not fitted for the process of generating new R&D-based products. Japanese companies' lack of specialists with intimate knowledge of basic science has been a hindrance to its ambitions. Michael Porter (2000) diagnoses lack of highly skilled specialist personnel as one of the things holding Japanese companies back. And Ono (2002: 2) notes that the "practice of training workers from within instead of hiring specialists from outside also becomes costly in the face of rapid technological change that demands a more diversified and specialized workforce.

Second, as Arthur Alexander (2002) has noted, Japanese companies also found themselves at a disadvantage because of the increasing role of basic research in advanced industrial technology in the 1990s. "Now the linkages between science and the economy appear to have intensified to such a degree that the practical orientation of much of Japan's scientific community and the acknowledged weaknesses of its basic research may retard productivity growth in the future." Meanwhile, the ties between American companies and universities became an important source of competitive advantage. Perhaps as a result of these disadvantages, many of Japan's high-technology initiatives have been expensive flops (Maitland, 1995).

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[6]A 1985 survey by Edwin Mansfield of two hundred matched large science-oriented firms in Japan and the United States found that Japanese respondents invested twice as much of their R&D budget in improving manufacturing processes as their U.S. counterparts (Mansfield, 1988).

A Re-examination of Lifetime Employment

We saw that, although it has come under enormous pressure, Japan's lifetime employment system is still largely intact. This may be a mixed blessing, however, because the immobility of labor has contributed to Japan's persistent overcapacity. The recession has also exposed other costs associated with lifetime employment.

A. *No Exit*

In our enthusiasm for Japan's lifetime employment system, we risk overlooking what Gilson & Roe (1999) call its "dark side," namely the effect it has of locking employees into their present employment. Japanese employees, in effect, have surrendered what in the United States is an employee's most valuable protection—his or her right to "fire his boss" by quitting.

Why don't Japanese employees have the option of quitting? It is because there are no comparable jobs available at other companies because other companies practice lifetime employment too. Hiring mid-career employees would disrupt the hiring company's seniority system. It would be demoralizing to current employees who have worked their way up the company's seniority ladder and who have accepted lower initial wages. As Itoh (1994: 249) notes, "[h]iring mid-level employees from outside the company would disrupt the hiring firm's wage and promotion structure. It would be perceived as unfair by the existing workforce who have accepted lower wages at the start of their careers." Consequently, "... hiring a new employee at a high hierarchical rank may have negative effects on existing employees' motivation..."

The flip side of lifetime employment, then, is that Japan has failed to develop a labor market for mid-career employees. Since all employment is for "life," there would be nothing for such a labor market to do. But the lack of such a market means that the bonds that tie the employee to his company are pulled even tighter.

If this analysis is right, then Dore's story of how Japanese employees make an implicit bargain with companies in which they trade for job security applies (if at all) only to new college and high school hires at the point that they are first employed. (Even then it is the only decent option available to them). Dore (1996: 8) says that, as a result of the bargain, "employees are less likely to leave the firm and take with them the investment the firm has made in their training." But this would be an empty threat since no other company would hire them anyway.

As usual, Dore favors a cultural explanation for the absence of employee mid-career mobility between companies. He says that "Toyota could no more think of employing an ex-Nissan executive, for instance, than the wartime British army would have inducted a captured German officer into its ranks" (1986: 72-3). But the simpler explanation is that Japanese companies' wage and seniority structures cannot accommodate mid-career hires anyway.

B. *Other Barriers to Job Switching*

Not only are there few alternative employment opportunities for employees of Japanese companies, but the stigma attached to job switching or "job hopping" makes workers who quit virtually unemployable in any case. Because no employee in his right mind would forgo the benefits of his accumulated seniority by quitting, in Japan it is widely assumed that job switchers haven't switched—they have been pushed.

