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Juro Teranishi

Institute of Economic Research
Hitotsubashi University
2-1 Naka, Kunitachi, Tokyo, 186-8603 JAPAN
Tel: +81-42-580-8405
Fax: +81-42-580-8333
e-mail: cei-info@ier.hit-u.ac.jp

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Investor Right in Historical Perspective: Globalization and the Future of the Japanese Firm and Financial System*

Juro Teranishi

(Hitotsubashi University)

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Summary

The evolution of investor right in Japan is examined in a historical perspective since the prewar period and in relation to the evolution in firm-specific skill formation. First, we will show that the investment in firm-specific skills spread from the top to the bottom in a firm system. Second, we will show that the delegation of control right of physical assets to employees was caused in order to accommodate the rapid technological changes. The weak investor right in Japan evolved through a rational choice of asset holders (shareholders and landlords), who delegated part of control right over their assets to actual producers (managers, workers, and tenant farmers) in order to maximize the benefits of firm-specific skill formation by them. A cautious approach is needed in adjusting the investor right to global standards: a stronger investor right would enhance allocation efficiency of financial resources, but it could be harmful to organizational efficiency based on investment in firm-specific skills.

1. Introduction

During the high growth period of Japan, the right of investors, shareholders in particular, was severely restricted; In terms of income right, a part of residual income was shared with workers in the from of bonus payment depending on the profitability of firms, and in terms of control right, the power of shareholders was curtailed through the intense cross-shareholding among related firms and because of various regulations on capital markets. These characteristics, moreover, are kept in tact by and large until now, in spite of noticeable changes such as a significant reduction in cross-shareholding related to financial institutions.

Globalization of financial markets since the 1980s is a serious challenge to the desirability and sustainability of the system of weak investor right[1]in Japan. It is often claimed that in order to promote international portfolio investment, homogenization of economic institutions and regulatory environment among economies is indispensable, and that in order to activate cross-boarder mergers and acquisitions it is necessary to realize equal and high level protection of investor right among firms of different nationalities. If we should follow this kind of reasoning, there is no doubt that the weak investor right in Japan should be rectified in some way, so as to be aligned to global standards.

The policy stance of the Japanese government in this regard lies in the positive adjustment of the Japanese system to the global standard at least after the initiation of the financial Big Bang in 1997. So-called structural adjustment policy includes followings with respect to investor right: further deregulation of capital markets, introduction of market-value principle in corporate accounting, and introduction of American type board system characterized by the separation of execution and monitoring of management. The theoretical ground for these policies, however, does not seem to have been articulated fully. In particular, there has not been any convincing explanations with respect to why these policies are effective in promoting investor protection, nor has been as to why strengthening of investor right is needed in the Japanese economic system from now on. In this paper, we will suggest that a more cautious approach is needed in this respect: In terms of the effectiveness of reform policy, the system of weak investor right is rooted in more deep historical tradition and path dependency is stronger, and in terms of the desirability of stronger investor protection, the balance of costs and benefits of the

[1] This does not necessarily mean that legal system in Japan regarding investor right is weak in international comparison. Instead, owing to the *de facto* protection of the management by cross-shareholding, *de jury* protection of the management has been quite weak until recently. Existing literature such as Fukao and Morita (1997), Goto (1993) and Horiuchi and Hanazaki (2000) claim that legal protection of investor in Japan has been stronger than in the US in many respects. On the other hand, La Porta, Lopez de Silanes, Shleifer and Vishny (1978) classifies Japan as German tradition in terms of legal origin of investor protection, and this means weaker protection of investor right compared with Anglo-American countries.

protection is more delicate and less self-evident, than is commonly believed.

With respect to the efficiency implication of investor right protection, the government policies seem to be guided by a simple-minded faith in the economic gains brought about by the efficient allocation of resources. There is no doubt that a stronger protection of investor right is desirable in the sense of enhancing allocation efficiency. Active participation by individual investors in capital market transaction would be welfare-improving through direct representation of the tastes of consumer-asset holders. Unfettered flow of funds facilitated by standardized investor right system would allocate resources more efficiently in international markets. However, these benefits in allocation efficiency must be evaluated against the influence on organizational efficiency of investor right system. The degree of investor right affects efficiency of individual organization through its effects on the incentives to invest in firm-specific managerial and production skills. As Hart (1995) indicates, whenever contracts are incomplete owing to transaction costs regarding negotiating and writing contracts, hold-up problems arise, retarding investment in firms-specific skills. In this case, granting residual control right entirely to the owner of firms (owner of cash-flow right) is not necessarily optimal. A trade-off relationship exists between organizational efficiency owing to firm-specific skills and allocation efficiency through open capital markets. A stronger investor right would be conducive to more efficient allocation of resources through capital markets. However, it could be detrimental to organizational efficiency through reducing incentive for investment in firm-specific skills by managers and workers. A weaker investor right could retard the development of capital markets. To the extent that workers cannot shift to other companies smoothly due to the firm-specific nature of their skills, allocation efficiency of labor markets is also affected adversely. However, conferment of part of control right to employees could be efficiency-enhancing in the sense of organizational efficiency as far as it gives them incentives for firm-specific skill formation. It is often argued that the postwar high growth of Japan was not possible without process and product innovation based on investment in firms-specific skills by workers at shop-floors. Further, we will suggest below that without investment by managers in firm-specific skills, the growth rate of prewar Japan would have not been so high. If Japan want to pursue the similar growth strategy in the future, a stronger investor right or the depriving workers of control right of firms might not necessarily be a sensible policy. The trade-off between allocation efficiency and organizational efficiency could be a focal issue for the future growth strategy for the Japanese economy.

With respect to the effectiveness of the reform policy regarding the weak investor right in Japan, the government policy seems to have been guided by the conventional way of understanding about the origin of weak investor right. It ascribes the origin to three things:

(i) Suppression of stockholder's right in terms of both residual income and control right during the wartime (the New Economic Region during 1940–41 and the production manager sovereignty system during 1943–45).

(ii) Cross-shareholding as a response by managers of *ex-zaibatsu* firms to the surge of rampant hostile take-over movements caused by "security democratization" (sale out of stock confiscated from zaibatsu to the public) immediately after the war, and to the threat of merger by foreign firms after the capital liberalization in 1964.

(iii) Continued regulation on capital markets by bureaucrats for the sake of credit rationing to key industries.

In short, the conventional understanding assumes that investor right in Japan was weakened because bureaucrats and the military suppressed shareholder right and suffocated the capital markets, and because rent-seeking corporate managers seized the opportunity of entrenching themselves and pursuing private benefits during the turmoil after the war defeat and at the time of capital liberalization. As far as one believes in this theory, it is reasonable to consider that weak investor right in Japan could be rectified by such measures as disciplining of managers by independent outside monitoring mechanism and by marking the value of cross-shareholding to the market as well as liberalizing capital markets from the control by bureaucrats.

However, it must be noted that the conventional theory was derived from casual observations of historical incidents during the wartime and thereafter and lacks coherency at least in the following sense. For one thing, while the theory emphasizes the rent-seeking behavior of managers, it never refers to the behavior and incentive of shareholders. It is true that due to the zaibatsu dissolution and the purge of "war criminals", the existing shareholders suffered from a severe blow immediately after the war (Teranishi 2005). However, in 1949, 69.1 percent of shares of listed companies were held by individual investors, so that large firms were truly public at that time. Why investors did not oppose the move to cross-shareholding that restricts their control power? It is true that in widely-held companies the incentive of shareholders to monitor is usually weak[2]. However, this caused continued and intense rivalry between shareholders and managements in the US since the beginning of the twentieth century. Why same thing did not occur in Japan? The conventional theory does not address itself to this question. For another, the explanation by the conventional theory lacks coherent explanation about the relationship between investor right and firm-specific skill formation. It admits that the two are related with each other somehow in the Japanese-style firm system or in the framework of a stakeholder society. However, it never clarified the mechanism in which

[2] Because of zaibatsu dissolution and land reform immediately after the war wealthy families disappeared suddenly from Japan. This rendered the problem caused by the absence of controlling shareholders more serious in Japan than in other countries.

both weak investor right and firm-specific skill formation are generated endogenously. Some researchers refer to long-term employment as a cause for firm-specific skill formation. However, promising to employ lifetime does not necessarily resolve hold-up problem (Gilson and Roe 1999)[3]. Credibility of the promise must be guaranteed in some way. Other researchers treat the development of firm-specific skill largely as an exogenous factor: the laborious research by Koike (1997) has clarified that firm-specific skill formation by workers became prevalent during the late 1950s and 1960s as regular job rotation system was introduced in order to accommodate demand fluctuations and unexpected absence of workers; Similarly, Aoki (1990) considers that firm-specific skill formation is closely related to the flow mechanism of information in a firm that is treated by and large as a characteristic exogenously endowed in Japan, and focuses on the information-sharing by workers at shop-floor level and the consequent formation of firm-specific skills.

