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Corporate Governance

Social Science Japan newsletter 54 takes up where it left off last issue and continues to explore the theme of governance. This time, the focus is on corporate governance. Six ISS scholars discuss the topic from various angles.

Tanaka Wataru summarizes the ISS research project and the book that inspired this issue's featured theme. He explains what corporate governance entails and the history of its transformation in Japan. Cato Susumu analyses the dynamics of the wage structure in firms and shows how firm-specific human capital affects wages under a seniority system. Focusing on middle managers as actors in corporate governance, Owan Hideo looks at how they affect firm productivity and what measure can be used to evaluate their performance. Sasaki Dan highlights the concurrent passage, in 2014, of amendments to corporate and school educational law and argues that the reforms have reduced autonomy and increased externally-imposed or top-down control. He raises concerns about the consequences of mandating the inclusion of "neutral," external members to the executive boards of large corporations.

Nakamura Naofumi and Nakabayashi Masaki explore corporate governance in its historical context. Nakamura looks at the corporate behavior and decision-making of *kennin-juyaku* (interlocking directors) in corporate acquisitions towards the end of the nineteenth century in Meiji Japan. He depicts the significant power that major shareholders of the time exercised in pursuing corporate mergers and break-ups to maximize their own profits. Focusing on the issue of moral hazard in corporate governance, Nakabayashi examines the possible distortion of market pricing and management structure through historical research of share prices and financial conditions of companies from the late nineteenth to the early twentieth century.

For the ISS Research Report, Kenneth Mori McElwain, an associate professor at ISS, shares his research interests in comparative and quantitative constitutional analysis. Using quantitative data and methods to assess the statistical relationship between constitutional content and change, he explores why the Constitution of Japan has never been amended.

This issue's Focus on ISS is the first of a three-part installment by ISS-affiliated Professors Nakamura Naofumi and Genda Yuji on *Kibougaku* (The Social Science of Hope). They introduce the Kamaishi Hope Study Project. Please refer to the ISS Contemporary Japan Group and recent publications by former and current ISS staff to learn about the exciting research and activities here at ISS.

Managing Editor, Ikeda Yoko

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Analyzing the Evolution of Corporate Governance in Japan

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From 2010-2013, teams of researchers from the Institute for Social Science collaborated in an Institute-wide Joint Research Project on "Reconsidering Governance." One team, the markets and corporations group, was led by myself and Nakabayashi Masaki. We examined corporate governance from multiple disciplinary perspectives including theoretical economics, empirical economics, economic history, civil law, corporate law, and labor law. Our findings were recently published in *Kigyō tōchi no hō to keizai* [Law and economics of corporate governance] (Tanaka and Nakabayashi 2015). In this issue of the Newsletter, five of my colleagues whose articles appear in our new book explain the main results of their individual research. This article, as an introduction, outlines the corporate governance project and the contents of the book.

The basic premise of corporate governance studies is the recognition that "complete" contracts that cover all possible contingencies cannot be written. Therefore, parties to contracts within and between firms need systems to promote the interests of different stakeholders when circumstances change. Our book examines the history of the transformation of corporate governance in Japan, explains current trends, and discusses what may lie ahead.

A complete contract would specify exactly how the parties must respond to any change affecting their contractual relationship. Removing uncertainty increases the value of the contract.

If complete contracts could be written, the institutions for corporate governance that we are familiar with would be unnecessary. General meetings of stockholders, boards of directors or any other decision-making body would be superfluous. Managers would have clear instructions on how to act in the best interests of the company in every possible scenario and therefore would not need further vetting of their decisions by a higher corporate power.

Complete contracts are value-maximizing for the firm, producing the "first best" outcome. Of course, such contracts cannot be realized, because it is all but impossible for contract writers to accurately predict what will happen and stipulate exactly how people are to respond.

Achieving "second best" outcomes requires distributing risks appropriately so and creating incentives that lead stakeholders to generate the greatest possible benefit for the firm. The systems that distribute risks and encourage stakeholders to generate value for their firms are what we call corporate governance.

Methods of corporate governance vary greatly across time and space, in part because economic and social conditions factor into the calculations made by economic entities when designing second best governance solutions. It is possible to understand corporate governance as one of the institutions that achieves governance equilibria through the interaction of economic entities.

Comparative institutional analysis relies on game theory as its fundamental method of analyzing how institutions vary and change by time and location (Aoki 2001). Our team of researchers adopted comparative institutional analysis as our primary analytical framework and applied it to the evolution of corporate governance in Japan from the prewar era through the high-growth era and on to the present. We also assessed the implications of our findings for future developments.

Kigyō tōchi no hō to keizai includes fifteen chapters divided into four parts. The four chapters of part one explain the standard theories of corporate governance and discuss the most recent research results in the field. Roles of the legal system and problems arising from the involvement of it in corporate governance are also addressed.

The history of corporate governance in Japan up to the postwar period is covered in the three chapters in part two. The established view is that in the prewar years, major shareholders served as outside directors and had considerable say in how firms were managed, labor markets were fluid, direct financing via capital markets expanded, and corporate buyouts—including hostile takeovers—were common occurrences. After the war, a very different form of corporate governance became the norm in Japan (Okazaki 1995).

However, the actual extent of the contrast between pre- and postwar governance needs further verification in more than a few areas. Using case studies and quantitative analysis, the contributors to part two present evidence describing the true state of corporate governance in the prewar period.

Part three, comprised of four chapters, features research on corporate governance in postwar Japan. The authors describe how the prewar systems that featured powerful major shareholders and fluid labor markets were affected by the economic controls imposed during the war and then changed again by the Occupation reforms, such as the dissolution of *zaibatsu* (conglomerates), before finally being transformed into "Japanese-style" management.

The chief characteristics of Japanese-style management are stable ("lifetime") employment, the main bank system, cross-shareholding, and boards of directors filled with people promoted internally. That these institutions were complementary and combined to provide the driving force for firms to generate value and sustain rapid economic growth in postwar Japan became the accepted view (Aoki and Dore 1994; Aoki and Patrick 1994).

However, this corporate governance arrangement had to be adapted to fit changing conditions. For example, in the early 1980s, deregulation and liberalization of financial markets presented firms with new opportunities (Hoshi and Kashyap 2001). It became easier for creditworthy firms to raise funds via direct financing, which weakened the main banks' influence over these firms. The collapse of the bubble economy in the 1990s accelerated the liquidation of cross-held shares involving main banks, while the percentage of shares owned by institutional investors, including foreign investors, grew.

These changes may have presaged the shift from the long-term employment and lasting business relationships of "Japanese-style" corporate governance toward an American (or prewar Japanese) style of governance based on capital markets. However, in reality this transformation was neither uniform nor unidirectional. Instead, corporate governance structures became more varied and hybrid (Miyajima 2011).

In part three, the authors report on how much the various institutions that shaped postwar Japan's corporate governance have themselves been affected by the changing business environment in recent years. Based on their analyses of recent trends, the authors also offer their perspectives of what changes may occur in the future. Interestingly, although each article concludes that the various institutions comprising corporate governance today are robust, the authors also note that tides of change are coursing through the institutions' foundations.

Finally, the four chapters in part four assess recent institutional changes relevant to corporate governance and present research findings on how corporate governance is likely to operate from now on. More specifically, recent efforts to strengthen corporate governance by revising corporate law are analyzed, as are the nature of Japan's labor laws and their likely modifications. In addition, how corporate governance can be altered to promote the development of human capital is considered.

For this issue's featured topic, "Corporate Governance," five of the contributors to *Kigyō tōchi no hō to keizai* outline the results of their research. I hope our description will raise readers' interest in our collaborative research enough so that they peruse our book.

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Employer-Learning and Firm-Specific Investment

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1. Introduction

An approach of "employer learning" focuses on the point that an entrepreneur as an employer accumulates information of labor's working, and updates the prediction on his skill[1]. This approach is useful to analyze the dynamic structure of wage in firms. Usually, it is assumed that a risk-neutral employer hires a risk-neutral employee (worker). The employer obtains information on a worker in each period. In a competitive situation, in each period, the equilibrium wage is equal to the *conditional expectation* of the (marginal) productivity level of the worker given information I_t. That is, I have the following equation:

$$W_t = E(y|I_t).$$

According to this equation, good news increases the wage and bad news decreases the wage. The formulation is tractable, and job assignment problems and human-capital investment are easily incorporated to this model. However, the argument is crucially dependent on this assumption. Indeed, it is easy to see that the wage profile is not optimal for a risk-averse worker because there is a fluctuation of his wage in future.

Freeman (1977) provided a seminal analysis on the wage dynamics for the risk-averse worker, and Harris and Holmstrom (1982) substantially developed his approach by extending the time and probability structures. Their approach focuses on the role of a firm as a partial insurance system. They show that the seniority wage system holds under a certain natural restriction, which I call the no poaching condition. The key condition requires that outside firms cannot poach the worker or the worker has no incentive to retire the current firm when new information is realized. Their framework can be substituted for the standard human capital explanation of the seniority wage system.[2]

In this essay, I explain fundamental properties of the Freeman-Harris-Holmstrom model, and discuss implications of introducing firm-specific human capital in the model. We show that firm-specific human capital is not a source of the seniority wage system, and it reinforces an insurance function of the firm. In our model, firm-specific human capital decreases rise of wages under the seniority system. Therefore, the role of firm-specific human capital in our model is contrary to that in standard models.