As a consequence, job switchers are assumed to have bad characters. They are perceived as "hard to handle" or workers who "do not fit well into the corporate culture" (Ono, 2002: 6). Firms may infer that a job-changer is of low ability or a 'bad' type" (Itoh, 1994, 249). "Once an employee obtains a job in a firm, changing firms will result in ... damage to his reputation" (Shishido, 2000: 207). As Ono (2002: 3) notes, "because the labor market matured presuming long-term employment, job-movers are viewed as job-quitters or defects. Similar to a marriage, a breakup signals failure of goodwill or lack of sincerity.

The stigma attached to job-movers thus discourages workers from quitting their jobs, and employers from hiring mid-career job seekers." This perception further curtails the employment options of Japanese employees.

C. *Human Costs of Dismissal*

We talk glibly of firing or dismissal in the United States and Japan as if the event was approximately equivalent in both countries. But plainly they are two radically different experiences. In the U.S., getting fired is just a tragedy. In Japan, it is a calamity. This difference is often lost in translation between two cultures.

To begin with, if job switching injures a worker's reputation with prospective employers, then obviously being fired is even more damaging. But there are other factors, too, that make being fired in Japan a far more traumatic event than in the United States. These factors are inextricably bound up with the "stakeholder" properties of the Japanese company.

In Japan, dismissal does not merely mean that an employee loses his job. It means that he is expelled from the corporate community. Dentzer (1995) observes that "Japan is a country where workers often refer to their company as *uchii*—home." The Japanese company is intertwined with many different facets of its employees' lives. It simultaneously provides not only a job but a career, a nest egg, an extended family or community, social status and respect—and so on. Consequently, losing one's job is so shameful in Japan that former *salarymen* will go to extraordinary lengths to conceal the fact from neighbors and even family. According to Wehrfritz (1999), "[e]very labor activist knows a fired salary man who still puts on his suit each morning and leaves home for the office [but actually] to kill time wandering in parks or daydreaming in coffee shops—unable to tell their spouses they've been 'restructured.'" Howard French (2000) gives a haunting account of a day in the lives of such workers.

D. *Bargaining Power in the Workplace*

It is true that Japanese companies may rarely fire employees. But even if the sanction of firing is rarely used, it is still a very potent (if latent) threat, precisely because its cost is so high to the employee. Although Dore claims that employees accept flexibility in their assignments in return for job security, I suspect that management's virtually unfettered freedom to manage the workplace as it wants—as well as Japanese employee's fabled commitment to his company—owe more to the resulting imbalance in bargaining power in the workplace.

E. *Dismissal by Other Means*

While the lifetime employment system has largely dammed up mass firings, it has sometimes just diverted their course into unofficial channels. The enormous strain the system has come under is suggested by the ways companies have tried to evade its constraints. Inevitably, because dismissal is not a socially acceptable option, many Japanese companies appear to have resorted to backdoor methods of reducing their workforces. Anecdotal evidence suggests that these practices are widespread and remarkably inventive.

Many companies appear to have choreographed steadily graduated pressures to stimulate "voluntary" quits. They typically begin with a so-called "shoulder-tapping": "Managers who get the dreaded *kata-tataki*, or tap on the shoulder, have the right to refuse, but they rarely do" (Ono and Schlesinger, 1998). "Staying means being stripped of a job title, the 25% extra pay that goes with it, and one's dignity" (Miller, 1993:47). If employees refuse incentives to quit, they can become targets of escalating pressures. Here the options are limited only by the imagination. Examples from news accounts include:

- Colleagues cease joining them for lunch or inviting them for drinks after work (Wehrfritz, 1999).

- They find their telephone lines cut and their desks moved to the basement (Wehrfritz, 1999).

- They get negative performance evaluations "laden with fabricated malfeasance—a paper trail used, if all else fails, to terminate" (Wehrfritz, 1999).

- They are instructed to stay at home or chop wood (Ono & Schlesinger, 1998).

The fate of excess employees who are not terminated is not much better. They are sent into a form of internal exile—the notorious the seat by the window. "They sit by the window and wait. Dubbed madogiwazoku in Japanese—the "windowside employees"—they are workers in a work-obsessed country who are paradoxically being paid to do almost nothing at all" (Dentzer, 1995).