In this paper, we will examine the evolution of investor right in Japan in a historical perspective since the prewar period. We will suggest that the weak investor right in Japan evolved through a rational choice of asset holders (shareholders and landlords), who delegated part of control right over their assets to actual producers (managers, workers, and tenant farmers) in order to maximize the benefits of firm-specific skill formation by them.

First, we will show that the investment in firm-specific skills spread from the top to the bottom in a firm system. At first, top managers became involved in the growth of firms in the Meiji period[4]. Then, formation of firm-specific skill and devotion to firm growth spread to the middle management during and after World War I, and finally workers at shop-floor level came to be involved in the investment in firm-specific skills after World War II. At the top-management level, the hold-up problem was avoided partly by resorting to loyalty sentiment due to the reminiscence of feudalistic relationship, and partly by the value system of the society that emphasized the role of actual producers and managers and degraded mere rentiers. With respect to the middle management, the experience of top management made the promise of long-term employment credible, so they were given incentives to invest in skill formation. Likewise, the hold-up problem of shop-floor workers was prevented because of the experience of top and middle managers. Allen and Gale (2000) show that, when a team with overlapping generation structure is organized, and team members invest in firm-specific skills, all the managers and employees tend to follow long-term maximizing behavior, and that this is consistent with

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[3] Gilson and Roe considers, instead, the lack of open labor market as a cause for the prevention of hold-up problem and the formation of firm-specific skill. Further, they argue that the absence of open labor market was caused by the political mechanism in which a coalition of conservative party and the corporate managers has introduced lifetime employment system in order to bring about labor peace. Teranishi (2005) examines this hypothesis critically.

[4] 1868-1912.

the request for share value maximization by shareholders. In their theory, both overlapping management structure and firm-specific skill formation are treated as two independent assumptions. The two evolved in close relationship with each other in the historical process

Second, we will show that the delegation of control right of physical assets to employees was caused in order to accommodate the rapid technological changes. In the case of three large zaibatsu, the necessity to diversify their business to new technological field, heavy and chemical industries, necessitated organizational reforms, and control right were conferred to professional managers. In the case of prewar leading firms in textile and food processing industries, control right was substantially delegated to educated middle managers in order to improve product quality and develop new products in the face of the intensification of competition in the world markets. Likewise, rice production was an area of most rapid technological progress in prewar Japan. Landlords were obliged to confer substantial control right to tenant farmers, and tried to reap the fruit of firm (land)-specific skill investment by them.

It is important to note that from the viewpoint of historical analysis it is not the rent-seeking behavior of employees but the maximizing behavior of asset holders that caused the transfer of control right and the consequent weakening of investor right. In the case of the postwar development of cross-shareholding also, it does not seem to be pertinent simply to ascribe it to the private-benefit based behavior by managers. It could be argued that most of stakeholders including widely dispersed individual shareholders shared the view that product and process innovation based on firms-specific investment by workers was the best way to maximize firm values, which was conducive to share value maximization in the long run.

Rajan and Zinglass (2000) argues that as the importance of knowledge and human capital increased in the modern society, the traditional modern business enterprises examined by Chandler (1977) and Berle and Means (1932) are now converted into firms as nexus of firm-specific skills. The control right in the hand of the owner of physical capital is shifting to the owners of human capital, they argue. In the case of Japan, a catch-up country, where import and modification of foreign technology was a key strategy for corporate growth, human capital increased its importance prior to the advent of knowledge economy in the sense of Rajan and Zinglus. It will be also shown below that, partly for this reason, while the organization of modern business in the world of Chandler took the form of vertically organized firm integrating all the up-stream and down-stream activities and concentrating all the decision at the central office, the large businesses in Japan took a more decentralized system delegating decision rights to individual factory level.

In sum, we will argue that the weak investor right in Japan evolved as a process of organizational reform in order to provide with adequate incentives to the various segments of organizations. It was compatible with the aim of corporate growth and probably with the desire for macroeconomic growth. It would be quite difficult to change it merely by imposing new regulatory framework or just letting private-benefit oriented managers to wear straight-jackets. It is also necessary to note that the choice between strong or weak investor right is closely related to the overall growth strategy of the Japanese economy; If the government want to resort to a growth based on allocation efficiency, it must choose policies that promote stronger investor right, and if a growth based on organizational efficiency is pursued, it must accommodate weakness of investor right in its policy choice.

Next section analyzes the evolution of investor right since the prewar period, and the last section touches upon the issue related the design of firm and financial system faced by contemporary Japan.

2. Evolution of Investor Right

This section is composed of two parts. The first section deals with the evolution of long-term employment and firm-specific investment by top and middle management, and the next section is devoted to the factors affecting the delegations of control right to actual produces.

In deriving the two propositions introduced above, we will examine the evolution of corporate governance system with respect to three types of "firms"; three largest zaibatsu firms (Mitsui, Mitsubishi and Sumitomo), large manufacturing firms in cotton textile industry, and the farm sector under tenancy system. In order to understand the reasons for focusing on these three types of firms or organizations, data on the relative importance of farm sector, light industries and heavy and chemical industries are shown in Table 1. The agricultural sector or farm sector comprised 41.5 percent of GDP of the country in 1888. Since the agriculture was related to various kinds of indigenous manufacturing and commercial activities (typically raw silk and tea), Japan was basically an agrarian economy at least until the 1920s. The light industries were leading industries in prewar Japan. These included textile (cotton spinning), food products, paper and pulp, cement, sugar refinery, and so on. Among ten largest companies[5] in 1918 in terms of total assets, four were cotton spinning companies, and one was sugar refinery, for example (Fruin 1992).

[5] Kawasaki Shipyards, Kuhara Mining, Mitsubishi shipyards, Kanegafuchi Spinning, Toyo Spinning, Dai-Nihon Spinning, Taiwan Sugar Manufacturing, Mitsubishi Steel, Fuji Gas Spinning, and Japan Steel.

The share of textile and food products in total manufacturing production was as high as 38.1 percent even in 1938. The growth of heavy and chemical industries started at the time of World War I, and accelerated during the period of World War II and thereafter. The three large zaitatsu accumulated their wealth through business in mining, banking, trading and marine transportation. Gradually, they invested their accumulated earnings in new fields, mainly in heavy and chemical industries. Table 2 traces the process of diversification of businesses of three largest zaibatsu. It is seen that the share of heavy and chemical industries rose to 63 percent at the end of World War II.[6]

(1) From Top, to Middle, and then to Shop-floor

The strict restriction of investor right in postwar Japan due to cross-shareholding was actually the third phase of the long-term trial and error process to reallocate control right of corporate firms since the Meiji period. At first, control right was conferred to professional top managers, then to the middle management, and finally to blue-collar workers at the shop-floor.

Top Management

The first phase was concerned with the control right of top managers. During the Meiji period, control right was delegated to professional managers both in zaibatsu firms and large cotton spinning firms. Three big zaibatsu were most active in recruiting professional managers, and granting them substantially autonomy. As Takahashi (1977) emphasizes, zaibatsu firms vigorously recruited high ranking government officials as well as promising young intellectuals, mostly sons of ex-*samurai* class and educated in leading universities, domestic and overseas, as top managers. They paid high salary and extraordinary amount of bonus for successful achievement to the hired managers[7]. The wage level of zaibatsu workers had been much lower compared with government officials in early Meiji period, but at least after late Meiji period, the salary of the top management became as high as high-ranking government officials.

Table 3 shows bonus payment to managers and dividend payment as percentages to profit after tax with respect to zaibatsu firms and non-zaibatsu firms. The percentage of manager bonus is as high as 5.3 percent for zaibatsu firms and 4.8 percent for non-zaibatsu

[6] Another big zaibatsu Yasuda was concerned mainly with financial industries. The so-called Taisho zaibatsu such as Furukawa, Suzuki, and Asano followed pattern of diversification similar to the three largest. The new zaibatsu that grew rapidly after the 1930s such as Nissan, Nichitsu, Riken, Mori and Nisso focused more in heavy and chemical industries.

