FRANZ WALDENBERGER

From Corporatist to Market Capitalism? Japanese and German Systems of Corporate Governance Facing a Changing Environment

Does the victory of Vodafone in the battle for control over the assets of Mannesmann's mobile phone service signal the beginning of the end of German corporatist capitalism? Do the similar cases of hostile takeovers by foreign companies in Japan imply the end of the Japanese postwar industrial system? Both in Germany and Japan, restructuring was so far the task of corporate insiders. Stable ownership combined with bank control kept unfriendly outsiders from gaining control over company assets. The recent cases clearly indicate that these structural obstacles are no longer insurmountable. However, what does this imply for the German and Japanese systems of corporate governance? The answer is not at all clear. There is room for at least three interpretations.

Endogenous change: The appearance of hostile takeovers could be the result of changes within the corporate system whereby traditional obstacles to this mode of corporate restructuring were lowered.

Exogenous shock: Rather than being the result of changes occurring within national systems of corporate governance, the appearance of hostile takeovers could be related to the severeness of the environment that German and Japanese companies are presently confronting. It is interesting to note that the first hostile takeovers, both in Japan and Germany, occurred in telecommunications services. Due to fast technological progress, markets in these industries are changing rapidly and the uncertainty about the future course of business is high. In such an environment, speed and size become a decisive factor for survival. Strategic alliances and external growth through mergers and acquisitions are a must. Given the high degree of uncertainty, consensus among prospective partners might be impossible or too time-consuming to achieve. Even insider systems might under such conditions be urged to resort to unfriendly means of restructuring.

Evolutionary change: The exogenous and the endogenous change interpretations can both be true and they might not be unrelated to each other, but mutually re-enforcing. Changes in the market environment might require adaptations in the pattern of ownership, or they might create the need to redefine traditional stakeholder relationships.

In what follows I will opt for the evolutionary interpretation, but with a caveat. The evolutionary argument stated above, while being more comprehensive than the first two interpretations, still represents a very simplistic model of change. It does not allow for obstacles in the process of transformation, nor does it allow for variety in the outcome. To make the evolutionary argument a bit more realistic, we will have to consider problems of system complementarity. In the age of computers, everyone is familiar with the term »system requirements« when installing new software. You cannot run a Windows application on a Macintosh. Similar arguments apply to systems of corporate governance. The introduction of market-based instruments of control in the relationship between management and shareholders requires adjustments in the relationship with other stakeholders of the firm. Incompatibilities will result in a malfunctioning of the system as a whole.

A general model of corporate governance should make this clearer.

Corporate Governance as a System

Modern economic theory views the firm as a nexus of contracts (Milgrom and Roberts 1992:20). The term contract is to be understood in a very broad sense, as it includes not only written, but mostly implicit obligations by the respective parties. A firm entertains contractual relations with employees, managers, equity owners, creditors, suppliers, dealers and customers. These are groups with conflicting interests. Owners want to earn a high return on their equity. Employees prefer high wages. Customers demand cheap products of high quality. Suppliers want a good price for their own products. Managers pursue interests of their own. At the same time, they have to manage the various contractual relations of the firm. In doing so, they have to reconcile and trade off the conflicting interests of owners, employees and other contractual parties. How can this be done?

The »stakeholder-versus-shareholder« discussion (see for example OECD 1998) gives a naive answer to this question. Managers with a shareholder-value orientation are said to put shareholder interests first. So when asked whether they would lay off employees in order to increase dividends for shareholders, such managers would say »yes«. Stakeholder oriented firms would answer this question with a »no«. They will try to balance out conflicting interests. Decisions tend to be more consensus-based. Contractual relations are regarded as long-term commitments and as important assets for future business.