F. *Outsiders*

Finally, it is worth reminding ourselves that many Japanese employees are not full stakeholders in the Japanese company. Only a core of permanent employees enjoys lifetime employment. There is a periphery of temporary, part-time or contract employees who bear the brunt of adjustment in bad times. These peripheral employees stabilize the jobs of core employees by giving management much needed flexibility in cutting the payroll. Thus a principal element of Japan's stakeholder company—lifetime employment—is possible only because some employees are denied stakeholder status.

Another non-stakeholder constituency is new entrants into the labor market. One of the ways companies reduce their payrolls while protecting the jobs of permanent employees is by freezing all nonessential hires. The cost of this adjustment is borne by college and high school graduates entering the job market. The Japanese press has labeled the recent job market a "Super Ice Age" for college seniors (Ono & Schlesinger, 1998). In other ways, too, some of which I will consider later, the costs of the stakeholder company system appear to be externalized to outsiders.

G. *Contrast with U.S. Employment Policy*

Despite these drawbacks, the Japanese employment system may still be judged to be more humane than the American one. The United States is notorious for the willingness of companies to downsize their workforces in order to please their stockholders. Loyalty is neither expected nor given. Employment-at-will is the norm. For some, the U.S. system epitomizes man's inhumanity to man or is even a violation of human rights (Morita in Ishihara and Morita, 1989).

Nevertheless, on the other side of the ledger is the fact that during the 1990s, when employment was stagnant in Japan, the United States added millions of jobs. Even during Japan's booming 1980s, the United States created jobs at almost twice the rate in Japan (Ono and Schlesinger, 1998). Ronald Dore (1996: 13) appears to discount this achievement when he says that an "in increasing number of jobs created in the United States are 'lousy' jobs " But the evidence does not back Dore up. A Bureau of Labor Statistics study of nearly 4 million jobs added from 1988 to 1993 found that, while most of the job growth came in low-paying industries, such as services and retailing, most of the new jobs were in relatively high-wage occupations within those industries (Berry, 1994).

Moreover, while U.S. jobs are destroyed at a faster rate than in Japan, they are created much more rapidly too. The rapid turnover of jobs means that job searches are shorter in the United States (Ono and Schlesinger, 1998). Hostile takeovers seem actually to fatten the pay packets of unionized employees (Bainbridge, 1998, 820: n. 511). Not least, there is not the same stigma attached to losing a job as in Japan. The U.S. system seems to be more forgiving of failure. As shareholder activist Robert Monks (1998) says, while it "would be an overstatement to say that American laws encourage individuals and corporations to declare bankruptcy,... there is little of the shame associated with commercial failure in other countries." Finally, the harshness of the U.S. at-will regime is mitigated by unemployment insurance. In Japan, by contrast, until the mid-1990s unemployment insurance was rarely used (Schaede, 2004: 288).

Consequences of Interlocking Corporate Shareholdings

Japan's stakeholder capitalism would not exist without the country's system of interlocking corporate shareholdings. It is these cross-shareholdings that shelter Japanese companies from the market forces and so create space for them to pursue objectives other than maximizing stockholders' wealth (Sheard, 1994). That holds, especially, for lifetime employment. According to Sheard (339), "the capacity of the firm to implement long-term employment contracts in the first place may have much to do with the financial organization of the firm." If the system of interlocking shareholdings is the price Japan has to pay for its stakeholder capitalism, then is Japan paying too much? This section briefly explores some of the inefficiencies of Japan's system of corporate governance by interlocking shareholdings.

A. *Japan's Stakeholder Form of Corporate Governance*

Sheard (1994: 312) has described the stylized features of Japan's system of interlocking shareholdings.

- A typical company has about 70 percent of its stock held by other companies.
- The stock is held by a large number of companies in relatively small parcels.
- The company has some kind of transactional relationship with these corporate stockholders (banking, insurance, lending, supply of inputs, purchase of outputs).
- The company holds shares in many of these companies, viz. the stockholdings are reciprocal.
- Companies hold each other's shares as "stable shareholders."