[7] For example, senior managing director (senmu-torishimari yaku) Hikojiro Nakamigawa of Mitsui Bank requested 10 percent of bank profits for his job at the bank, and the bonus of Toyoji Wada, senior managing director of Fuji Spinning (later Fuji Gas Spinning), was 300 thousand yen when total profit of the company was 3 million yen in 1905 (Yui and Hirschmeier 1977).

firms. Generally, zaibatsu firms paid more as bonus payment to managers and less as dividend to stockholder compare with non-zaibatsu firms.

Contribution of professional managers to the growth of zaibatsu was substantial. It is true that some of large zaibatsu were established by aggressive and active founders such as Yatarô Iwasaki, Zenjirô Yasuda, Ichibee Furukawa, Sôichirô Asano and Kihachirô Ôkura. However, the growth of zaibatsu after establishment owes crucially to the managerial human resource procured from outside.[8] Morikawa (1980) raises following cases as evidence for the importance of managerial skill for zaibatsu growth.

(i) Failure of Ono-gumi and Konoike to become zaibatsu owing to the lack of modern managerial resources

(ii) Crisis of Mitsui zaibatsu before the hiring of Hikojirô Nakamigawa[9] as a top executive in 1891.

(iii) Stagnation of Sumitomo zaibatsu before the resignation of traditional housekeeper in 1883, and the modernization of managerial system led by Masaya Suzuki[10] and Kin'ichi Kawakami[11] and others.

(iv) Successful diversification of businesses outside copper mining and high growth of Sumitomo zaibatsu in the twentieth century led by a powerful modern managerial team, and the failure of Furukawa zaibatsu in expanding business outside copper mining after the death of Ichibee Furukawa in 1903 due to complicated internal struggle among family members and top managers.

As is well known, in Mitsubishi zaibatsu Yanosuke Iwasaki, younger brother of Founder Yatarô Iwasaki, played a leading role in the management, but his successful leadership is said to owe substantially to the groups of capable modern managers led by Heigorô Sôda. In the case Mitsui, the eleven families intervened in the managerial strategy frequently. It is sometimes claimed that the internal struggle between the families and hired managerial team caused a conservative behavior of the group in expanding business in heavy and chemical industries. However Morikawa (1977) claims that the decentralized decision mechanism based on three powerful leading companies, Mitsui Bank, Mitsui Bussan and Mitsui Kôzan, and the conflict of interests among them was the main cause of Mitsui's turmoil in strategic decision making. It goes without saying that in the case of Sumitomo, the family showed any interest in business matters[12] and all the power was delegated to hired managers.

A similar phenomenon of delegation of control power to professional managers occurred

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[8] Some of them became insiders of zaibatsu family through marriage after their successful achievement.
[9] President of Sanyo Railway Co., previously chief of a bureau of the Ministry of Foreign Affairs, educated in England.
[10] Former high ranking official of the Ministry of Agriculture and Commerce, invited to Sumitomo in 1897.
[11] Former director of Bank of Japan, invited to Sumitomo in 1899.
[12] The interest of the family was in philanthropy and arts.

also with respect to leading cotton spinning companies. Most of cotton spinning companies had been established as joint investment companies by rich merchants and industrialists, many of them engaged in textile-related businesses. During early period, these firms had been managed by directors selected from large shareholders. Since the number of shareholders was small,[13] the consensus-based control by large shareholder was effectively implemented. As the international competition of the industry intensified, however, these shareholder-managers were also replaced by professional managers. For example, in Kanegafuchi Spinning, Sanji Mutô, a graduate of Keio University and an American University (Pacific University in California), was invited from Mitsui Bank, and became senior managing director in 1908.[14] In Fuji Spinning, Toyoji Wada was recruited from Kanegafuchi Spinning, the largest company in the industry, as the senior managing director 1901 and became president of Fuji Gas Spinning[15] in 1916. He was also a graduate of Keio University and from ex-*samurai* family. The rise of professional managers in corporate control is clear from the data in panel A of Table 4. It can be seen that companies which hired more than two professional managers increase from 5 out of 75 in 1905 to 113 out of 158 in 1930.

Middle Managements

After the 1920s, there occurred the second phase of the delegation of control right. This time, the middle management and white-collar workers increased their control power. First, seniority wage system and life-time employment system spread among middle managements of large firms. Ono (1989) points out that seniority wage and internal promotion system became common among large firms, and raises three reasons for the phenomenon; the necessity to secure skilled labor through OJT, an increase in the share of male workers owing to the development of heavy and chemical industry,[16] and the necessity to insulate skilled labor from labor movements. Odaka (1993) also claim that among white collar workers lifetime employment and seniority wage system became prevalent during the same period, while blue-collar workers were quite often fired during the prewar period by the convenience of companies even if they were skilled workers.

Second, the share of internally promoted employees increased in board members, and at the same time board members became integrated with management members. For example, in 1921 Sanji Mutô of Kanegafuchi Spinning revised the article of association at the shareholder's meeting and introduced following rules; (i) president and directors must

[13] With respect to 63 cotton spinning companies, average number of shareholder was 347 with maximum 1,114 and minimum 29 in 1898 (Murakami 1970).
[14] And became president in 1921.
[15] Established in 1916 through a merger of Fuji Spinning with other spinning companies.
[16] Ono claims that indexing to living cost was needed for male workers who were major income earners in household.

be chosen among those who had worked for the company more than five years and (ii) part-time members cannot became board members. Similar reform took place at Tôyê Spinning, another leading cotton spinning company, in 1922, and Kurashiki Spinning, Fuji Gas spinning and Nishin spinnig as well (Yui 1995). Panel (B) of Table 4 shows that number of companies in which more than one-third of board members are composed of professional managers increased from 19 out of 69 in 1915 to 45 out of 65 companies in 1930. Further, panel (C) shows that among professional managers internally promoted member increased from 8 out of 36 in 1905 to 247 out of 470 managers in 1930.

Third, there occurred a substantial decentralization of control power and decision making (Yui 1995). Factories dispersed in local areas increased autonomy, and as a result middle management at factories obtained significant discretion in decision making. Many of factories became equipped with managerial capability with specialized sections including purchasing of materials, labor management, accounting, and so on. Many promising university graduates were delegated to factories, and being a section chief at major factories became an elite course in the career path. It is natural that they found instrumental value in the growth of firms, and devoted to the growth of firms through investing in firm-specific shills.

In sum, in the prewar period, shareholders right was weakened first by the delegation of control right to professional managers, and then to the middle management. It is worth noting that in the case of United State the emergence of "managerial capitalism" or the rise of powerful top management owes to the separation of ownership and management and hence entailed serious agency problem between the dispersed shareholders and the top management, while in Japan the rise of professional managers occurred without such a separation of ownership and management; i.e. family-owned zaibatsu and joint-investment style companies.

Blue-Collar Workers

With the backdrop of this, there came the third phase of reallocation of control right after World War II. The experience during and immediately after World War II bears special importance here (Teranishi 2005). Munitions production required accelerated technological progress and improvement in heavy and chemical industries. In order to improve the production process and quality control, it was crucial to promote the formation of firm-specific skills by workers and factory managers. The military paid significant efforts to strengthen the autonomy of the factory managers, and this culminated in the enforcement of the Munitions Financing Designated Financial Institution System in January 1944. In this system, a production chief in each factory could finance necessary fund from designated financial institutions at his will, could substitute the approval at shareholder meeting by the approval by the Ministry in charge of the factory, and could decline the disclosure of information. At the same time the military tried to promote the incentive for firm-specific skill formation by workers at shop-floor. They intervened in wage system so as to increase the share of fixed wages or living-cost compensation. Long-term employment was also encouraged as far as the factory obeyed the compulsory reallocation of workers for the military purpose.

Partly owing to this wartime experience and to the experience of overcoming intense labor disputes immediately after the war, blue-collar workers came to be treated equally with white collar workers in the postwar period. Both lifetime employment and seniority wage system was applied to them also. Since the top and the middle management are already lifetime employed and they are actively investing firm-specific managerial skills, it was natural for blue-collar workers to have incentives to invest in firm-specific skill. The promise of life-time employment and seniority based wage system, which was composed of living-cost part as well as experience and skill based part (Teranishi 2005), was credible, and hence, hold-up problems were avoided.