The rest of this essay is organized as follows. Section 2 presents basic results on the Freeman-Harris-Holmstrom model. In Section 3, I present a model with firm-specific investment and discuss its implications. Section 4 concludes.

2. Basic Results

The Freeman-Harris-Holmstrom model focuses on the relationship between an employer and an employee. The employer is assumed to be risk-

[1] Farber and Gibbons (1996), Gibbons and Waldman (1999, 2006), and Altonji and Pierret (2001) provide significant contributions on this subject.

[2] See Aoki (1988) for an argument of human capital investment.

neutral but the employee is risk-averse. The employee is high-skilled (good type) with probability 1/2 but is low-skilled (bad type) with probability 1/2. The performance of the employee is good or bad. If the employee is high-skilled (low-skilled), then the good outcome is realized with high (low) probability.

There are the two periods[3]. The employer does not know information on employee's skill, but she can learn from the first-period outcomes of the worker. That is, if the outcome is observed, the employer updates her prediction on the worker's skill in the Bayesian manner. By using the Bayes' rule, it is easy to see that (i) if the good outcome is observed in period 1, then the posteriori probability that he is high-skilled (resp. low-skilled) is upwardly (resp. downwardly revised) revised, and (ii) if the bad outcome is observed in period 1, the posteriori probability that he is low-skilled (resp. high-skilled) is upwardly (resp. downwardly revised) revised. A fundamental assumption of the present model is that outside employers can learn performances of the employee. Then, the leaning process is *symmetric*.

By this Bayesian learning, the following is obtained:

$$P(G|G) > P(G) > P(G|B),$$

where $P(G)$ is the probability of good outcome under no information and $P(G|G)$ (resp. $P(G|B)$) is the probability of good outcome if good (resp. bad) outcome is realized in period 1. The good outcome increases the posteriori probability of the good outcome and the bad outcome increases the posteriori probability of the bad outcome.

As a consequence, the expected productivity is updated in the following manner:

$$E(y|G) > E(y) > E(y|B),$$

where $E(y)$ denotes the *ex-ante* productivity under no information, and $E(y|G)$ (resp. $E(y|B)$) is the updated productivity if good (resp. bad) outcome is realized in period 1.

The wage profile consists of three components: (1) the wage W_1 in period 1, (2) the wage $W_2(G)$ in period 2 when the good outcome is realized in period 1, (3) the wage $W_2(B)$ in period 2 when the bad outcome is realized in period 1. Since we assume that firms are competitive, the wage profile maximizes the intertemporal expected utility of the worker given the zero-profit condition of the firm.

First, I focus on the first-best situation. Since one agent is risk-neutral, and the other is risk-averse, the former must bear all risks and the wage profile is constant independently of the performance. Moreover, the wage level is equal to the ex-ante expected productivity:

$$W_1 = W_2(G) = W_2(B) = E(y).$$

The perfect insurance is achieved in the equilibrium.

Next, I consider the second-best situation. Note that that the ex-post expected productivity of the high-performance agent is higher than the ex-ante expected productivity. If the good outcome is realized, the employee can earn the wage, which is higher than the first-best wage, by retiring the present firm and moving other ones. This possibility cannot be denied unless the agent can make a commitment to working at the current firm. However, such a commitment is not usual in real economies.

I introduce a constraint that requires that wage in period 2 is not smaller than the ex-post productivity, which is updated by using information on the outcome in period 1 (*no poaching condition*):

$$W_2(G) \geq E(y|G)$$

and

$$W_2(B) \geq E(y|B).$$

Under this condition, working at the current firm is weakly better than moving to another firm for the employee. As a result, outside firms cannot poach the employee in the beginning of the period 2.

Given this condition, the perfect risk-sharing cannot be achieved. A fundamental property of the equilibrium wage profile is as follows:

$$W_1 = W_2(B) < W_2(G).$$

A notable point of the wage profile is that it corresponds to the seniority wage system. If the worker fails his project, his wage does not change, but if he succeeds, his wage rises. The pay cut never occurs, and there is a positive probability of an increase in salary.

[3] Freeman (1977) considers the two-period structure, while Harris and Holmstrom (1982) assume the general time structure of finite horizon.

There are several explanations of the seniority wage system, but most of them are associated with the existence of human capital. The Freeman-Harris-Holmstrom model is important because it can explain the seniority wage system without human capital. The key assumption is risk aversion. If the worker is risk-neutral, then the second-best wage profile is identical with the first-best one. The model sheds light on an insurance aspect of the seniority wage system.

Before moving the nest section, we comment on the access to credit markets. In the preceding analysis, it is assumed that the worker cannot access to credit markets. This assumption is crucial. Indeed, if the access is completely possible and there is no borrowing constraint, then the first-best outcome is achieved. An interesting point is that the seniority wage system can achieve the outcome, and the profile is steeper wage than that yielding the second best outcome.[4] This suggests that a wage profile in a major company is steeper than that in small and medium sized company since workers in major companies can access to the credit market easily. This is consistent with observations in the United States and Japan. Thus, there is a complementarity between the seniority wage system and the access to credit markets. As argued above, the access to credit markets enhances the seniority wage system. Moreover, if the seniority wage system is established, then it is easy to lend money for the bank or other lenders. Therefore, two systems complement each other.

3. Firm-Specific Investment

In this section, I argue how firm-specific investment affects the wage profile under the equilibrium[5]. Suppose that the employee accumulates skills in the firm employed in period 1. The production level increases but the skill is completely firm-specific. The production levels when he moves to other firms do not change. If the ex-post productivity levels are denoted by $E^*(y|G)$ and $E^*(y|B)$, I have $E^*(y|G) > E(y|G)$ and $E^*(y|B) > E(y|B)$ because of firm-specific investment. In this case, $E(y|G)$ and $E(y|B)$ represent the production levels when the employee is hired by outside firms. Note that the no poaching condition is relatively relaxed in this case. The condition requires $W_2{}^*(G) \geq E(y|G)$. This condition is the same as that in the case without firm-specific investment. The employee's productivity in the current firm is given by $E^*(y|G)$. Then, it is possible that the wage is smaller than the ex-post productivity in the presence of firm-specific investment, i.e., $E_2{}^*(y|G) > W_2{}^*(G)$. This means that the restriction is essentially relaxed because of the commitment effect of firm-specific investment.

A fundamental property of the wage profile is the same as that in the case without firm-specific investment:

$$W_1 = W_2(B) \leq W_2(G)$$

In the present case, I can show that if firm-specific investment is sufficiently productive, the first-best risk-sharing is achieved, and thus it is the case that $W_1 = W_2(B) = W_2(G)$; otherwise the risk-sharing is not perfect, and $W_1 = W_2(B) < W_2(G)$. Under the latter case, it must be true that $W_2{}^*(G) = E(y|G)$. That is, the condition is binding for the good-performance case.

Waldman (1984) also examines the role of firm-specific investment in a model of employer leaning. He assumes that the leaning process is not symmetric in the sense that the current employer can observe the employee's output but potential employers outside of the firm cannot observe outputs. He shows that firm-specific investment can improve the ex-ante efficiency. Therefore, the implication of his results is similar to ours. However, he focuses on production efficiency, but we pay attention to distributional efficiency.

It is also notable that the seniority wage system is not observed in the Waldman-type model. That is, the rent from an accumulation of human capital is paid in advance in the model of asymmetric learning. Therefore, the wage often decreases. In our model, the seniority wage system holds under firm-specific investment.

4. Concluding Remarks

This essay explained the essence of the Freeman-Harris-Holmstrom model and the implications of

[4] For a rigorous argument, see my article published in [9].

[5] Throughout this section, we assume that workers cannot access the credit market.

firm-specific investment. One of the main observations is substitution between the seniority wage system and firm-specific capital. This is contrary to the conventional arguments.

I comment on some possibilities of extensions. We consider a simple two-period model with binary structures. Our model with firm-specific investment can be extend to the case with a general probability structure and a general time structure as studied in Harris and Holmstrom (1982). The results will be robust under such an extension. However, this extension may be important for empirical purposes.

More importantly, the problem of job assignment and promotion is not considered in our model. However, firm-specific investment is closely related to the problem. Thus, it is important to examine the interaction between firm-specific investment and job assignment in the present model. Considering asymmetric learning under risk aversion is also meaningful. Most works on the employer learning with a risk averse worker assume asymmetric learning. However, there is much information of workers which outsiders cannot know. These extensions remain for future research.

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The Role of Middle Managers and Performance Evaluations[1]

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Management cannot formulate strategies and decisions effectively, if middle managers do not allocate resources accordingly. This article reviews issues of selection, assignment, and evaluation of middle managers and their management of workers from the viewpoint that middle managers are actors in corporate governance. It discusses, in particular, mechanisms through which middle managers create value, performance evaluation systems through which they manage workers, and economic problems that arise in the process. This article relies on insights derived from personnel economics, especially my own research that exploits personnel records from Japanese companies.

Value of middle managers

The middle manager affects firm productivity through five roles: planning and budget allocation, information collection and aggregation, coordination across business functions, performance evaluation and task assignment, and staff development, including training, motivating, and supervising employees. How much do middle managers contribute to the firm profit through these roles? Owan, Takahashi, Tsuru, and Uehara (2014) evaluate the branch managers' productivity using performance records of salespersons from one of the largest Japanese car sales companies. According to our research, one standard deviation improvement in branch manager productivity leads to a 9.3 percent increase in branch gross profits from new car sales. This means that just replacing bad managers with good ones could lead to a 10 to 20 percent improvement in the branch profitability. This finding is consistent with Lazear, Shaw, and Stanton (2014), who analyzed employee productivity records at a US information technology service firm.