Each large company has entered into cross-shareholding arrangements with, say, twenty other companies in the same *keiretsu* (business group). As a result, a controlling bloc of each company's stock is in "friendly" hands (Sheard, 1994: 311). These friendly or stable or insider shareholders do not hold the stock to make a profit. Consequently, they do not sell the stock if it underperforms. Apart from considerations of friendship or loyalty, there are stark political realities that deter the insider stockholders from selling the stock. Remember that both companies own stock in each other. As Fukao (1998) explains, "when both Company A and Company B hold shares in each other, Company A can retaliate by selling Company B's shares if Company B sells Company A's." In effect, the two companies have stabilized their relationship by an exchange of hostages.

As a result of these arrangements, there is no competitive market for corporate control in Japan. The control for companies is not for sale because each company's allies hold a majority (or a controlling share) of its stock. In turn, the absence of a market for corporate control means that, unlike management in the United States, the management of Japanese companies is insulated from pressures from the stock market to increase its companies' stock price. Japanese management's tenure is secure so long as allied companies continue to hold its company's stock. That frees it to pursue goals other than maximizing profit—like keeping its workers employed, supporting troubled fellow *keiretsu* members, taking a long-term view of its business, and not least securing its own jobs. In this way, Japan's system of interlocking shareholdings makes its form of stakeholder capitalism possible.

In theory, Japanese management is monitored by its company's main bank and other companies that are interlocked with it. These actors (a) have superior knowledge about the company than an arm's length lender because of information sharing within the business group and (b) can collectively oust incumbent management if it does not produce results because they have a controlling shareholding in the company (see, for example, Sheard, 1994). But, in practice, only in very rare cases has incumbent management been ousted in this way. Shishido (2000: 223) concludes that there are "few means available to fire ineffective management when they do no resign voluntarily.... The Corporate Community has few effective methods to force poor managers out." Wanner (1998) says that Japanese management is "better at expanding a firm's productive assets than dismantling and recombining them."

In short, Japan's cozy system of interlocking shareholdings has been used as a shield for incumbent management rather than as a sword for cutting incompetent management. In contrast, U.S. management has been under the yoke of quarterly earnings reports. But the market for corporate control, whatever its shortcomings, is the United States's means of holding management accountable. If U.S. management fails to perform, then the company's stock price declines, thereby exposing incumbent management to the possibility of a hostile takeover. The M&A wave of the 1980s restructured the U.S. economy and so laid the foundation for rapid growth in the 1990s. Japan's stakeholder capitalism has failed to come up with a practical alternative to the American market for corporate control.

B. *Main Banks*

The crucial role that main banks play in Japanese corporate governance[7] deserves a separate discussion. By unwritten agreement, main banks are responsible for nursing sick borrowers back to health.

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[7] Japanese law limits a single bank's holdings to no more than 5% of a company's shares. However, "the combination of banks, affiliated trust banks, insurance companies, and other concerns concentrated a considerable percentage of shares in the hands of financial institutions" (Ahmadjian and Robbins, 2003). There is evidence that the main bank system is dissolving as Japanese borrowers, particularly manufacturing firms, have already become almost as independent of banks as comparable U.S. firms (Hoshi and Kashyap, 1999).

This may, as a last resort, involve replacing incumbent management and restructuring the companies.

Even before Japan's present crisis, main bank relationships have helped financially depressed firms to continue business investment in spite of bad times (Aoki, 1994: 121). More recently, Peek & Rosengren (2003) have confirmed the existence of this pattern. In the United States the best credit risks tend to get loans. By contrast, in Japan the weaker a company is, the more likely it is to get a bank loan. Banks have been unwilling or unable to pull the plug on even hopeless cases. Instead, they have "evergreened" sick companies' loans; that is, extended more credit so that the companies could go on making their interest payments on the existing loans—and so live to go bankrupt another day. Virtually all Japanese banks (but not non-bank lenders) appear to do this, but it is particularly pronounced with main banks. An insolvent company is more likely to get credit if it was affiliated with a main bank. Peek and Rosengren argue that this has aggravated Japan's economic problems by promoting allocation of increasing share of bank credit to many of the firms least likely to use it productively.[8]