Since almost all the managers and board members came to be composed of internally promoted members in the postwar period, it was not necessary to pay extraordinary high income to the top management, so that the percentage of bonus payments to profits was reduced substantially to less than one percent as is shown in Table 5. Instead, in order to give incentives to workers at shop-floor and the middle management to invest in firm-specific skill, bonus payment or the sharing of residual income with them was substantially increased; 35.3 percent in 1970 and 49.8 percent in 1980 of the sum of profit after tax and bonus to regular employees.

Owing to the virtual disappearance of the wealthy zaibatsu family and their commitment in corporate governance, new top managers and board members, promoted from the position of factory chiefs or directors, took the role of firm growth. When some hostile takeover attempts occurred, it was natural for them to cope with them by cross-shareholding among ex-zaibatsu firms, which were crossly related with each other both technologically and in terms of human relationship.

Hold-Up Problem

So far, we have argued that control right of firms was delegated to the top management at first, then to the middle management, and finally to shop-floor workers. Lifetime employment and investment in firm-specific skills spread in this order. This explains why hold-up problem did not occur. For the middle management, the long-term employment and high salary of top managers was convincing evidence that they can recover cost of investment in firms-specific skills in the future. For blue-collar workers, the internal promotion and seniority wages of the middle management made the promise by the company of lifetime employment a credible one. In this way, overlapping generation structure (Allen and Gale 2000) came into existence. However this raises a question: How about the top management? Why they believed that their efforts and investments could be recovered in the future? Let me answer this question with respect to zaibatsu case. One of the clues to this question is quasi-feudal relationship between zaibatsu family and house butler-type top managers. Before the recruitment of top-managers from the bureaucracy or Bank of Japan, management of zaibatsu was in the hand of house –butlers, who were still tied with the family with quasi-feudal loyalty sentiment. However, another and probably more fundamental reason is the atmosphere to degrade merchant and assetholder class compared with ex-*samurai* and actual producers. In order to clarify this point, let us start with pre-Meiji, feudal period. We will show that the majority of the top management recruited from outside zaibatsu was ex-*samurai* or from other related classes, which had social grade higher than merchant class including zaibatsu families.

Let us start with pre-Meiji, feudal period. During this period there was a strict class system among occupations. There were four categories in occupations, and the highest was the *samurai*, the second was farmers, and the third was manufactures or engineers, followed by merchants. It is interesting to note that the ruling class of the feudal Japan, the *samurai* class, was not asset holders. This is quite different from European case, where ruling class was a huge wealth owing class. Most of financial assets were held by merchants, and land was held by farmers; small owner-cultivating farmers called *hyakusho* and emerging landlords. The ruling class had only taxation right, and did not possess any significant income-yielding properties. Partly for this reason, during the feudal period investor's right was not necessarily respected. The rulers (chief of feudal clan) as well as lower class *samurai* borrowed heavily from merchants, and the lending contracts were quite often cancelled by formal decrees in order to restore fiscal condition of the fief governments as well as to relieve *samurais* and peasants in poverty.

The Meiji Restoration in 1868, which threw away the feudal system and introduced modern capitalism, was implemented by lower class *samurai* in the South-Western region of Japan. Among the various measures to modernize the economy, joint-stock company system was introduced, and national banks (nationally-chartered private banks) were the first joint-stock companies. Starting from the establishment of four banks in 1874, 153 national banks were established by 1879.

Three characteristics in the corporate system of national banks are worth noting. First is the investors in banks. As is clarified by Asakura (1961), most banks were established by rich merchants and landlords.[17] They invested in banks and other modern businesses in order to profit from new investment opportunities provided by the expansion of markets,

[17] Ex-rulers of feudal fiefs also invested their money substantially. Meiji government gave national bonds to them in order to compensate for confiscating taxation right from them. The National Banking Act in 1876 was aimed to facilitate their investment in national banks in the form of bond instead of species.

domestic and overseas (Teranishi, 2003 and 2005). Second is the role of ex-*samurai* in the management of banks. Many of ex-*samurai*, who lost jobs as rulers, became bureaucrats, joined the military, and the rest became managers of newly established modern firms. In the case of fourteen national banks with main offices in Tokyo city, there were 62 managers all together, of which, 39 managers were ex-*samurai*[18], and managers of three banks out of fourteen were entirely composed by ex-*samurai*. Third, voting right of large shareholders was severely restricted in national banks. In other words, one-share one-vote rule was not applied, and shareholders received one vote for the first 10 shares they owned, one vote for every 5 additional shares they held up to 100 shares, and one vote for every 10 additional shares they owned over 100 shares. Incidentally, before the promulgation of 1893 Commercial Law, it was a common practice to curtail voting right (control right) of large shareholders, as is shown in Table7: the share of corporations, which did not restrict large shareholders' voting right or adopted one-vote one-share system, was 6% during 1877–85, 15% 1886–89, and 31% during 1890–1892; after the promulgation of the Commercial Law in 1893, the share rose to more than sixty percent. Voting right were curtailed by various measures; national bank or Nihon-Yusen style[19] method was most common, and in some cases a maximum was set on the number of votes that a shareholder can exercise.

According to Imuta (1976), the restriction of voting right was endorsed and recommended by the government. Since the government was established by ex-*samurai*, it might not be far out of mark to conjecture that the government intended to protect manager's position in modern corporations. The government seems to be ambivalent; they were eager to mobilize accumulated funds at the hand of rich merchants and landlords, but at the same time, they did not want to give much power to investors. This was partly because ex-*samurai* government bureaucrats valued highly to serve companies as organizations without pursuing any private benefits (Takahashi, 1977, p. 158), but mainly because they had value system that emphasizes social value of actual producers and managers compared with merchants or *rentiers*.

Three reservations are in order. First, many of managers of ex-*samurai* origin obtained huge bonus from the companies they run and many of them became large stockholders later, during the Taisho-Showa period, as they invested their income into stocks. Second, one-share one-vote became common after the revision of commercial Law in 1893. Third, the restriction of voting right was not special in Japan. In the eighteen century United Kingdom, for example, one vote for one person was a common practice. In the United Stats, it was common among banks to restrict maximum number of votes to ten per person

[18] Sixteen banks were established in Tokyo. But one of them does not have sufficient data, and the fifteenth banks were an outlier in this case because it was established exclusively by nobility. Refer to Takahashi (1977) on these points.

[19] According to the article of Nihon-Yusen revised in 1883, shareholders received one vote for the first 10 shares they owned and, one vote for every 5 additional share they held.

during the eighteenth century. In the mid-nineteen century, however, one-share one-vote rule was established as a norm. In Meiji Japan there seems to be no doubt that the government had information about the evolution process of voting right system in thes countries. Nevertheless, the government tried to curtail the voting right of large shareholders.

(2) Maximizing Behavior of Asset-holders and Technological Progress

Why control right has been delegated to employees by shareholders? A readily conceivable reason is the rest-seeking behavior by managers and workers. Although this factor cannot be denied completely, we consider that major driving forces toward weakening of shareholder right lie in rapid technological changes and the necessity to accommodate them by means of organizational reforms.

Zaibatsu Firms

In the case of zaibatsu firms, the main reason came from urgent needs to go into heavy and chemical industries. During the nineteenth century, the three zaibatsu expanded and diversified their business into traditional profitable businesses such as mining, marine transportation, foreign trade and banking. Since these were areas to which the new government devoted most effort in order to modernize the economy, three zaibatsu families with close contact with the government leaders were quite successful in these businesses. It is well known that the privatization of state enterprises started in 1885 benefited them greatly. After the turn of the century, it has become clear that further growth of zaibatsu was possible only through launching new businesses in the areas of heavy and chemical industries; they had accumulated huge amount of retained profits, and light industries such as textiles and food products had already been started by smaller indigenous industrialists other than zaibatsu. Thus, both Mitsui and Mitsubishi decided to go into steel production in 1913, and Sumitomo that had already a steel factory in Niihama (Shikoku) since 1892 bought a big iron factory in 1901, and went into steel pipe production after 1912. Data on diversification into heavy and chemical industries is given in Table. 2. It was after the 1920s that zaibatsu entered into the area actively.