Another interesting finding in Owan, Takahashi, Tsuru, and Uehara (2014) is that although there are large differences in the branch manager productivity, the magnitude of the learning effect through the accumulation of experience is quite small—1-2 percent at the peak. This result implies that screening out good managers is far more effective than training bad managers to make them good.

Selection of Managers

What are the characteristics of those who are promoted to the ranks of managers, and what processes are used to select them? Using records from the alumni office of Stanford University Graduate School of Business, Lazear (2012) finds that C-level executives such as CEOs, COOs, and CFOs are mostly generalists who have experienced a variety of job functions. Frederiksen and Kato (2013) also analyze the relationship between job history and current job level using employer-employee matched data from Denmark. They

[1] I would like to thank Professor Tsuyoshi Tsuru of Hitotsubashi University, Professor Shingo Takagashi of International University of Japan, and Katsuhito Uehara of Tenri University for allowing me to introduce our unpublished co-authored papers in detail in this article.

find that workers with broader job experience tend to move up to the level of top executives—results similar to Lazear (2012). They also find that: (1) people with higher education are more likely to acquire broader job experience; and (2) those who acquire broader functional experience within the same firm have a higher chance to become top executives than those who do so by hopping jobs.

In our study discussed earlier (Owan, Takahashi, Tsuru, and Uehara 2014), we also find evidence consistent with a positive association between the breadth of functional experience and the incidence of promotion to branch manager positions even at the middle management level. Specifically, manager productivity is higher for those who have experienced other functions than new car sales, including used car sales, service, and corporate administration. Having broad functional knowledge may help branch managers acquire information and coordinate between functions, which may, for example, facilitate cross-selling.

The pattern of branch manager assignments portrayed in our study is also interesting. The branch managers' tenure at one branch is two to three years on average. They typically start at small branches and move up to larger ones. Along the way, some are promoted to the ranks of area managers or directors in the corporate office, and others are laterally transferred to middle management in the corporate office. A small number of branch managers are demoted to non-managerial positions. We argue that there are three interpretations of this pattern.

First, this pattern of starting at small branches can be interpreted as a sorting process through which the firm promotes workers with managerial ability and screens out those without it. The reason why firms start the process at small branches is that lacking a track record, new managers have expectations of relatively low productivity and thus matching them with small branches is desirable. The second interpretation is that the assignment system works as a training process in which managers acquire skills to manage branches. Since large branches require broader management skills, starting at small branches allows them to expand their skill set gradually as they move up to larger branches. Third, this process can be seen as an incentive system in which branch managers' pay increases as they move to larger branches. Pay rates increase because their performance-based pay is linked to the total branch profit. Larger branches also offer a higher social status. The rewards associated with a move to larger branches provide managers with strong incentives to work hard to succeed and rotate to larger branches.

Our study indicates that the first two mechanisms have only fairly limited effects if any, leaving the possibility that the role of the incentive system may outweigh the first two.

Performance Evaluation Systems

The third role of middle managers—performance evaluation and task assignment—critically affects firm productivity through human resource allocation. Which performance measures one should use to evaluate the ability of employees is not a trivial question.

Although individual performance measures, including objective and subjective metrics, are used in many jobs, they often discourage employees from taking into account their actions' impact on the performance of others or other divisions, thus leading to less cooperation or coordination. Individual performance measures are also prone to manipulation. To encourage cooperation and maximize firm value, using stock price, accounting firm profits, or other group performance measures is more reasonable. The problem with this approach is that since the impact that one employee could have on broad-based measures such as the company stock price is so small, there will be free-riding. Furthermore, these measures are affected by many factors that are beyond the control of one employee. Evaluations linked to those measures will expose employees to excessive income risk.

Therefore, at most firms, both group and individual performance measures or group performance measures that have a smaller coverage than the firm-wide profit measure are used. For middle managers, many firms use a mixture of group incentives that are linked to the division profit or the firm-wide profit (such as stock option plans) and individual incentives that are mostly implicit, such as promotion based on performance appraisal. For non-managerial employees, individual pay levels or pay raises are often linked to subjective performance evaluation (e.g., the degree of fulfillment of targets set under the management by objective technique) while bonuses, in the spirit of profit sharing, are linked to the firm's accounting profit. It is also common that a firm offers matching contributions in employee stock ownership plans so that the employees pay more attention to the firm-wide performance.

Earlier, we argued that one problem with relying on individual performance measures is that they hinder cooperation and coordination with other business units or functions. This is what we call the *multitasking agency problem*. In general, most jobs consist of multiple tasks. For example, loan officers at banks, in cooperation with other divisions, need to develop new clients and examine their applications as well as advising existing clients on a variety of issues including asset management, the issuance of corporate bonds, etc. Their job description should include non-routine tasks such as handling complaints and solving problems as well as routine tasks. Managers typically have many non-routine tasks, including problem solving, training and mentoring subordinates, and coordinating with other units and functions.

When employees face multiple tasks, designing an incentive scheme becomes challenging. Since the performance on some tasks is easier to monitor and evaluate than other tasks, hard-to-measure tasks are either neglected or given smaller weights in evaluation leading to distorted allocation of effort, attention, and time. Since the performance on non-routine tasks is typically more difficult to measure than that on routine tasks, we need to pay more attention to the performance evaluation of managers whose job have many non-routine components.

Objective and Subjective Measures

To mitigate multi-tasking agency problems, it is effective to combine objective and subjective measures in evaluating employees' performance. As a principle, we should look for objective measures as much as possible in designing an incentive scheme for the following reason: compensation contracts based on objective measures are legally enforceable thus there are no concerns about the firm's commitment, which may arise for pay contracts that are based on subjective measures because the firm may act opportunistically by misreporting performance.

In a job that has multiple tasks, however, it is rare to have objective performance measures that monitor the performance of all the tasks—a situation where the multi-tasking agency problem arises. In such occasions, the firm can mitigate the distortion by combining subjective appraisal with objective measures. But this approach is a double-edged sword because subjective evaluations inherently have bias problems—centrality and leniency biases. Mechanisms to minimize such biases need to be implemented at the same time.

Takahashi, Owan, Tsuru, and Uehara (2014) show that firms actually use a mixture of objective and subjective measures to mitigate the multitasking agency problem. The study looks at three tasks of salespersons: selling, mentoring trainees, and marketing activities for corporate customers. Since salespersons receive performance pay based on the gross profits they earned, they are likely to focus too much on selling activities neglecting other important tasks. This study shows that branches that have more trainees or those that have more sales to corporate customers tend to have subjective performance ratings less sensitive to sales performance. In other words, as multitasking agency problems become more severe, the weight given to sales performance in determining pay decreases.

Biases in Subjective Performance Evaluations

It is a human nature that colleagues will relate to each other differently. Thus, it is expected that personality differences often lead to favoritism or discrimination. Using performance appraisal records from a large manufacturer, Kawaguchi, Owan, and Takahashi (2015) analyze what biases exist in evaluation. We did not observe any significant favoritism or discrimination associated with differences in gender, education, recruitment target group (new graduates vs. mid-career hires), or marital status. The study, however, reports some evidence that an evaluator-evaluatee pair with different identity characteristics may have more severe centrality bias in subjective performance evaluations—ratings are attenuated and become less extreme. This may mean that the evaluator cannot collect sufficient information to make a fair judgement of subordinates with different demographic characteristics due to less frequent interactions or different work style and experience, which in turn induces the evaluator to avoid extreme ratings. Kawaguchi et al. find such centrality bias when there are differences in gender and education between the evaluator and the evaluatee. This may partly explain why unmarried employees and less educated employees are less likely to be promoted, amplifying the marriage and college premium.

One problem with biases in evaluation is that they lead to wrong decisions in job assignment—failing to promote the right people or promoting the wrong people. Another problem is that employees who are dissatisfied with unfair decisions quit their jobs. In fact, Takahashi, Owan, Tsuru, and Uehara (2014) show that evaluation ratings that are substantially below the level suggested by objective evaluation measures are associated with higher turnover even after controlling for the evaluation ratings themselves.

Conclusion

There is a large variation in the productivity of middle managers. Hence, it is important to understand how they affect firm value and optimally design the process of selecting, training, evaluating, and motivating them. Furthermore, to govern the organization effectively and allocate human resource efficiently, it is critical to reduce biases in evaluation by optimally combining objective and subjective performance measures. These tasks are becoming more important in maintaining competitive advantage because the competition for talent becomes increasingly intense and global as Japanese firms expand their operations on a global scale.

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Governance and Self-Governance

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The 20th of June 2014 shall be a day to be mourned in the history of corporate governance in Japan. Amendments to the corporate law and to the school education law passed the national congress on the very same day, both for worse than for better. Although receiving little public notice, there are alarming similarities between the two amendments. Their lack of attention may have resulted from the tendency to discuss the two separately. The education "reform" led by the Liberal Democratic Party has been criticized mostly for its reactionary, nationalist, and history-denialist tint. In contrast, the corporate law has been discussed in purely economic, non-political terms, eliciting much less criticism. It is daunting to realize, however, that these twin reforms are not merely coincidentally synchronized but substantively and purposefully aligned in strikingly concurrent directions.