Japanese banks, of course, are not simply keeping their commitments to their borrowers. There is tremendous pressure on them from both the government and the public not to force financially weak companies into bankruptcy. The banks' own viability depends on implicit guarantees from the government. From the end of the war up till 1997, not a single sizable Japanese bank had been allowed to fail. If a bank got into trouble, the government would arrange for stronger banks to absorb it (Katz, 1998: 219).

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[8] Contrary is Ahmadjian and Robbins (2003: 16-17). They find a positive relationship between financial ownership of a company and large downsizings. One possible explanation is that as downsizings have become more acceptable, the role of main banks has flipped, and they are now serious about restructuring failing companies.

The pressure on banks to roll over loans to insolvent companies is vividly illustrated by the experience of Shinsei, the former Long-Term Credit Bank that had been acquired by a consortium of Western investors after its collapse in 1998 (Fulford, 2001; Singer, 2003). To shorten the story, when Shinsei restricted credit to some small businesses and called in some loans, it met with a firestorm of criticism and demands that it show more social responsibility. Shinsei's president, Masamoto Yashiro, was hauled before the Diet and grilled about the bank's lending policies. A parliamentary finance official told Yashiro, "You cannot leave everything to market forces. You must protect the country." Japan's top banking regulator scolded Yashiro for failing to uphold a bank's public responsibilities. He warned Yashiro that "Shinsei should be concerned about its reputation risk, as anything can happen down the road." The regulator admonished the bank to "behave in line with other Japanese banks." There was also a public hue and cry. Shinsei was called "a child of evil" by the author of a popular novel based on Shinsei that depicted greedy Wall Street bankers who milk Japan. The *Weekly Post* editorialized that the "nation must be outraged" by Shinsei's behavior. In the end President Yashiro was forced to promise that Shinsei would lend more to small companies even if it meant bearing some losses. He lamented: "The more they put things off, the bigger the wound gets."

C. *Price of Japan's Stakeholder Capitalism*

One of the attractions of Japan's stakeholder governance of the company is that it shields key relationships (employer-employee, main bank-company, company-supplier) from market forces. But, on the evidence of Japan's lost decade, precisely this feature of the system has been a source of moral hazard. It has the effect of insulating companies from the consequences of their own bad management decisions like overinvestment (Lincoln and Gerlach, 2004: 5). If Japan's stakeholder system is to be viable, it needs some substitute for market forces to discipline management. The much-touted system of main bank monitoring appears to have been proved to be inadequate to perform this task.

Conclusion

In re-assessing Japan's stakeholder capitalism in light of the country's "lost decade," it is helpful to distinguish between stakeholders and non-stakeholders. First, let us consider non-stakeholders. Sometimes Japan's system gives the appearance of a conspiracy among stakeholders at the expense of non-stakeholders. If the Japanese company is a community, it is a gated community. Paradigmatically, the institution of lifetime employment for a company's core or permanent workforce would be impossible without the protection provided by the periphery of temporary employees (mostly women and retirees) who bear the brunt of adjustment in bad times. In this way, the stakeholders may externalize the costs of their privileges.

In other ways, too, some of the costs of the system appear to be externalized to outsiders. As we saw, the Japanese system of interlocking shareholdings has entrenched incumbent management and protected it from the consequences of its own poor business decisions. All Japanese have paid through their pocketbooks for the resulting economic stagnation. The Japanese public has also indirectly subsidized the stakeholders because the government has been unwilling to face the consequences of widespread layoffs. Consequently, it has pressured lenders to throw good money after bad by bailing out failing companies. It is well known that the Japanese consumer has for a long time been forced to subsidize industry through higher prices. College and high school graduates have faced a drastically shrunken market for entry-level jobs because incumbent employees are locked into what jobs there are. Again, it is the outsiders or non-stakeholders who have had to bear most of the cost of adjustment.