Organization reform was needed in order to realize efficient management of diversified business (Takeda 1995) and in order to make pertinent decision about the launching of new businesses (Okazaki 1999). The establishment of holding companies were landmark for the organizational reform for these purposes. Table 6 shows most zaibatsu established holding companies by the end of the World War I period.

Holding companies held huge power through controlling internal capital and labor markets: All the investment projects needed to be approved by holding companies, although drawing up of project draft was left to individual professional managers (Miyajima 2004); All the new graduates from universities hired by zaibatsu became employees of holding companies at first , and allocated to group companies thereafter.

Establishment of holding companies was implemented by top professional managers under the monitoring by zaibatsu families. Takashi Masuda led the process with close consultation with eleven Mitsui owner-families in the case of Mitsui. In the case of Mitsubishi, Koyata Iwasaki (eldest son of Yanosuke Iwasaki, who was a younger brother of the founder Yatarô Iwasaki) took the leadership. In the case of Sumitomo, the professional manager Masaya Suzuki took the leadership under the approval of Kichizaemon Sumitomo, who owned 98.7 percent of the assets of the Sumitomo-Gôshi.

How much power the owner families retained in the operation of holding companies is an interesting question. Yasuoka has emphasized the power of families for years[20], and Morikawa (1980) of professional managers. More recently, Morck and Nakamura(2004) emphasizes the maximixing behavior by zaibatsu families. Okazaki (1999) draws attention to the effective control by holding companies over the entire decision process of zaibatsu groups. Miyajima (2004) claims also that the opinion of family members, who were the organizing members of holding companies with unlimited liability, were important before the 1930s, when holding companies were converted into joint-stock companies with limited liabilities.[21] Quoting mainly Mitsui's case, where whole assets were held jointly by eleven families,[22] Takeda (1995) claims that holding companies played the role of softening the "voice" of family members. At any rate, it seems difficult to deny the ultimate control power by zaibatsu families. Nevertheless, these families chose to delegate part of their power to professional managers in order to diversify family businesses in the field of heavy and chemical industries.

<u>Cotton Spinning Firms</u>

Let us move on to the case of cotton spinning companies. In these companies, control right were delegated to professional managers and directors internally promoted after the 1920s. Yui (1995) considers that the major reasons for this lies in the drastic changes in competitive conditions. After World War I these firms faced with severe competition with British firms with respect high quality products and Indian firms with respect to low

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[20] Refer to Yasuoka (1998) on this point.

[21] The main reason for this lied in tax saving. In order to mitigate the impact of the rise in inheritance tax rate in the wartime atmosphere, zaibatsu families converted their holding companies into joint-stock companies so as to be able to divide their wealth into small units owned by individual members.

[22] So called "soyusei" system was adopted by Mitsui, in which each family had income right to the profits in proportion of its equity, but never allowed to sell its equity. Since "exit" by family members was forbidden, their "voice" tended to be louder, Takeda (1995) claims.

quality products. In order to survive the competition, it was indispensable to reorganize the managerial structure so as to improve the competitive edge of the companies. At the top management level, old-type shareholding directors who had been textile merchants mostly were replaced by professional managers, who were acquainted with new technology in production and new managerial system. At the production site, three kinds of improvements were undertaken; (i) improvement of shop-floor coordination so as to effectively utilize work time and workers' motions, (ii) diversification of routes for material purchasing and selection of materials suitable for each product, and (iii) diversification of products adjusted to each market and the consequent diversification of production lines.

In order to accomplish these improvements, the strategy of cotton spinning companies was to give incentive to invest in firm-specific skills by middle managers in charge of each factory. This is why lifetime employment and seniority wage system was introduced with respect at to the middle management. Further, internal promotion system extended to board members and president worked as a powerful incentive for middle managers.

It is important to note that structural reform of these companies, which eventually curtailed control right of shareholders, were undertaken with explicit approval by shareholders. For example, reform of board system was only possible with the approval at shareholder meetings. Instead of delegating control right to employees, shareholders requested high dividend. Miyajima (2004) claim these companies were still under the pressure of disciplining through capital markets.

Incidentally, during the 1920s, the high dividend ratio of non-zaibatsu firms became a target of social criticism. Moral hazard such as tunneling and high dividend and bonus payment by deficit companies occurred frequently. In many cases, moral hazard was caused by the collusion of large shareholders and top managers. Kamekichi Takahashi published a book "Joint-stock Companies Ruin the Country" (Kabushikiki-kaisha Bôkokuron) in 1930. During the 1930, this kind moral hazard subsided, and Takahashi claims that one of the major reasons for this was the shareholding of these companies by other large firms, which fulfilled effective monitoring role.

<u>Landlord System</u>

The mechanism of delegation of control right to workers in order to promote technological progress is most clearly seen in the case of farm management by landlords. In Japan, land-renting contract was overwhelmingly fixed rent system. This stands in clear contrast to other East Asian economies, where share-cropping contract is a usual practice. We will show that the major reason for this difference lies in the difference in technological progress in two regions.

Let us start with discussing why we focus on agriculture in the examination of corporate governance system.

From the viewpoint of asset-holders, corporate governance bears importance because it determines characteristics of investment in the corporate sector as an asset. Therefore, in a historical process, corporate governance tends to evolve in close relationship with the characteristics of assets alternative to corporate ownership. Since most important asset alternative to stocks during the industrializing process was land or real estate, it is worthwhile to examine the asset-holding pattern of wealthy landlord.

In prewar Japan, landlords were major wealth holders together with merchants. Since many of merchants invested in land, and some of landlords were involved in commercial activities, there was no qualitative difference in the asset holding pattern between merchants and landlords[23]. Of course, main source of income for landlords was rents paid by tenant farmers. In Japan of the nineteenth century and thereafter, direct management of farm by landlords was very rare, and there were only very few agricultural workers. Most of lands held by landlords were rented to peasants. Table 8 shows percentage composition of income by sources of a typical landlord in the South-Western part of Japan, a region with well-developed commercial and industrial activities. Many of landlords were involved in money-lending activity utilizing their information network in rural areas, so that interest incomes from such activities as well as bank deposits were another source of income. As industrialization proceeds, landlords invested their assets in stocks, both of local companies and of central and national-level companies, and obtained dividend income. Table 8 shows that the share of dividend income increased and the share of rent decreased.[24]

Let us examine the nature of land as an asset, which was determined through tenancy contract. First, tenancy contract was implemented by fixed-rent method; i.e., rent was fixed mostly by the amount of rice[25] in the case of paddy field per a unit of land (*tan*). Share tenancy or share cropping was very rare, confined to very underdeveloped or mountainous areas in such peripheral prefectures as Aomori, Iwate, Nagano, Kumamoto, Okinawa, and so on. Rents were sometimes reduced especially in seriously poor crop years, but never increased above contracted level in the years of good crops. In other words, in the Japanese land contract system, residual income right did not resided in the hand of landlords (investors or asset holders) but belonged to tenant farmers.

Second, it is interesting to note that tenant farmers enjoyed not only residual income

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[23] Osamu Saito pointed out a possibility that land holding or land accumulation by landlords was a passive behavior necessitated by the massive sale of land by peasants struck by deflations and recessions. I consider that this is not the case in view of the vast amount of literature about the portfolio selection by landlords regarding land and security investments. (See, for example, Nakamura 1979).

[24] This is a typical pattern in the case of landlords in developed region. In less industrialized region of Northern Japan, the share of rent stayed very high throughout the prewar period. Incidentally, Shoji (2003) refers to the case of Ito-ke, the largest landlord in Niigata prefecture, who specialized in landholding through
divesting commercial activities and committed itself to social activities as *meiboka* (Teranishi 2005).

[25] In the case of dry field, contract was in terms of rice or currency usually.

right but also substantial degree of control right regarding rented land. With respect to farming method, most of contract stipulated that agreement of landlords is required only in the case of significant changes of land use such as planting trees such as fruit trees or mulberry. Therefore, tenant farmers had wide range of control right over the use of rented land including the choice of crops, inputs of fertilizers, and marketing of harvested crops. Even re-renting of land and transaction of tenancy right was popularly undertaken.