For readers unfamiliar with these reforms (or with Japanese laws and regulations in general), they are outlined as follows. The gist of the corporate law reform was to mandate the inclusion of external members in corporate executive boards. Meanwhile, the school education law was rewritten to restrict the autonomy of academic departments in each university and thus to centralize the administrative power in university headquarters. Taken together, a common theme becomes evident: both reforms will reduce autonomy and replace it with externally imposed control.

Before detailing specific aspects of the reforms, it may be useful to glance at commonly cited criteria for good governance, such as autonomy, democracy, participation, and transparency. In essence, these criteria stipulate that those who are affected by the institutional decisions should be included in decision-making procedures. In other words, stake-holders are encouraged to engage in the (self-) governance of their institutions.

Curiously, but hardly surprisingly, these common criteria are closely in line with economic theory. In economics, when a decision influences those who are outside of the decision making, such influences are called externalities. When the outsiders benefit (or conversely, suffer) from decisions they have not made, the effects are called positive (negative) externalities, or external economies (diseconomies). Typical textbook examples of externalities include economic transactions that affect not only sellers and buyers, who have agreed upon the deals, but also the general public such as neighbors or the society at large who lack opportunities to express their (dis)approval. Left alone, however, the decision makers, sellers and the buyers, for example, will freely agree upon deals that maximize their own utility, without due regard to externalities.

Therefore, if our objective is to optimize the aggregate utility of everyone in society, recipients of externalities, i.e., those who are affected by the decisions, should be allowed to have their say. Put differently, no stake-holder should be left out of decision making. Alternatively, those stake-holders outside of the decision making need to be duly compensated, that is, the recipients of positive externalities should pay therefor, whilst those of external diseconomies should be remunerated commensurately for their disutility. In economic theory, this is called the internalization of the externalities. When all externalities are fully internalized, the decisions and the resultant resource allocations are socially optimized. The more externalities are left uninternalized, the more decisions are socially inefficient.

Coming back to the twin amendments, it is unmistakably clear that both are pointing in the direction of externalising, not internalising, corporate decision making systems. This is the exact opposite from what elementary economic theory teaches us.

The amended corporate law, mandating the inclusion of external members on executive boards, would be able to heed the economic theory successfully if, and only if, those external members are selected from amongst the stakeholders, i.e., those affected by corporate activities, such as customers, trade partners, or neighbors who are not shareholders and thus would otherwise not have a say in corporate decisions. In this way, the participation of these external board members could be expected to internalize the externalities created by the corporate activities. In reality, however, mandated external board members are expected to be "neutral" regarding corporate interests, that is, in practice, refusing the role of a stake-holder. Then, what contribution can their participation possibly bring to corporate governance?

Neutrality implies either objectivity and honesty or ignorance and indifference. There is scarcely any scientific reason to believe in the former, i.e., the innate benevolence of mere mortals. In economic terms, these neutral board members have little incentive to work hard for the corporation, where, by definition, they hardly care. In contrast, internal board members, who are employed by the corporation, have far more obvious economic incentives not to ruin their own company. This argument becomes trivially clear when applied to institutions other than corporations. How many of us would seriously argue that our national congress should recruit a certain fraction of nonresident foreigners who are "neutral" to our national interest? Or, how many families would like their household finances managed by a committee that includes strangers with little interest in their families' well-being?

Another argument ostensibly supporting the corporate law reform is a human resource argument, simply that the pool of suitable corporate executive candidates would be broader if recruited from outside of the corporation. What about the case of personal finances? An individual is undoubtedly the narrowest set of candidates; why not recruit a handful of external superintendents who keep nagging us about what to buy and what not to buy? Besides, historical facts prove that even a large country thousands of times the size of the largest corporation on the planet has sometimes failed to govern internally, like the Reichstag in the 1930s Weimar Republic, not to mention the LDP's dishonest Abe administration plotting to undermine the peaceful spirit of the Constitution. Surely, a large pool inevitably means there are a few Adolfs and Abelfs in it, especially when we do not know everyone in the pool closely enough.

Yet another push for the corporate law reform has been the debatable, rather than arguable, claim that the presence of external board members is, whatever theory aside, "empirically" beneficial for the performance of the corporation, as measured, for instance, by the stock price. In fact, this claim is triply debatable. First, if it is genuinely profitable, why would it need to be enforced by law? That so many companies did not voluntarily include external board members suggests that it has not always been profitable. An empirically "neutral" interpretation here should be that it was profitable for some, but not all, companies, which had already volunteered even before the law was amended, in which sense there exists corporate heterogeneity unobservable to researchers and lawmakers. Second, it may be a mere advertising signal for a good, solid company, in which case those that adopt it can enjoy a premium over companies that do not, though the premium disappears if all companies follow suit. Third and finally, even if there exists correlation between the presence of external board members and corporate performance, it does not prove causality. The correlation may well be purely symptomatic, in which case what is the point in enforcing a mere symptom?

The amended school education law, reducing departmental autonomy and substituting it with direct control from university headquarters, suffers a similar defect. The history of autonomy in each academic department in universities is as old as the history of universities altogether. There are two solid reasons why such an institution has been the global standard for many centuries. On one hand, academic departments are highly specialized, and in effect all their decision matters are inseparably related to their specialization, so that these matters are difficult for anyone outside of the specialization to decide. It would make far more sense to invite external decision makers from similar departments in other universities than from the same university's headquarters, which are generally ignorant about the specialization. It is the latter, however, that the amended law stipulates. Relatedly, on the other hand, most departmental decisions affect almost solely the department itself. Past graduates, their employers, and prospective future students and their high-school teachers have a stronger claim to being stake-holders than other departments in the same university, let alone the headquarters. Taken together, giving the university headquarters a strong voice in departmental decisions is bound to produce the same pitfalls as external members rambling at corporate executive board meetings.

Viewed closely, there are two further defects unique to the school law amendment which are not found in the corporate law reform. Firstly, it prohibits the election of the university executive (president, or vice chancellor) although, technically, such elections were not legally decisive even in the preceding systems. A similar regulation has been in effect in primary and secondary schools, where headmasters were legally obliged not to conduct opinion polls among subordinate teachers. Again, the key here is that it was merely opinion polls with no legally enforceable effect whatsoever that were regulated by the authorities. These regulations are clearly promoting the ignorance and indifference of the executives, presumably under the dubious pretext that they should serve as "neutral" decision makers. Secondly, the centralization of decisive power has been idealized, based upon an embarrassingly elementary misunderstanding in systems engineering, as if it would facilitate institutional decision making. Scientifically, on the contrary, processing of information can easily be congested, if the channels are concentrated in one place, say, the headquarters, which is why delegation is commonly recommended. The top-down architecture mandated by the school law reform will not only suboptimize decisions made but also slow them down.

Democratic peace, the general historical fact that a war is unlikely to break out between democratic countries, teaches us how important it is to reflect the opinions of stake-holders on important decisions, including, although by no means confined to, national security. Only a small minority of powerful politicians and industrial giants profit from a war, at the expense of millions of lives. Therefore, if the decision making procedure is democratically accurate in that every stake-holder is duly represented according to their stakes, then those millions whose lives are at stake always vote against war.

Viewed from the flip side, the real danger materializes when those who are not going (nor have children to be sent) to the battlefield decide to sign the declaration of war. And when those who are neither going nor sending their students to war decide to sign on to military research. And when those who are neither going nor sending their colleagues to the unemployment lines decide to wreck the company.

Preventing these dangers justifies autonomy, that is stake-holders' self-governance. Amongst those three principles newly added in the postwar Constitution of Japan that had been absent in the prewar Imperial Constitution, regional autonomy is somewhat less publicly recognized than the other two, peace and gender equality. Previously, regional mayors and governors had been appointed by the central Imperial government, not locally elected. Recent waves of municipal mergers and talks on federalism with larger regional states, may possibly be aligned in the direction of confiscating autonomy from small jurisdictions to subordinate them to larger, more centralized top-down architectures. Science shall stay alert.

Buyouts and Boundaries of Firms in Meiji Japan: Tagawa Mining and the Hoshu Railway, Meiji Mining, and Mitsui Mining

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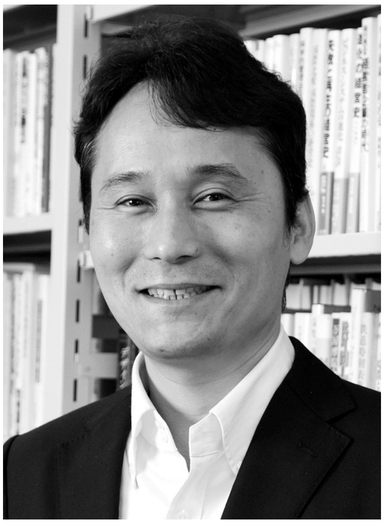

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Introduction

The purpose of this paper is to examine the behavior patterns of business owners and managers known as *Kennin-Juyaku* (interlocking directors), in the light of changes in 'boundaries of firms' in coal mining operations in the Chikuho region of northern Kyushu. Through this research, I would like to consider some distinctive aspects of corporate governance in Meiji Japan.