What about the stakeholders? The most significant stakeholder group is employees. This paper has re-examined the lifetime employment system. Undoubtedly job security in a prolonged recession is a tremendous benefit (even if that job security had a hand in prolonging the recession). However, some early or impressionistic accounts of the system have glossed over its costs. The most important of these costs is the effect that lifetime employment has of locking employees into their jobs. They don't have the right enjoyed by U.S. employees to fire their bosses by quitting.

We saw that the reason for this is that lifetime employment has pre-empted the development of a labor market for mid-career employees. There is a general lesson to be learned from this about the viability of a stakeholder form of company. Almost by definition, the stakeholder company relates to its stakeholders on a non-economic as well as an economic dimension. It is a community rather than just a nexus of contracts. That is what sets it apart from the stockholder company and explains its appeal. But, as we saw, this arrangement also has serious drawbacks. If the company is a community, and if it supplies the social as well as the economic needs of its stakeholders, then the dissolution of the relationship is bound to be more traumatic, because it severs more than simply economic ties.

From a welfare standpoint, then, the stakeholder corporation is a bad bet. It means that if the company fails, the stakeholder loses both his paycheck and his community. In turbulent times, when there is a substantial turnover of companies, it would seem prudent for the stakeholder to diversify away from dependence on his company. Just as it is unwise for the employee to invest the bulk of his retirement savings in the company that employs him, so too it is unwise for him to rely exclusively (or even substantially) on the company for his most important social as well as economic relationships. That leaves all these relationships at the mercy of fluctuations in the fortunes of his company.

The stakeholder company in Japan, precisely because of its attractive features, is guilty of increasing the dependence of its stakeholders. Since the company has provided internally for so many needs, it has stunted the development of external providers of those needs. In the same way that lifetime employment pre-empted the emergence of a labor market for mid-career employees, so too the stakeholder company may have delayed the development of other institutions or social infrastructure. (A light-hearted example is Major League baseball teams in Japan: They too are company-based). We saw that until the 1990s unemployment insurance was rarely used. According to Ulrike Schaede (2004: 288), through the mid-1980s, the Japanese government "neglected its task of building a welfare system for the future, leaving the country with an insufficient social safety net when growth stalled." That may be an added reason why the Japanese government has been so hesitant to allow U.S.-style mass layoffs. Employees would lose not only their jobs but their safety nets as well, because Japanese government had effectively sub-contracted that function to companies.

The stakeholder company is advocated in large part because it is more considerate of its stakeholders. It does not subordinate stakeholders' rights and interests to the single-minded pursuit of profitability. This paper has offered the example of corporate employment policies in Japan and the United States. In comparison with the practices of the Japanese stakeholder company, the employment-at-will policies of many U.S. companies seem harsh, if not inhumane. However, if we compare the two employment systems, as opposed to the companies, the picture is more mixed. The U.S. system—largely because of the flexibility of the country's labor market—creates jobs at a faster rate than Japan and being laid off is not shameful. Job searches are relatively short and many of the new jobs pay as well or better than those that have been lost. In addition, an unemployment compensation system (and other programs) puts a safety net under unemployed workers. (As we saw, although Japan has such a system on the books, it was rarely used until the mid-1990s). In contrast, Japan's facially more humane policy of lifetime employment has the unintended consequence of ratcheting up the pain of job loss when it does happen. We will miss these points if we limit our analysis to company policies in the United States and Japan rather than the two systems in which the companies operate.

Any meaningful comparison of how well stakeholders fare in the two countries needs to be at the "system"-level of analysis. By historical accident or design, in Japan the protection of stakeholders—especially employees—has largely devolved on companies (whence "stakeholder companies"). In the United States that protection is provided by the labor market and other public and private alternatives. We have argued that depending on stakeholder companies for such protection is a bad bargain for stakeholders. It raises the economic and human costs of allowing companies to fail, and as a consequence it hinders Japan's ability to adjust to economic and technological change.

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