Delegation of both residual income and control right gave tenancy farmers high incentive to invest in firm (land)-specific skill such as irrigation control and land improvement. Especially active were small owner farmers, who rented arable land and expanded the scale of their business. Such a behavior of tenant farmers resulted in a rise of their productivity compared with landlords (self-cultivation) and owner farmers as is shown by Table 9.[26, 27]

Why landlords delegated income and control right to tenant farmers? In order to examine this point, let us compare Japan with contemporary East Asian countries. In both East Asia and Japan agriculture is subject to monsoon climate, managed by family units, and mainly composed of rice production. However, while fixed rent contract is a dominant pattern of tenancy contract in Japan, share-cropping is dominant in East Asia.

Table 10 shows basic information about Asian agriculture. Gini-coefficient of land is low, indicating smallness of arable land per production unit. The percentage of tenanted land is 10–30 percent, and the percentage of share-cropping is 50–90 percent except for Thailand. Incidentally in terms of comparison among continents, the percentage of share-cropping is 89.5 percent in Asia, 0 percent in Africa, 16.1 percent in Latin America, 12.5 percent in Europe, and 31.5 percent in North America (Otsuka, Chuma and Hayami 1992).

Theoretically, sharecropping becomes an equilibrium contract pattern when contract enforcement costs are high, yield variability is high, and tenant farmers are risk averse, while fixd-rent contract is seen when contract enforcement costs are low, yield varibility is low, and tenant farmers are risk neutral (Otsuka, Chuma and Hayami1992). This leads us to conjecture following hypothetical reasons for the difference in two regions.

First is the difference in yield variability[28] and the degree of poverty of tenant farmers. It is already touched upon that in the case of Japan sharecropping is occasionally seen in

[26] From the viewpoint of asset holders, land as an asset was more or less a fixed income asset, although changes in rice prices caused some price risks.

[27] Wataya (1959) and Ouchi (1952) claim that semi-tenant farmers or middle-sized farmers actively engaged in technological improvement.

[28] It is important to note that fixed-rent system in Japan was usually accompanied by the widely spread practice of state-contingent rent reduction. Arimoto (2004) examines the effect of this practice, and shows that if a tenant is not too risk averse and/or the variability of the yield is not too high, then fixed-rent contract with a state-contingent rent reduction is preferable for landlords to a fixed-rent contract or share tenancy.

especially poor regions. Asian farmers are very poor in general, as Hayami (1992) and Oshima (1987) claim. However, it is not certain whether they are poor in comparison with tenant farmers in the prewar Japan. Average income per farm household was 1,138 dollar in Japan (1960), 806 dollar in Taiwan (1966), 422 dollar is Korea (1965), 433 dollar in the Philippines (1965), 388 dollar in Thailand (1967/68), 421 dollar (1976), 470 dollar in Western Malaysia (1967/68) (Oshima 1987). Although the figure for Japan is extraordinarily high, it is partly owing to income compensation scheme adopted in the postwar period. Further, in prewar Japan, there is a comparison of labor cost of workers at cotton spinning factories between India and Japan in 1891; 135.5 sen in Japan and 151.9 sen in India per 600g of cotton yarn (Yamada 1934). In India workers were male, and in Japan female at cotton spinning factories, so that we must take gender difference into consideration. Since wage level of unskilled labor in manufacturing was close to the wage level in the agriculture, this seems to indicate that peasants were extremely poor in prewar Japan also.

As the second reason, one may point out difference in enforcement costs. In East Asia, landlords intervenes tenant farming heavily. For example, in the case of Philippines, landlords, usually managers employed by landlords, intervene severely with respect to the choice of rice variety, timing of planting and harvesting, use of fertilizer and pesticide (Umehara 1970). In other words, residual control right of land is scarcely delegated to farmers. This is quite different from Japan.

Otsuka, Chuma and Hayami (1992) claim that enforcement cost of contract was reduced significantly owing to strong community and family ties and its effect on reputation. Although this factor could be effective in explaining the difference between Asia and other continents, it is doubtful this could entail significant difference between Japan and other Asian countries, since it is a common understanding that in the rural area of the prewar Japan community tie was also very strong.[29,30]

If neither poverty nor enforcement costs are unable to explain the difference, what else could do so? We consider the difference is closely related to the difference in the nature of technological progress. In prewar Japan, the rate of technological progress in agriculture was substantially high, and the new technology was composed of introduction of high-yielding rice varieties that required delicate water control and soil improvement, carefully tailored to the conditions of individual farm lands. The adoption of new improved variety was only possible with incremental technical improvement based on

[29] Further, the level of intervention or the degree of delegation of control right depends on the nature of contract. In this sense, both contract pattern and enforcement costs are emdogenous.
[30] One important difference is that in South East Asian countries tenants were quite often relatives or children, who work as tenants before land is given to them as inheritance. This case is important because land is equally inherited by all children, while in the prewar Japan inheritance by the eldest son was a rule.

investment in farm(land)-specific skill by tenant farmers. In order to catch up the rapid diffusion of new variety and related technological know-how, it was optimal for landlords to delegate substantial control right over farming to tenant farmers so as to give them incentive for investment in firm-specific skills. Technological progress was also rapid in East Asia during the 1960s and 1970s owing to the Green Revolution with respect to high-yielding varieties of rice. However, in the case of the new varieties in the Green Revolution, high yielding was possible only through large-scale irrigation, use of agricultural machinery, and mass input of fertilizers. This required large operating funds, but did not need any kind of delicate skill formation at the farm level.

In sum, we consider that under the condition of rapid diffusion of new agricultural technology, control right of farmland was delegated to tenant farmers by the decision of landlords in order to induce the tenants to invest in firm(land)-specific skills[31]. Incidentally, let us give a piecemeal and preliminary evidence on the importance of technological factor. In Hiroshima-prefecture of Western Japan that comprised of 16 countries (gun). While in most of counties fixed rent contract was prevalent, villages in 4 counties located in mountainous areas, and island areas (Saiki, Takada, Koyatsu, Futami) are characterized by sharecropping (Noshomu-sho 1924, p. 104). According to the data on the diffusion of new rice varieties given by Katsube (2002), in these areas the diffusion of the representative high-yielding variety, jinriki, is very low (p. 244).

<u>Cross-shareholding after World War II</u>

We have argued that the delegation of control right to employees was implemented as a result of maximizing behavior of owner families and controlling shareholders. After the war these wealthy families and shareholders disappeared due to zaibatsu dissolution and land reform. The shares held by zaibatsu families, amounting 57 percent of the total paid-in capital of corporate firms at the end of 1945, were sold out to the public, and land held by landlords, amounting to 28 percent of the total arable land in the country, were transferred to tenant farmers. The number of individual shareholder increased from 1,674 thousand in 1945 to 4,191 thousand in 1949, and the percentage of rented land in total arable land decreased from 46 percent in 1946 to 13 percent in 1949.

During the slump of stock market from December 1949 through 1950, there occurred several attempts of hostile takeovers by those who obtained huge profit in the boom due to the Korean War. Targets included Fuji Electric, Sumitomo Electric, Nihon Electric, Taishô Insurance, and Yôwa Real Estate and so on. This gave rise to a move to cross-shareholding

[31] Incidentally, through an examination of a couple of large landlords, Shoji (2003) argues that the improvement of farming technology by tenants and the support by landlords therewith were beneficial for both parties, and suggests that the behind such a benevolent behavior by landlords was skepticism about the private landholding system.

by the ex-zaibatsu companies. Shacho-kai (president meeting) of each ex-zaibatu group took the role of organizing cross-shareholding and the banks in each group lent necessary funds actively. Partly owing to the impact of capital liberalization after 1964 when Japan became a member of OECD, the percentage of cross-shareholding increased toward the 1970s (Table 12).

It is interesting to ask who were the ultimate decision makers with respect this cross-shareholding and for what purpose. One possible answer would be to emphasize the role of managers who were motivated by the pursuit of private benefits or empire building. It is difficult to deny this aspect completely, and it seems that, the later the period, the stronger would have been this entrenchment effect. However, as far as the initiation of the cross-shareholding is concerned, we would like to conjecture that this was the result of the joint decision by managers and shareholders, and the purpose lied in the increase of firm value by means of encouraging firm-specific investment by employees. Such a motivation was based on the recognition that in view of the critical conditions of international balance of payments, enhancement competitiveness of products in international markets was the only way for the survival of the companies, and that product and process innovation based on firm-specific investment was the most effective method to accomplish the purpose.