As is widely known, the great power and influence of major shareholders was a hallmark of corporate governance in Japan prior to the World War II, although not thereafter (Okazaki 1995). By virtue of their status as major shareholders, big investors were also installed as directors of multiple firms and could thereby wield direct influence over a variety of businesses. These investors (*Kennin-Juyaku*) did not operate independently but tended to form large or small groups in order to make investments and do business collectively. Recent work has begun to analyze such nationwide networks of wealthy individuals in the prewar period and elucidate trends among groups of investors throughout Japan (Suzuki, Kobayakawa, and Wada 2009), but as yet no study has analyzed the corporate behavior of *Kennin-Juyaku* (interlocking directors) at the level of actual decision-making.

This paper will examine the status and role of *Kennin-Juyaku* within the process of a Meiji-era corporate acquisition, focusing mainly on the Tagawa Mining Company (later Mitsui Mining Co.'s Tagawa Coal Mine), located in the Tagawa district of Fukuoka Prefecture. This, I hope, will help reveal the attitudes and behavior of shareholders and owner-managers in Japan with respect to corporate acquisitions around the turn of the twentieth century.

1. Vertical Integration of Mining and Rail: Tagawa Mining Co. and Hoshu Railway

Tagawa Mining Co. was established in 1889 by a group of investors drawn mainly from Tokyo and Osaka. The company commenced operations the following year in the Yugeta section of the Tagawa district and, by 1892, held one million yen in capital and was operating one of the largest mines on the Chikuho coal fields.

In the early days, Tagawa Mining Co. transported its coal in horse-drawn wagons to the banks of the nearby Chuganji River, a tributary of the Onga River. From there, it was carried by boat to Kanda Station, which opened in February 1893 as the terminal of the Chikuho Railway and was then transported by rail to the ports of Wakamatsu and Moji to be shipped overseas. When the river was running low, however, boats could not travel on the Chuganji, and large volumes of coal piled up outside the mine. During the first half of 1893, at a time of peak demand, the company reportedly had to forfeit an invaluable business opportunity when low water prevented it from shipping coal for as long as 60 days (Tagawa-shishi hensan Iinkai, 1976, p. 887). To resolve this problem, Tagawa Mining Co. urgently needed railway access in the immediate vicinity of the mine itself. In 1893, the company approached the Chikuho Railway with a request for the construction of a branch rail line from Kanda to Ikari (Gotoji) near the mine. The Chikuho Railway, concerned that a hold-up problem could arise, responded by proposing a strict long-term shipping contract. As a result, negotiations on building a new branch line broke down, and Tagawa Mining Co. ultimately joined forces with another coal-shipping railway in the Chikuho region, the Hoshu Railway, which was still being developed at the time.

The establishment of the Hoshu Railway began in 1888 at the instigation of influential residents of the Buzen area in Fukuoka Prefecture. Incorporated in 1890 with 1.5 million yen in capital, the railway was expected to be based in Yukuhashi and have a main line running from Yukuhashi to Ikari (Gotoji). From the beginning, however, it had problems arising from unpaid stock, and after long-delayed construction on its new line finally began, work had to be suspended due to flooding in 1891. The company's financial struggles continued; as of August 1893, it had yet to commence actual operations (Nakamura, 2014).

Following the breakdown of negotiations with Chikuho Railway for the construction of a new railway link, Tagawa Mining Co. was painfully aware of the disadvantages of relying on an external party to transport its coal. Sensing an opportunity, the company formulated a plan to join forces with the Hoshu Railway that would enable shipping to be handled internally. The merger plan, prepared at the initiative of Tagawa Mining's president, Fukushima Ryosuke, envisioned the following arrangement. First, all the unpaid stock among the Hoshu Railway's 30,000 shares (valued at 2 yen a share) would be amortized, reducing the railway's capital by two-thirds, to 500,000 yen. Next, 1.5 million yen in new capital would be raised, half of which would be used to finance the construction of a railway line between Yukuhashi and Ikari, with the other half used to purchase the mine and offset development costs. The railway would then acquire Tagawa Mining Co., which would become its subsidiary. At that time, it would issue 30,000 new shares of stock for which payment would ostensibly proceed apace, with 5,000 shares sold locally and the remaining 25,000 sold to "new shareholders" in the Kansai region—primarily Tagawa Mining's shareholders. This meant that Tagawa Mining's investors would own at least 60 percent of shares in the revitalized railway, far exceeding the 15 percent allotted to local shareholders in Fukuoka Prefecture.

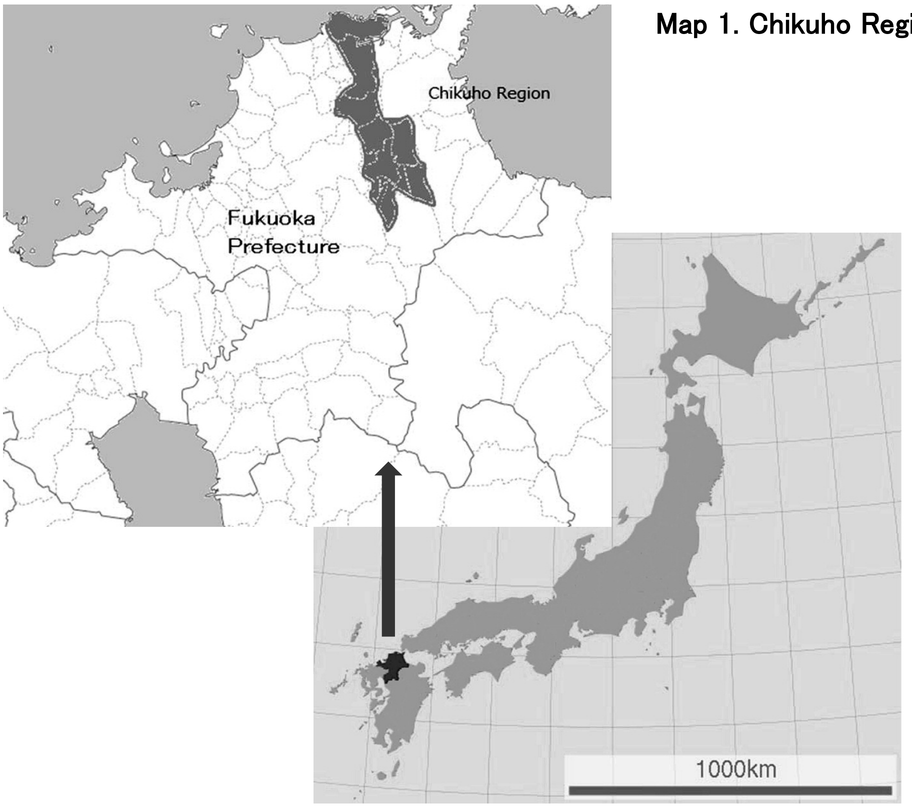
To provide a sense of regional balance, five of the ten directors and auditors of the new Hoshu Railway would be from Osaka and the other five would be from Fukuoka. Five of these same ten, however, would also be former corporate officers and shareholders of Tagawa Mining Co. Furthermore, former Tagawa Mining shareholder Matsumoto Jutaro would assume the post of executive director; Fukushima Ryosuke, the former president, would serve both as a director and a division manager; and another former shareholder, Murai Masatoshi, would be appointed general manager. These three would form the core of the railway's management.

2. Horizontal integration: Tagawa Mining and Meiji Mining Co.

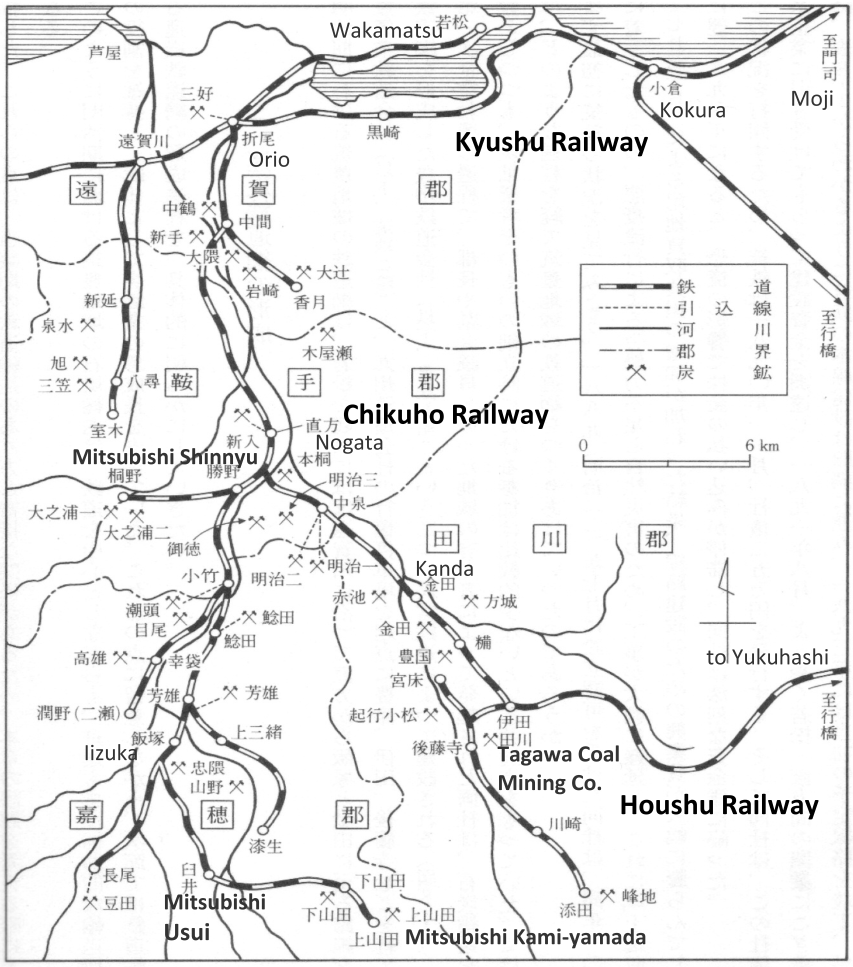
With the establishment of the new Hoshu Railway in 1894 and the opening of a new rail line linking Yukuhashi, Ita, and Gotoji in 1895, Tagawa Mining's shipping problems were alleviated. Through vertical integration with the Hoshu Railway, Tagawa Mining addressed its biggest challenge, getting its coal to port, and successfully paved the way for rapid expansion. This is considered a classic example of the use of integration to resolve a hold-up problem arising from a bilateral monopoly (Hart 1995). In the absence of a change in external circumstances, Hoshu Railway's rail division and mining division (Tagawa Mining) would be inextricably bound to one another.