According to this classification, Japanese and German firms are regarded as stakeholder oriented, whereas companies in the US or the UK are classified as shareholder oriented. In a survey conducted by Masaru Yoshimori in the mid-1990s, managers of large companies from these countries were asked how they would decide when given the choice between (A) increasing profits through laying off employees or (B) keeping both the level of profits and the level of employment (Yoshimori 1995:28). 98 % of the US and 98 % of the UK managers opted for the »more profit« alternative. In Germany, the preference for this alternative was down to 41 %. In Japan, the »more profit« alternative would have been chosen by just 3 % of the respondents.

While the »shareholder-versus-stakeholder« discussion captures differences of managerial behavior in various countries, it does not explain at all where these differences come from. Therefore, it is of little help in the analysis of change. The discussion suggests, that companies can more or less freely choose between being shareholder or stakeholder oriented. Whether managers give shareholder interests more emphasis or whether they follow a consensus-based approach is seen as the outcome of modifiable regulations and incentive structures. For example, stakeholder-oriented managers are seen to lack control from the shareholder side. So simply strengthening the legal position of shareholders would turn a stakeholder oriented management into maximizers of shareholder value.[1]

This view-point is naive because it neglects the constraints managers have to consider when they trade off opposing owner, lender, employee, customer and supplier interests. Also, these constraints are defined by the economic environment and not by legal stipulations. For the purpose of analysis, it is helpful to assume that managers in all countries pursue first of all their own personal interests. As Adam Smith already noted, in the context of division of labor, pursuing ones own income interests requires that one serves the income and consumption interests of others. This holds true for managers in all countries. Differences in managerial behavior are thus not due to the fact that managers in different countries have a different goal function, but are rather the result of differences in the way the interests of owners, employees and other contractual parties are to be served.

There are basically two ways to protect economic interests. One is managerial commitment. In Japan for example, management is highly committed to employment stability. This is not only apparent in the responses to questionnaires, it is also evident in the actual behavior of companies. The reluctance to lay off employees is again shown in the present recession (OECD 1999:47–50, Keizai Kikaku Chô 1999:160). The alternative way of protecting contractual interests is through competition. Competition is certainly the cheaper way of protecting income and consumption interests, but it is not always available. To put it more clearly, the explicit commitment of management to the protection of specific stakeholder interests is directly related to the fact that these interests are insufficiently protected by competition. This is a central proposition, so let me explain it in more detail with regard to the employment relation which is

1. Roe (1994), Blair (1995), Porter (1997) and Miller (1997) represent such normative approaches.

after all the most important contractual relation in this context.

Under ideal market conditions, the additional income that one employee contributes to the value-added of the firm is just equal to the income she can earn somewhere else. In that case the market not only prices the marginal product of the employee correctly, it also assures that the income interest of the employee is perfectly protected. If she does not get what she can earn elsewhere she will quit. The short-term exit option provided by the market is a perfect safeguard for the employee. However, the protection provided by the exit option only works to the extent that the market prices the marginal product correctly. Prices measure opportunity costs. They measure the income to be earned at other companies. Opportunity costs will only be close to the employees present marginal product if labor qualifications and work place specifications are sufficiently standardized, so that labor services can, without productivity loss, be transferred to other companies. The less the standardization requirement is fulfilled, the more firm-specific labor services are and the wider the gap will be between actual marginal product and opportunity costs, i. e. market price. Asset specificity, here the specificity of the human capital employed in labor services, implies that income interests are only insufficiently protected by the exit option of the market. Consequently, these interests must be protected by other means, namely by commitments on the part of the firm. Insufficient commitment will lead to underinvestment in firm-specific assets and will forfeit the associated productivity gains.

How about the capital side? Here, management will have to serve the interests of equity owners and long-term lenders. These interests are also not protected by short-term exit options. Equity capital is completely locked in. Long-term debt cannot be withdrawn before the maturity of the underlying contract. How can management commit to both employees and to providers of capital? As long as the company is profitable enough to serve its long-term debt and to generate enough return for equity owners, there is no problem. However, in rough economic conditions that require the restructuring of assets the situation is different. Here, the task is to find a compromise that will ensure that the various groups of stakeholders continue to believe in the commitment of management to protect their interests. Under restructuring, protection can of course only be interpreted in relative terms. Every stakeholder group will have to be convinced that the burden they share in the total cost of restructuring is fair.