Let us raise a few supporting evidence for this conjecture. First, owing to the wartime emphasis on producer right, factory chiefs had accumulated enough competencies to run the firms, and these people were recruited as top managers after the war because of the purge of the top management in charge of wartime economy. Second, since the war economy required significant amount of additional funds, which even zaibatsu could not afford to finance, rationing of shares to other companies in the same group was already a common practice among zaibatsu firms (Teranishi 1994). Even cross-shareholding was extensively undertaken by some of new zaibatsu groups. Third, the eruption of intense labor dispute after the war induced the corporate managers to emphasize the "right to manage", and various national organizations had been organized in order to assert the role of managers in corporate governance. Moreover, it must be noticed that there was no effective legal measures to protect management from the threat of takeovers such as poison pill[32], purchase of own shares, requirement to disclose of shares purchase, and the like at that time (Goto 1992). It follows that cross-shareholding was the only way to protect the managements and to avoid harmful effects on the firm value, so that there was no reason for the dispersed small shareholders to oppose the cross-shareholding.

[32] Poison pill was introduced in1982 in the US in its prototype form and became legally legitimate in mid-1980s.

3. The Future of Shareholder Right: Concluding Remarks

We have derived two propositions with respect to the historical origin of the weak investor right in Japan. (i) The delegation of control right to employees occurred gradually from the top to the bottom ; at first the top management obtained substantial autonomy, then control right was granted to the middle management, and finally, shop-floor workers acquired autonomy in their jobs. (ii) The delegation of control right was implemented by the decision of controlling shareholders who tried to increase the firm value by encouraging investment in firm-specific skills by employees. These propositions indicate that the weak investor right and the bank-centered financial system are not necessarily the evidence of "underdevelopment" of corporate governance mechanism and financial system.

On the other hand, the Japanese government has been activity committed to promote the working of capital markets. The deregulation of financial markets since around 1980 was the main measure for this purpose. The deregulation was started in order to maintain the effectiveness of monetary policy through accommodating the internationalization of the financial system. Then, the emphasis shifted to the conversion of the financial system form bank-centered to capital market-based system, and further, to the promotion of international competitiveness of financial industries in the global capital markets.

More recently, in view of the trouble in the banking sector that used to have played the role of main bank monitoring, reform of corporate governance system in the direction to emphasize the share value maximization and to emphasize the benefits of shareholders became the focal issue. In 1993 the fee of representative shareholder litigation was reduced and became uniform; in 1993 appointment of outside auditor became mandatory; in 1994 purchase of own share is partially liberalized; in 1997 establishment of pure holding companies became liberalized, and in 1997 stock option became allowed. The reform of the commercial law that became effective in March 2003 was the highlight of these reforms, by which firms were allowed to choose a new corporate board system similar to the United States system.[33]

It seems, however, that despite these reform efforts, changes in corporate governance and bank-centered financial system have been rather slow until now. With respect to the reform of board system, the number of firms that adopted US-type board system, called Iinkai-to-Sechi-Kaisha, is only 101, of which 19 is composed of Hitachi group, a manufacturing group with high reputation but recently stagnant, as of February 2005. With respect to cross-shareholding, cross and stable shareholding by banks and other

[33] Nevertheless, the legal system of Japan regarding corporate governance seems to be still very underdeveloped. In particular, as the cross-shareholding by financial institutions decreased, how to protect corporate managers from hostile take-over by such legal measures as poison pill has become a hot issue recently.

financial institutions has decreased substantially after 1997 as is shown in Table 11. This is partly due to the introduction of market valuation of stockholding under the new accounting standard. In response to the drastic mergers among ex-zaibatsu banks since the mid-1990s, the cross-shareholding among large business groups has decreased substantially (Table 12). It must be noted, however, that cross-shareholding among non-financial firms did not decrease so much, and relation-based shareholding has increased significantly after 1997 (Table 11). Part of the reason for such a move lies in the expected lift of ban on mergers by foreigners by means of stock transfer scheduled in 2006 and in the conversion of internal division activities to external subsidiaries[34]. Another reason, however, is the reorganization of inter-firm relationship in order to promote relation-specific investment and to enhance technological cooperation.

It would be also surprising that high-degree of financial intermediation has been by and large kept in tact until now. Table 13 indicates that percentage of household assets held in the form of deposits did not show any noticeable trend throughout the postwar period[35]. Further, while large firms decreased their dependence on borrowings recently because of the increased issue of corporate bonds, the dependence of all firms on borrowing did not change significantly until now.

It seems that the pattern of working of the corporate system and capital markets in Japan is rooted in long-term trial and error process of institutional reforms and the choice of corporate and, probably, national growth strategy. This paper tried to show that weak investor right, or the delegation of control right to employees, occurred as a result of maximizing behavior by asset holders, who intended to increase firm value by adapting to rapid changes in technology and industrial structure. Our investigation is still very preliminary and many things remain to be done in the future. There is no doubt, however, that it is difficult to change it simply by resorting to regulatory reforms or disciplining of corporate managers. Neither would be effective to "educate" investors in various ways. Recent recommendation by government officials to promote investor education at elementary and junior high school level seems to be guided by a serious ignorance about the mechanism of institutional changes. Globalization of financial markets and the consequent homogenization of institutions is certainly a serious challenge for the on-going system. Whether or not we should adjust to or resist it, however, must be decided on the basis of careful evaluation of future growth strategy; a stronger investor right would enhance allocation efficiency of financial resources, but it could be harmful to organizational efficiency based on investment in firm-specific skills.

[34] I owe to Yutaka Kosai for the comments on these points.

[35] Part of the reason lies in the incompleteness of the pay-off system in Japan. The pay-off started from April 2005 does not include deposits for settlements such as demand deposits. In other words, demand deposits are one hundred percent guaranteed even after the start of pay-off.

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Table 1 Percentage Composition of Real GDP

Year	Percentage composition of primary sector in total GDP	Percentage composition of industrial sector in total GDP	Percentage composition of textile and food products in manufacturing sector GDP	Percentage composition of heavy and chemical industries in manufacturing sector GDP
1888	41.5	8.1	68.6	13.6
1900	34.6	15.4	72.7	13.3
1920	24.7	19.0	58.4	30.4
1938	15.9	32.4	38.1	51.4
1955	16.7	12.6	35.4	39.1
1987	2.8	28.4	14.3	75.2

Source: Minami (1992).

Note: Percentage composition of seven-year moving average series. Primary sector includes agriculture, fishing and foresting, and industrial sector, manufacturing and mining. Heavy and chemical industry is composed of metal, chemical and machinery. Data 1888 on manufacturing sector composition refer to data in 1877.

Table 2 Diversification by Three *Zaibatsu* (Mitsui, Mitsubishi and Sumitomo)

	1896	1914	1919	1945
Traditional businesses	96(92)	652(82)	2,461(83)	2,107(28)
Heavy and chemical industries	2(2)	53(7)	301(10)	4,683(63)
Others	6(6)	91(11)	214(7)	651(9)
Total	104	796	2,976	7,431

Source: Takeda (1995) and Hadley (1970).

Note: Traditional business includes mining, marine transportation, foreign trade and banking. Heavy and chemical industries are metal, chemical and machinery. Units are one million yen, and figures in parentheses are percentages. From 1986 through 1919, figures show values of investment or total assets, and figures in 1945 refer to paid-in capital (excluding investment in colonial regions).

Table 3 Average Percentage Composition of Bonus Payments to Managers and Dividend Payments in Profits after Tax (Prewar)

	Manager bonus / profits after tax	Dividend / profits after tax
(A) 1922		
zaibatsu firms	5.3	77.8
non–zaibatsu firms	4.8	86.5
(B) 1932 (firms established before 1922)		
zaibatsu firms	4.9	57.3
non–zaibatsu firms	3.7	63.8
(C) 1932 (firms established after 1932)		
zaibatsu firms	4.5	54.8
non–zaibatsu firms	3.6	47.8

Note: Sample of (A) and (B) are 22 firms belonging to four big zaibatsu (Mitsui, Mitsubishi, Sumitomo and Yasuda) and 65 other firms given both in *Kabushiki-kaisha-nenkan* No.1 (1922) and No. 14 (1936). Sample of (C) are 50 firms of four big zaibatsu and 376 other firms. Data for them are obtained in No. 14 of *Kabushiki-kaisha-nenkan*. Firms are those belonging to manufacturing, mining and transportation and public utility, so that financial and service industries are not included.