In 1899, however, the Kyushu Railway (having merged with the Chikuho Railway) opened the Ita line, which ran between Kanda to Ita, and thereby ended the Hoshu Railway's local monopoly. In addition, increased mining along the Hoshu Railway line had left the railway with a critical shortage of capacity, which made Tagawa Mining less important to the railway as a source of demand. The bilateral monopoly that had brought the two enterprises together had now

Map 1. Chikuho Region and Fukuoka Prefecture



Map 2. Coal Mines and Railways in the Chikuho Region in 1913



資料：井奥成彦「鉄道開通以降の筑豊石炭の輸送について」（荻野喜弘編著『戦前期筑豊炭鉱業の経営と労働』所収）290頁。

Source: Ioku 1990: 290.

come undone. From the railway's standpoint, the prospect of a hold-up was no longer a serious concern and the advantages derived from vertical integration with Tagawa Mining (reduction of transaction costs) were diminished. Diminished advantages alone would not constitute a sufficient reason for decoupling the two sides, but increases in internal transaction costs as the organization expanded was a feasible justification (Williamson, 1985). Higher internal transaction costs caused by a merger with a completely different type of business—a mining firm—would probably be more important to the railway than merely expanding its corporate boundaries. At the time, the Hoshu Railway had come under criticism from outside parties for lax corporate governance and for not adequately preventing wrongful actions by mine managers and employees.

The Hoshu Railway's owner-managers and *Kennin-Juyaku* (interlocking directors) decided to streamline their mining operations by merging Tagawa Mining and its vast coal reserves with the Meji Mining Co., another firm they controlled. In response to the reduced need for vertical integration between the railway and the mining operation, Matsumoto and other *Kennin-Juyaku* did not simply seek to maximize the profits of the Hoshu Railway alone but were able to incorporate the mining operation into the domain of various other businesses in which they were involved. They sought to stabilize operations and maximize earnings by decoupling Tagawa Mining from the Hoshu Railway, which had failed to properly oversee its subsidiary, and merging it with Meiji Mining Co., where it would be overseen by the skillful mining executive Yasukawa Keiichiro. In other words, they selected a new agent, Yasukawa, deemed capable of attaining the goal of eliminating the moral hazard posed by Tagawa Mining.

This horizontal integration of Tagawa Mining with Meiji Mining Co., based on the principle, espoused by Matsumoto and others, that the company belongs to the shareholders, was an effort to sever the link between the Hoshu Railway and its mining subsidiary and entrust the management of the latter to Meiji Mining Co. The merger, however, was strongly opposed by the workers, including crew bosses, and caused serious disruptions that not even a capable manager like Yasukawa could prevent.

3. Divestiture: From Tagawa Mining to Mitsui Tagawa

Matsumoto and the others involved with Meiji Mining Co. abandoned their hopes for the long-term rehabilitation of Tagawa Mining and sought instead to profit by selling off the mining firm. In March 1900, a mere eight months after acquiring it, Meiji Mining Co. sold Tagawa Mining to Mitsui Mining Co., earning a short-term profit of 300,000 yen on the sale. For Matsumoto and the other *Kennin-Juyaku* who had overseen the decoupling of Tagawa Mining from the Hoshu Railway, the acquisition and subsequent divestiture constituted a qualified success, at least in the short term.

Mitsui Mining Co. dispatched the mining engineer Yamada Buntaro (a graduate of the Imperial University's College of Engineering, Mining and Metallurgy Department) to Tagawa to serve as general manager and chief engineer. By instituting a system of direct control and forward-looking labor measures that included comprehensive benefits, Mitsui Mining Co. was able to gain control over the workplace. The new labor policies, coupled with additional capital investment, led to a rapid increase in coal production at Mitsui Mining's Tagawa Coal Mine (Mitsui Tagawa). Under the stable corporate governance practiced by the Mitsui *Zaibatsu* (conglomerate), Mitsui Tagawa eventually became the largest coal-mining operation in the Chikuho region.

Conclusion

In this paper I have examined the background and significance of a corporate acquisition of the sort that frequently occurred in the Meiji era, with attention to changes in corporate boundaries. The outcome of this acquisition was a series of corporate actions consisting of (1) the merger and subsequent separation of Tagawa Mining Co. and the Hoshu Railway and (2) the acquisition of Tagawa Mining by Meiji Mining Co. and its subsequent sale to Mitsui Mining Co. This behavior illustrates how the issue of corporate boundaries in relation to the peculiarities of assets is intertwined with the conduct of corporate governance at the time, which was heavily influenced by the wishes of

Kennin-Juyaku (interlocking directors). The process constituting (1) above corroborates the argument presented in Hart (1995), which holds that corporate boundaries are determined through comparisons between the advantages of a merger (addressing a hold-up problem) and the cost (moral hazard). In the process constituting (2) above, the nature of corporate governance at the time is revealed in the behavior of owner-managers who freely split up a business to maximize their own profit based on the premise that a company belongs to its shareholders. In the Meiji period, shareholders held considerable power, and a company was clearly regarded as an entity that could be sold off to turn a profit for shareholders (Iwai 2003).

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Dawn of the Capital Market and Corporate Governance: Finance, Governance, and Stock Prices at the Tokyo Stock Exchanges

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Economists usually define property rights as a set of "residual control rights" and the "residual claims." Residual control rights are the authority to utilize an object as the holder likes as long as the agent satisfies legal, contractual, and customary constraints. A residual claim is the right to receive what remains after financial obligations have been performed. If both are bound together, the holder of both exercises a residual control right such that the residual he receives is maximized. Combining residual control rights and claims contributes to the improvement of resource allocation through the property right holder's maximization behavior. This is the foundation of the capitalist economy, why the Constitution of the Empire of Japan held and the Constitution of Japan stipulates property rights are sacred.

Then, what happens if residual control rights and residual claims are separately held by different agents? If the residual control right holder and the residual claimant are different, both interests are not in general consistent. When the residual control right holder tries to maximize her or his own interests, the actions may not maximize the residual claimants' interests. This inconsistency emerges as a real problem if there exists asymmetric information between the residual control right holder and the residual claimant and the latter cannot observe the former's actions. Resource allocation would be distorted favorably to the residual control right holder whose actions are not observed by the residual claimants. This class of asymmetric information problems is called a "moral hazard" or "principal-agent problem."

When discussed in the context of relationships between the manager of a firm and the shareholders of the firm, the "moral hazard" problem is mentioned as an issue of "corporate governance." In fact, the definition of property right in economics is largely the same as shareholders' right stipulated by corporate law. Anyway, a typical moral hazard easily develops between the shareholders and managers, particularly if each shareholder owns only a small portion of a firm's entire stock and if each shareholder distributes its financial wealth into several assets to diversify risk, as pointed out in Adam Smith's *Wealth of Nations*.

As long as the residual control right and the residual claim belong to different parties, the first best resource allocation, which when there is a single holder, can be realized by the use of the residual control right to maximize residual claims, is not attainable. Meanwhile, the joint stock company, where shares are widely held by many investors, is a convenient vehicle to raise a large amount of capital from the entire society where savings might be slack. Then, some better second best institution is pursued.

Stock exchanges may be such a second best institution. There transactions of shares of listed companies are concentrated, and information about the listed companies' performance is quickly shared among market participants. Therefore, if investors are rational and if the market is sufficiently efficient that relevant information is immediately reflected by share prices, then a better second best pricing of shares is possible, and managers are disciplined and resource allocation improved.

Another device is incentive payment to managers. Even when shareholders cannot observe the details of managers' actions, they often observe the outcomes, like profits, of the mangers' actions. By making managers' salaries depend on profits, managers may be better motivated to serve shareholders' interest in maximization.

It is roughly based on such assumptions that our social economies are operated. A focal point at which both assumptions intersect is leverage. Debt—bank borrowing and bond floatation—is often determined by management. The more management deviates from the efficient decision, the more leverage would be distorted. Organized markets, such as stock exchanges is a mechanism to curb possible distortions by using market pricing of shares.

In Japan's case, the mechanism was formed in the late 19th century, after the Tokyo Stock Exchanges and the Osaka Stock Exchanges were formed in 1878. To address the possible distortion of market pricing and firms' leverage, our research questions are straightforward. How the market priced shares, in other word, whether the market was sufficient enough that it calmed moral hazard of managers. Data covers semiannual share prices and financial conditions of all listed companies from 1878—1910. We ask 1) whether the market value of each firm was efficiently priced in responding to the financial performance, and, if so, how; 2) how management structure affected capital structure.