The requirement to negotiate the terms of restructuring among employees, equity owners and long-term lenders has far-reaching implications for the organization of capital markets. Capital finance relationships will have to be stable. This means that secondary markets for trading equity and debt contracts cannot be developed to their full extent. Equity ownership and lending relationships have to be stable in order to built up trust. Without trust from the side of capital providers, management will not be able to make a commitment to protect the interests of other stakeholders, notably employees. Without trust, there would be the fear that in situations of restructuring the capital side would not extend funds. This uncertainty would in turn prevent other contractual parties from investing in company-specific assets.

So here we have a first system complementarity. The underdevelopment of markets for qualified labor requires the underdevelopment of secondary markets for equity and long-term capital. The complementarity requirement is well demonstrated by the traditional German and Japanese corporate systems. Stable ownership of stock and stable mainbank or »Hausbank«-relationships, the pillars of the German and the Japanese corporate finance (OECD 1995, 1996), have supported the commitment of management vis-à-vis employees.

It should be noted that this complementarity has long been acknowledged in the corporate governance literature (Blair 1995, Porter 1997). But to my knowledge, it has not been related to the characteristics of the market environment. According to the argument developed here, asset specificity is not a variable that can be controlled by management. It is dictated by the development of markets for the respective productive resources.

A third element of the German and Japanese system completes the picture of an insider system. Insider systems are typically characterized by a strong information asymmetry between insiders and outsiders. This asymmetry arises from two sources. Firstly, the existence of asset specificity implies that essential resources of the firm are not correctly priced by the market. This creates a basic problem for the evaluation of company assets. Secondly, the underdevelopment of secondary stock markets impedes the pricing function of these markets. With little stock turnover, analysts will not find it profitable to specialize in the evaluation of stock. Also, because of stable relationships with the capital side, management has little incentive to provide the markets with company information.

Scenarios of Change

Systems of corporate governance, as described above, are determined by the market environment in which the contractual relations of companies are embedded. Instead of making the distinction between stakeholder- and shareholder-oriented systems, it is more appropriate to talk about market-based versus relational systems of governance. Shareholder orientation arises in an environment where contractual relations are embedded in well developed markets. Stakeholder orientation is the typical approach of companies that operate in a less developed market environment.

The above characterization of governance systems has two direct implications for the analysis of change. Firstly, change can only result from changes in the market environment. Secondly, attention has to be paid to system complementarity. Speaking of the German and the Japanese system, structural change as such and the development of secondary markets for stock and external debt alone will not shift these systems away from their stakeholder orientation and insider quality. For this to happen, the functioning of other markets, especially labor markets, will have to improve. If this condition is not met, strategies that, under the pressure of structural adjustment, one-sidedly submit to the interests of capital markets will be bound to fail. In what follows, I will elaborate on this proposition.

Structural Change

Structural adjustment can be dealt with in relational systems of corporate governance. The success of Japanese companies in overcoming the two oil crises in the 1970s showed that stakeholder systems can be quite good in coping with structural change. However, this episode also demonstrates that success hinges on one very important precondition. There must be new fields of business and technology into which companies can diversify. Only if companies can find new fields of growth will they be able to overcome the conflict between employee and capital interests. This situation was met in the 1970s, when Japanese companies entered the semi-conductor industry and could use the micro-electronic revolution as an engine of growth.