Table 4　The Rise of Professional Managers

	1905	1915	1930
(A) Number of professional managers in a company			
Less than 2	69	86	42
More than 2	5	29	113
Total number of companies	75	115	158
(B) Share of professional managers on the board of director			
Less than one-third	–	50	20
More than one-third	–	19	45
Total number of companies	–	69	65
(C)Career Path of professional managers			
Internally promoted	8	–	247
Other career path	28	–	224
Total number of managers	36	–	470

Source:　Morikawa (1980) and (1991).
Note:　Figures show number of companies in panel A and B, and number of managers in panel C. In panel A and C, total includes unknowns.

Table 5　Percentages Composition of Bonus Payments and Dividends in Profits after Tax (Postwar)

	1970	1980
(a)Dividend / profits after tax	42.8	22.6
(b)Bonus to mangers / profits after tax	1.4	1.4
(c)Dividend / (profits after tax + bonus to regular employees)	27.7	11.4
(d)Bonus to managers / (profits after tax + bonus to regular employees)	0.9	0.7
(e)Bonus to regular employees / (profits after tax + bonus to regular employees)	35.3	49.8

Source and Note:　Sample is 1,337 companies in 1970 and 1,589 companies in 1980 given in the Database of Development Bank of Japan. Bonus to regular employees is not given in the database.(Only total wages and salaries are given.)　But we can calculate the ratio of special earnings to the sum of special earnings and contract cash flow earnings from Chingin Kouzo Kihon Tokei Chosa (total firms with more than one thousand employees), which is 0.23 in 1970 and 0.26 in 1980. Bonus payment to regular employees is estimated by multiplying these ratios to the wages and salaries given for the sample companies.

Table 6 Establishment of Holding Companies

1909	Mitsui–Gômei
1912	Yasuda–Hozensha
1919	Mitsubishi–Gôshi, Furukawa–Gômai
1918	Asano–Dôzoku
1921	Sumitomo–Gôshi

Source: Takeda (1985).

Table 7 Number of Firms by Types of Voting Rights (percent in parentheses)

	One vote for one share	Curtailment of voting rights			Other	Total Number of firms
		National bank or Nihon Yusen type	One vote for one shareholder	Curtailment voting rights in some other measures		
1872–1876	3(50)	2	–	1	–	6
1877–1885	2(6)	14	3	15	–	34
1886–1889	12(15)	15	1	42	8	78
1890–1892	5(31)	1	–	9	1	16
1893–1896	63(61)	20	–	18	2	103
1897–1900	26(76)	2	4	2	–	34

Source: Imuta (1976), p. 206.

Table 8　Percentage Composition of Revenue of a Landlord (Nozaki-ke) in Kinki Region

	Rent on tenanted land	Interest income (deposits and money lending)	Dividend income	Others
1905	62.1	5.4	30.7	–
1907	63.9	–	35.5	–
1909	61.2	9.1	29.5	–
1911	43.4	16.0	37.4	3.6
1913	38.8	22.9	34.4	3.5
1915	22.3	6.8.	66.4	4.4
1917	19.3	5.9	71.2	3.3
1919	31.0	2.0	63.4	2.8
1921	18.2	3.4	74.7	3.4
1923	14.4	11.0	69.5	3.3
1925	22.9	3.3	67.3	5.7
1927	21.1	12.6	60.3	6.0

Source:　Nakamura (1979).

Note:　Other includes rent on houses.　Temporary incomes are excluded.

Table 9　Land Productivity of Various Types of Farmers

	Landlords	Owner farmers	Tenanted farmers
1890	4.6	2.9	2.7
1899	4.6	3.0	2.7
1908	4.2	3.1	3.2
1911	3.2	3.0	2.7
1912	3.0	2.9	3.2
1939–41	3.8		3.7

Source:　Hayami (1986) and Kawagoe (1993).

Note:　Kg / ha of brown rice.

Table 10　Agriculture of Asia and Latin-America

	Year	Average cultivated land (ha)	Gini coefficient of land distribution	Percentage of tenanted land	Percentage of tenanted land with share-cropping
Bangladesh	1976/77	1.6	0.42	20.9	91.0
India	1970/71	2.3	0.62	8.5	48.0
Indonesia	1973	1.1	0.56	23.6	60.0
Nepal	1971/72	1.0	0.56	13.2	48.3
Philippine	1971	3.6	0.51	32.8	79.3
Thailand	1978	3.7	0.45	15.5	29.0
Brazil	1970	59.7	0.84	10.2	n.a.
Costa Rika	1973	38.1	0.82	9.0	9.4
Colombia	1970/71	26.3	0.86	11.5	49.4
Peru	1971/72	16.9	0.91	13.6	0.0
Uruguay	1970	214.9	0.82	46.3	4.7
Venezuela	1971	91.9	0.91	2.4	n.a

Source:　Otsuka, Chuma and Hayami (1992).

Table 11 Cross Shareholding of Listed Firms (Percentages to Total Equity Outstanding)

	Stable holding by financial institutions		Stable holding by non-financial firms			Total stable Holding
	Cross shareholding by banks and insurance companies	Total including others	Cross Shareholding	Holding of share of related companies	Total including others	
1987	7.7	31.3	10.6	3.1	14.5	45.8
1988	8.0	32.3	9.9	2.8	13.4	45.7
1989	8.1	31.3	9.1	3.7	13.5	44.9
1990	8.3	31.5	9.6	3.7	14.1	45.6
1991	8.5	31.8	9.3	3.9	13.8	45.6
1992	8.4	31.8	9.4	3.8	13.9	45.7
1993	8.1	31.2	9.3	4.1	14.1	45.2
1994	8.2	31.1	9.1	4.0	13.8	44.9
1995	8.3	29.8	8.8	4.1	13.6	43.4
1996	8.6	29.8	7.5	4.5	12.3	42.1
1997	8.3	28.9	6.7	4.6	11.6	40.5
1998	7.3	26.7	6.0	7.0	13.2	39.9
1999	6.0	22.0	4.6	11.1	15.9	37.9
2000	5.8	20.7	4.2	7.9	12.3	33.0
2001	5.3	18.8	3.6	7.8	11.4	30.2
2002	4.3	17.0	3.2	6.9	10.0	27.1
2003	3.8	13.9	3.8	6.5	10.4	24.3

Source: Nissei-Kiso Kenkyujyo, *Kabushik Mochiai-jyokyo Chosa*.

Note: Covers all the listed firms; 1924 companies in 1987 and 2690 companies in 2003. Stable shareholdings by non-financial firms includes those of security companies.

Table 12 Cross Shareholding in the Six Largest *Keiretsu* Groups (Percentages to Total Equity Outstanding)

	(A)					(B)	
	1955	1965	1975	1985	1987	1987	2000
Mitsui	–	14.3	21.2	21.6	19.5	10.2	5.1
Mitsubishi	20.3	23.7	30.3	36.9	35.5	14.8	11.3
Sumitomo	21.2	28.0	29.6	29.7	27.5	13.4	8.9
Fuji	–	11.4	18.3	16.4	16.4	11.2	4.6
Sanwa	–	–	20.3	16.5	16.5	9.4	4.9
Daiichi-kangin	–	21.9	23.8	14.6	14.6	9.1	6.2

Source: Data in Panel (A) are obtained from Kôsei Torihiki Iinkai (1992), and show average percentages of group firms of the percentages of stocks held by other firms in the same group. Data in Panel (A) are from Nissei Kiso Kenkyujyo, *Kabushiki Mochiai-jôkyô Chôsa* (2000) and shows percentages of the sum of the values of stocks held by firms in the same group to total value of stocks issued by the firms in the groups.

Table 13 Intermediation by Banks

	Percentage of deposits in household financial assets	Percentage of borrowing in financing of corporate firms	
		All firms	Large firms
1960	–	48.2	56.1
1965	60.1	45.7	48.2
1970	62.6	42.1	43.7
1975	64.3	45.3	46.2
1980	64.3	43.1	42.7
1985	58.5	47.7	43.8
1990	53.9	50.6	43.9
1995	55.7	52.0	41.8
2000	53.1	49.2	38.9
2002	56.4	49.8	39.4

Source: Bank of Japan, Economic and Financial Data, and Ministry of Treasures, Financial Statistics of Corporate Firms.

Note: All firms are composed of all corporate firms with equity capital more than ten million yen, and large firms with equity capital more than one billion yen.