For management structure, we constructed a data set of shareholders from management who had the largest and smallest number of shares. From the late 19th century to the early 20th century, management was often dominated by large shareholders. Executives were defined by the corporate law as representing shareholders, and they were elected pursuant to the principle. In addition, managing large firms requires professional knowledge. As firms grew, as occurred in the United States, professional managers, often ex-employees, came to be appointed as managers. That system was later dubbed the "division of ownership and management" and hailed by Alfred Chandler Jr. The same phenomenon is observed in early 20th century Japan. To evaluate the impact of the shift of management structure, we constructed a data set from financial reports. While it is impossible to figure out who the 'professional' managers were, there was available information about shares owned by managers. Thus, we assume that if a person was appointed as an executive, even though he was a small shareholder, it was because of his merit other than ownership; that is, he was a professional manager. Then, we calculate the difference between the size of the largest shareholder and that of the smallest shareholder within management as a proxy for degree of "division of ownership and management."

First about the pricing, our robust finding is that the share prices respond sensitively to Return on Equity (ROE) but not to Return on Assets (ROA). While the latter is affected by whether the management has efficiently utilized entire assets, the former could be elevated by increasing debt even when the debt increase lowers return on assets. Thus, the Tokyo market from the late 19th century to the early 20th century was a little myopic provided that they responded only sensitively to ROE, but not necessarily to ROA. However, it is not surprising. Readers often hear discussions about ROE among investors. Contemporary investors, including professional ones, are often most interested in ROE. Japanese investors a century ago were maybe as smart as the contemporary global investors are.

Second, about possible distortion due to too much debt leverage: We did not find any evidence from companies with high ROE or low ROE. A high ROE is hard to achieve just by increasing debt. A low ROE company cannot make up their profitability just by debt structure anyway. Thus, investors in myopically efficient stock markets did not make a mistake when they invested in excellent companies and in junk companies. A problem was found among companies with middle-level profitability, which could increase ROE by issuing more-than-optimal bonds. They tried to cheat myopically efficient investors, and at least some of them succeeded.

Then, what about governance structure? Our result is straightforward and a little bad news for the contemporary "widely shared and actively traded" capitalist market. Debt distortion was least in companies that were predominantly owned by the largest shareholders, who were likely founders. Meanwhile, the distortion tended to be the greater at companies where the smaller shareholders joined the management executives. The "division of ownership and management" began in the sample period both in Japan and in the United States. At least in Japan, it came with greater distortion of financial structure to cheat the market.

This result might have a contemporary policy implication. Japan's corporate financial development was driven by direct finance—shares and bonds—and reached its highpoint in the mid-1930s, when the capitalization of the Tokyo Stock Exchanges amounted to more than 120 percent of the then-current gross domestic product. Corporate financing was completely transformed during the wartime effort from 1938 to 1945 to a system dominated by indirect finance, the banking sector. The government suppressed stock and bond markets and controlled manufacturing firms through a regulated banking sector originally designed for the war effort. Even after the war, the mechanism survived. Japan's corporate financing had been greatly reliant on the banking sector until the 1980s. Only since structural reforms began in the mid-1990s, has the Japanese government tried to put corporate finance back to original form, led by direct finance. Behind the idea of structural reform, there is a naïve assumption that the market should efficiently price shares and corporate governance should be well disciplined, even if firms are dominated by "professional" managers. Historical experience a century ago endorses such an assumption to some extent, but with some reservations. In a comparison of firms dominated by large shareholders, who were often from founding families, and those that promoted "professional" mangers, capital distortion was significantly greater in the latter case. This intuitively makes sense. Compared with long-term shareholders, employed mangers' foresight is generally short. Their performance is evaluated by shareholders only during their term in office, typically for a few years or ten years at most. To boost their financial performance for a few years or so, they may want to distort the financial leverage of their firms.

Indeed, many firms that have enjoyed long-term growth in contemporary Japan are run by founding families, not by employed executives. Our findings from historical research are consistent with that observation. For Japan to have better corporate finance, given a naïve trust in the market, it may not be sufficient simply to promulgate corporate governance and stewardship codes.

The Constitution of Japan in Comparative Context

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The literature on comparative constitutionalism has traditionally focused on questions of jurisprudence and judicial practice, such as variation in interpretations of human rights or the independence of courts from elite or public pressure. While these are crucial issues that relate to the operation of constitutions, the last decade has seen new attempts to systematically study the *textual content* of constitutions themselves. Instead of taking the enumeration of certain rights or institutions as given, these are treated as the outcome of political bargaining. What explains variation in the guarantee of civil liberties across countries and over time? What types of provisions are amended more frequently than others? Armed with new quantitative data and methods, we can test how particularistic versus common interests influence constitutional provisions, and whether the enumeration of human rights or political institutions improves constitutional legitimacy and survival.

Constitution of Japan in Comparative Context

My interest in this topic began with a simple question: why has the Constitution of Japan (COJ) never been amended? In an earlier project on electoral system design, I found that institutional changes were less common in countries where the constitution specifically enumerated the electoral system (McElwain 2008). In Japan, by contrast, Article 47 of the COJ relegates most aspects of elections to legislation, making it changeable by a simple majority in the Diet. In fact, a quick reading of the COJ makes it clear that many institutional provisions are vaguely defined. Articles 92-95, which concern local self-government, similarly leave the organization and powers of local public entities to be determined by law. Perhaps constitutional amendments are rare in Japan, because changes that may require amendments in other countries can be made by regular law?

In a joint project with Christian Winkler (Hokkaido University), we examine whether the COJ is distinctive from current and historical constitutions in the range of topics it enumerates (McElwain and Winkler 2015). Our analysis is based on data from the Comparative Constitutions Project, a prodigious effort by Elkins, Ginsburg, and Melton (2009) to code all national constitutions since 1789 on more than 700 indicators of constitutional content. We find that the COJ's primary trait is the *mismatch* in its enumeration of political institutions and human rights. The COJ mentions only 40% of common political institutions, but lists 77% of common human rights. In fact, the COJ enumerates more human rights than any older constitution still in force today, but ranks in the bottom 20% on institutions. This mismatch reflects the historical conditions underlying the drafting of the COJ in 1946 by the General Headquarters (GHQ) of the Allied Occupation. The officers involved were mostly progressive in outlook, and they linked the consolidation of Japanese democracy to the enumeration of rights, while being more ambivalent about imposing political institutions on a country they little understood (Hellegers 2001).

This constitutional taxonomy begs a second question: to what extent does the specification of rights and institutions influence the constitution's evolution? Constitutions change in two ways: the text may be *amended* piece-meal by adding, deleting, or replacing specific provisions, or the entire document may be *replaced* wholesale with a new constitution. The peculiarities of the COJ inform this distinction. The COJ is an outlier because it has resisted both types of changes; in fact, it is the oldest unamended constitution in the world today. It is also an outlier because it is uncommonly specific on rights but vague on institutions, as discussed above. Perhaps the frequency of amendments and replacements are related to this pattern of specificity?

I test this insight in a paper (2014) with Jean Clipperton (University of Michigan), using a mix of statistical techniques and original constitutional data. We find that constitutional longevity improves when constitutions enumerate more rights, while amendments become rarer when constitutions are vague on institutions. This is precisely the pattern we find in Japan. In other words, while the COJ may be an outlier in terms of its contents and evolution (or lack thereof), its characteristics can help us better understand how constitutions around the world operate.

Implications from Quantitative Constitutional Analysis

The content and evolution of constitutions is particularly interesting in the Japanese context, because despite numerous amendment proposals from conservatives, who have had a stranglehold on postwar governance, the document remains word-for-word the same as it was more than 65 years ago. This is not to say that constitutional *practice* has been static: the definition and enforcement of provisions have changed over time through reinterpretations by the Supreme Court and the Cabinet. However, the legitimacy of such "informal amendments" has come under attack in recent years, most notably following the Cabinet's redefinition of the Article 9 Peace Clause in 2015 to permit collective self-defense. Legal theorists have taken the lead in dissecting the rationale and validity of such qualitative, interpretative amendments, basing their arguments on careful analyses of case law precedents and judicial practice.

That said, there are certain topics that are better assessed using quantitative information and techniques. The first, which I have discussed above, is the statistical relationship between constitutional content and change. The second is the spread of constitutional norms relating to human rights. Law and Versteeg (2011) and Elkins, Ginsburg, and Simmons (2013) show that the enumeration of rights has expanded steadily over time, due to the spread of democracy and the establishment of constitutional templates such as the Universal Declaration of Human Rights.

These innovations in "matching" constitutions by their civil rights content provide new ways to assess isomorphism in constitutional structure and practice. However, this still leaves a lacuna in the constitutional analysis of *political institutions*. Civil rights and institutions are not two separate worlds. For example, one recurring issue in Japanese jurisprudence is the principle of "one man one vote". For much of the postwar period, Japanese elections have been plagued by high levels of malapportionment, or significant differences in population size across constituencies. This can inflate /deflate the voting power of certain electorates, which in turn influences the issues and interests on which politicians focus (McElwain 2012). Going forward, I believe that there is much progress we can make in the constitutional study of institutions—both from the perspective of textual specificity and judicial interpretations—and that this will fruitfully marry the expertise of legal experts and political scientists.