This condition was not met in the 1990s. Instead, the specific problems of the relational system of corporate governance became apparent. Structural adjustment requires the reallocation of resources, especially labor and capital, from old to new industries. In the relational governance system, both skilled labor and risk capital are stuck with the companies in old industries. If these companies cannot manage to diversify into new industries, the reallocation of resources will fail or it will at least consume much more time. Here, market-based systems are in an advantage, because labor and capital can move out of the old industries leaving the old companies behind. The ongoing sluggishness of the Japanese economy tells us that companies in old industries have indeed much more difficulty in coping with the structural challenges of the 1990s. At the same time, the slow process of restructuring confirms that the relational system of governance is still in place.

In Germany, the growth potential of companies seemed to have been already exhausted in the 1970s. Since then, unemployment has been rising steadily and this certainly undermined the trust relationship between labor and management. The reluctance of management to lay off workers was further reduced in the restructuring phase following German unification. The separation rate (number of lay-offs and quits in per cent of total employment) was 4,3 % in the 1990s compared to 1,6 % in the 1980s (OECD 1997:148). According to the complementarity argument, markets for skilled labor should thus be more developed in Germany than in Japan. Employment and wage data for 1992 indeed suggest that, in comparison with Japan, asset specificity of human capital plays a minor role in Germany (Waldenberger 1999: chapter 6). This can be related to differences in German and Japanese skill formation systems, which tend to be more profession-oriented and less company-based in Germany.

Corporate Governance and Stages of Economic Development

Whether consensus-based governance systems can cope with structural change seems to depend very much on the overall stage of economic development. Both Japan and Germany are successful late-comers among the industrialized nations. The late-comer position provided Japanese and German corporate systems with the incentives to create company-based skill formation and employment systems. In order to close the technology gap, companies in late-comer nations had to train employees. They could not wait for the market to provide them with the skills required by new industrial technologies. At the same time, the catch-up position created the growth environment in which relational commitments could be fulfilled.

Sectoral employment and income per head data indicate that Germany was about 30 to 50 years ahead of Japan (Waldenberger 1998:403–404). This means that the German corporate system lost the growth potential and, with it, its ability to sustain company-based training and employment systems earlier than Japan. Seen under the longer historical perspective, Japan might by now have reached the position the German corporate system confronted in the 1970s. The crucial point would then not be how to preserve the stakeholder approach of management, but how to move to a more market-based system of corporate governance.

Capital Markets in Germany: The Age of Shareholders?

Will pressure from globalized capital markets force management in Japan and Germany to further submit to shareholder interests? Empirically, the following developments are of relevance: (1) the spread of shareholder-value concepts of management, (2) the decline of banking and the growth of secondary markets for stock and debt, (3) growing efforts of companies in the field of investors relations, (4) the rise of a shareholder culture among small private investors, (5) the use of market-based management incentive systems such as stock options for managers and high-level employees. Let us first look at the German case.

The concept of »shareholder value« has become quite popular in Germany (Hilpert et al. 1999:16). The restructuring strategies of large traditional German companies, for example Siemens or Hoechst, suggest that this is more than just part of a new rhetoric. Also, large companies have become less and less dependent on bank credit. Instead they rely on in-house funds and capital markets. As a consequence, investors relations activities by large German companies started to be systematically pursued since the mid 1980s (Günther and Otterbein 1996). In the 1990s, this trend was further emphasized by a rising interest of private households to invest their savings in securities (Monopolkommission 1998). Recently, companies have been experimenting with stock-option schemes for top managers (Bernhardt and Witt 1997).

However, despite these changes and despite the well developed infrastructure of German stock exchanges, the number of listed companies in Germany is comparatively low, ownership of listed stock is still highly concentrated and stable, and high volume turn-over of stock is limited to a few publicly held companies (Schmidt et al. 1997). I am not aware that the new listings at the »Neue Markt«, the German version of Nasdaq, have US-like patterns of diversified ownership. How is this reluctance of German companies, to move away from »old« structures of ownership control to be interpreted? Three reasons are probably relevant.