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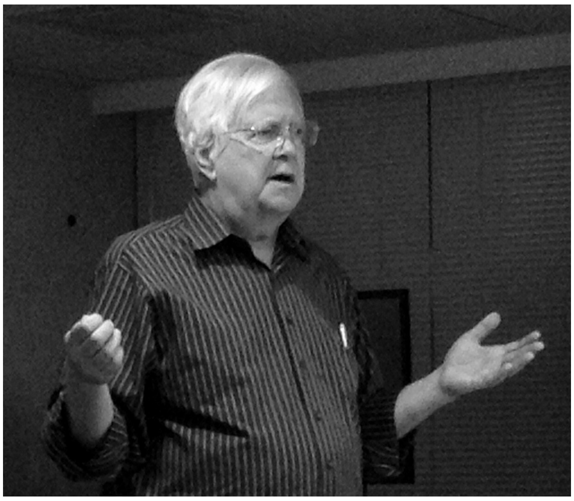

John Creighton Campbell
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October 29, 2015

Is Japan a Silver Democracy?

It is often argued that Japan is the world's leading example of a "silver democracy." It provides generous benefits to older people because there are so many of them, they vote at such a high rate, and they often live in over-represented rural areas. On closer examination, this depiction of Japanese old-age policy does not stand up to comparisons with other advanced nations; moreover, the timing of policy changes indicates that older people did better when they were fewer. The old-age vote does have policy implications but these are much narrower than implied by "silver democracy" as an analytic hypothesis—it is better understood as a motto for conservative politicians.

David H. Slater
(The Director of the Institute of Comparative Culture and Professor of Cultural Anthropology at Sophia University)

November 25, 2015

Networks of Political Possibility: Post 3.11 Social Movements and Political Activism

In the years since 3.11, we have seen many different sorts of activism, some of which rises to the level of a social movement, others not so much. This talk is a first attempt to identify the characteristics of these movements, in terms of their institutional connections, rhetorical focus, performative repertoires and relations with both mass and social media. We will ask not only what distinguishes activism today from that before 3.11, but also how it might allow us to re-think our understanding of changes in civil society.

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保城広至（著）
『歴史から理論を創造する方法:
社会科学と歴史学を統合する』
（勁草書房）2015年3月20日

中澤渉・藤原翔（編）
『格差社会の中の高校生: 家族・学校・進路選択』
（勁草書房）2015年9月5日

中西聡・井奥成彦（編）（中村尚史）
『近代日本の地方事業家:
萬三商店と小栗家と地域の工業化』
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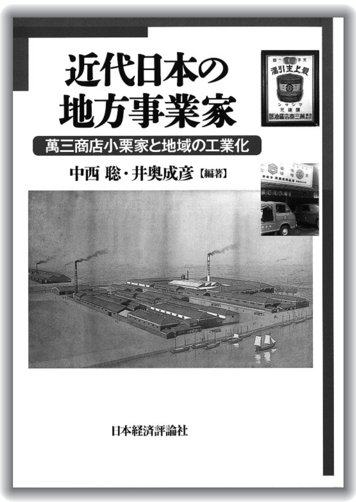

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『「平和国家」の誕生: 日本の原点と変容』
（岩波書店）2015年12月3日

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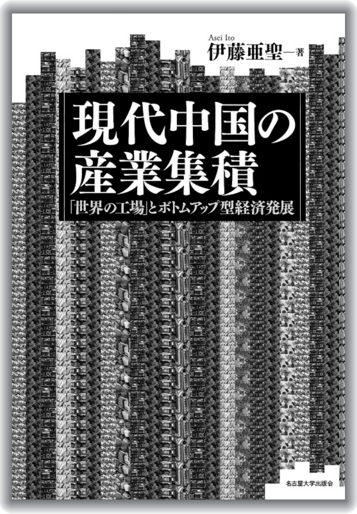
（名古屋大学出版会）2015年12月15日



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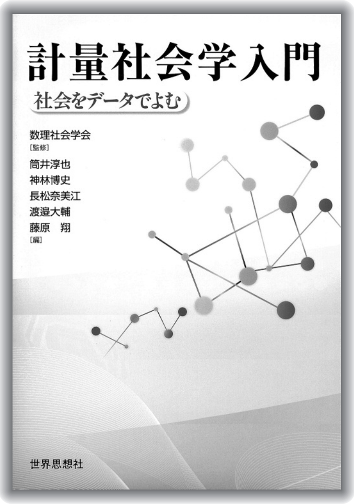

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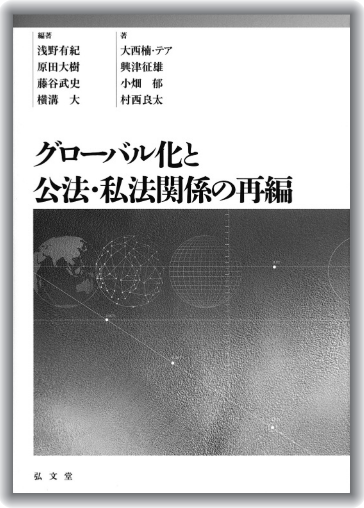
（弘文堂）2015年12月30日



中村尚史（著）
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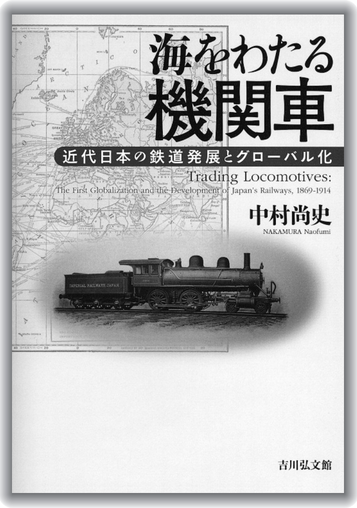
（吉川弘文館）2016年1月29日



Focus on ISS

The Social Sciences of Hope in Kamaishi: How "Kibougaku" Was Applied to Disaster Work (Part 1)

NAKAMURA Naofumi and GENDA Yuji

The Kamaishi Hope Study Project: 2006-2010

In this and the next two issues of SSJ Newsletter, we will share some of the highlights of our Kamaishi Hope Study Project. We begin with 2006-2010, a span that covers the three years of multidisciplinary fieldwork in Kamaishi.

In 2006, the Institute of Social Science began an ambitious field study, the "Social Sciences of Hope (SSH)," or "*Kibougaku*" in the Kamaishi-Otsuchi region of Iwate prefecture. "*Kibougaku*" as the project is also known, featured a comprehensive and in-depth community survey. Researchers in the fields of law, economics, political science and sociology worked together to design and carry out the research.

The overall research design of the project was also unusual. Instead of hypothesis testing, the primary goal of the project was to identify new lines of inquiry into how communities are reborn after recovery from setbacks. Rather than analyzing only the current state of affairs, researchers also delved into local history, culture, and thought. SSH researchers met multiple times with local residents and had frank discussions with them. In some cases residents and researchers huddled together as we identified research questions. The Kamaishi Hope Study Project was a community survey distinctively committed to collaboration between researchers and subjects.

The SSH produced many new findings and publications, the foremost of which are the four volumes of *Kibougaku*, published by the University of Tokyo Press in 2009. Volumes 2 and 3— *Kibou no saisei: Kamaishi no rekishi to sangyō ga kataru mono* [Reproducing hope: what the history and industry of Kamaishi tell us] and *Kibou o tsunagu: Kamaishi kara mita chiiki shakai no mirai* [Connecting hope: seeing the future of the local community in Kamaishi]—are comprised of research reports from the community survey. To commemorate the publication of these volumes, in June 2009, a major symposium was held in Kamaishi City.

The first stage of the Kamaishi Hope Study Project was also completed in 2009, at which point we began the other general regional research project at Fukui prefecture. Although the scope of the project expanded, in years 5-10 of our study, we remained mindful of the need to continue making fixed point observations in Kamaishi and therefore stayed in contact with its residents.

Similarly, our ties to the area were also sustained by ongoing work with the Kamaishi city government and the Kamaishi-Otsuchi local development office within the Iwate prefectural government. In addition, we offered public lectures and acted as advisors in the city's long-range comprehensive planning.

A street view of Kamaishi on June 1, 2008
Photo by Ohori Ken

March 2011 and the Launch of the Disaster Recovery Project

The Great East Japan earthquake of March 11, 2011 devastated Kamaishi's coast. Immediately after, communications were down, and we could learn nothing about the fate of the people who had helped in our research. The SSH researchers worked together to coordinate their efforts to collect information.

Around March 16, we began to receive indirect information from people connected with NHK, the Iwate prefectural government, and Nippon Steel. Finally, on March 18, we were able to contact Kamaishi directly. What we learned from the city government and local residents about the damage they had sustained was far worse than what we had imagined.

On April 2-3, the SSH team, Ohori Ken (presently an ISS research associate) and I, Genda, made our first post-disaster visit to the area. On April 4, we held our first public meeting to share our findings on the state of the Kamaishi-Otsuchi area. On April 12-13, we returned to Kamaishi, joined by Uno Shigeki (ISS professor) and Sato Keiichi (currently associate professor at Senshu University). We held a second public meeting to report our findings on April 19.

We continued this pattern of site visits and public meetings until 2013, holding 21 meetings in all. Throughout this time we continued to record our observations on Kamaishi's recovery process and our own thought processes regarding that recovery. We also held two more workshops in which local residents participated.

In the next issue of SSJ Newsletter, we will describe how we collected oral histories of residents' memories of the earthquake and its aftermath.