Firstly, many shareholdings are kept within the corporate sector. They have a market value which is far above the book value. Selling them would result in extraordinary profits. These would be highly taxed. Therefore, not selling preserves value. This argument will, however, become irrelevant if the presently planned tax reform of the German government should take effect.

Secondly, influential owners might be necessary to balance out the influence of the labor side which is guaranteed by the German co-determination law. German co-determination law gives employees a representation in the supervisory board. Without a strong board representation of owner-interests, management might be one-sidedly controlled by the employees.

Thirdly, dispersed ownership of stock, which is the rule in the US, requires that managers of large companies have built up a reputation in the investment community for serving ownership interests. This reputation substitutes the personal trust relationship managers can entertain with stable and influential groups of owners. To build up a reputation requires that manager careers are visible to the investor community. Germany will need to develop its market for top managers in order for the market reputation mechanism to function.

The Japanese Task: Developing External Markets for Skilled Labor

Japanese companies, while experiencing the same changes in the capital market environment, confront a different labor market situation. Top management in Japan, as well as representatives of the Japanese industrial community proclaim that concepts of shareholder-value maximization are not applicable and not preferable in the Japanese context. However, the present crisis forces Japan to move to a market-based system of corporate governance in many industries. The reason is simply that the medium-term growth potential of the Japanese economy is too low for reconciling both employee and capital interests. The crucial question is: how swiftly can Japan develop an external market for skilled labor to allow for the necessary structural adjustment of labor and capital.

Economists know little about how markets develop. Most of economics is based on the assumption that markets already exist. It is therefore hard to speculate how fast markets for qualified labor services can develop. All one can do is to point out various channels of influence that support their development.

Undoing artificial mobility barriers: Seniority based pay and promotion schemes as well as company-centered pensions have long obstructed the mobility of labor. There are attempts undertaken to undo them. Larger firms, in particular, are experimenting with new performance-based wage schemes and are trying to introduce more flexible employment schemes (Dirks 1997). Further incentives for mobility result from new labor market policies. Employment policies tended to subsidize existing employment within companies in recessions. The focus here is shifting to instruments that support labor mobility (OECD 1999:205).

Developing a market infrastructure: Deregulation has widened the scope for agencies offering services in the field of recruitment and job search (OECD 1999:207). With rising unemployment, their business will further grow and contribute to the development of external labor markets.

Developing standardized skill-formation systems: The underdevelopment of external labor markets is directly related to the fact that human capital is firm-specific. One way to lower the importance of asset specificity is to offer more outside facilities and programs for skill formation. This requires a redefinition of the role educational institutions play with regard to skill formation. Japanese universities are presently under pressure to develop new fields of business as the number of students will, for demographic reasons, predictably decline. They will thus be ready to respond to new demands. However, respective strategies will need to be coordinated with the business community, and that will take time.

It is to be expected that the development of external labor markets will proceed. Changes in professions, where the requirements of standardization can more easily be met are already observable (Demes 1998:156–159). As companies reduce the number of core employees and show less willingness to bear the costs of human capital investment, the portion of more flexible employment patterns will grow, also among the more qualified groups of employees.

Conclusion

The German and Japanese relational systems of corporate governance are products of a successful catch-up era which both economies enjoyed as late-developers. The overall economic growth potential made investment in relational contracts both necessary and sustainable. Thus, this mode of governance became characteristic for both countries. In the present stage of economic development, which combines a high need for restructuring in old industries with reduced growth expectations for the economy as a whole, relational governance will no longer be supportable on a large scale. It will no longer be the characteristic feature of the German and the Japanese corporate sector. But this does not mean that in prosperous new industries, where the application of new technologies requires investments in firm-specific skills, the option of relational governance will be precluded. As can be seen by the variety of legal forms of businesses and by the variety of financial instruments, companies can choose among a whole set of governance types. In Germany and Japan, the *national profile* within this set will shift from relational to market-based forms of governance. But this will widen and not narrow the choice of German and Japanese *companies.* ◀

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