Reforming Corporate Governance and Employment Relations

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1. Introduction

Before discussing the impact that reform of corporate governance has on company-employee relations it is necessary to clarify the goal of corporate governance. When considering this question, the mass media and others unseriously place emphasis on the interests of shareholders, while some academics, equally irresponsibly, stress the importance of stakeholders and are dismissive of the interests of shareholders. The latter assertion gains persuasive power when remembering the argument that excessive importance placed on shareholders triggered a recent series of accounting scandals in the U.S. However, importance placed on shareholders is less inconsistent with the long-term interests of other stakeholders, and also increases the transparency of its function as a benchmark of corporate governance. Hence, this article attached long-term importance to shareholders' interests as a benchmark in determining the long-term aims of corporate governance.

This article, while noting possible future directions for corporate governance in reaction to ongoing external changes, aims to clarify which company-employee relationship is compatible with such changes. As a first step in preparing for the discussion, significant changes in external conditions faced by the Japanese economy are noted, including the transformation of the financial system consequent to changes in the nature of the main bank system and the unwinding of cross-shareholdings; the transformation of production technology and organization following the evolution of module and openness methods; demographic changes, mainly fewer young people and an increase in the elderly population; changes in the quality of workers as symbolized by educational problems; intensifying international competition; and frequent corporate scandals.

Changes in corporate governance in response to these external changes can be classified in two ways: changes in external and internal governance. The former refers to the rules which corporate management must observe at the request of outside creditors and shareholders who have come into existence due to changes in patterns of debts and share ownership. Internal governance, on the other hand, means the rules which corporate managers must observe within the mechanism of the organization, such as the board of directors, contracts concerning remuneration for management or shareholdings by business managers, choosing between a divisional structure and a company system, and so on.

Company-employee relations should be reformed in line with the dominant changes in external and internal governance, otherwise there will be a gap between the form of corporate governance and the employment relationship, which in turn will undermine the efficiency of the firm. This article examines a desirable approach to employment relations from the following perspectives: (i) the necessity of devising new incentives for employees; (ii) consistency between protection of employees' assets and the new incentives; (iii) increased mobility of the labor market and the internal promotion system; and (iv) corporate scandals and the whistle-blowing system.[1]

2. External Changes and Japanese Firms

The major challenges that Japanese firms are facing at the moment are related to the reform of the financial system; the transformation of production technology and organizations; demographic change and change in the quality of workers; intensifying international competition; and frequent corporate misconduct and corporate compliance.

The reform of the financial system includes the undermining of the main bank system and the unwinding of cross-shareholdings. The main bank system deteriorated partly because the process of deregulation for bond floatation in the corporate bond market, which started in the late 1970s, was almost completed in the 1990s, which resulted in large blue-chip firms no longer requesting bank loans. The deterioration of the main

[1] For more detailed discussions, see Osano (2002), and Osano and Kobayashi (2003).

bank system also seems attributable, to a large extent, to the fact that for years banks have failed to serve as main banks in that they suffered from a large amount of non-performing loans, leading to various problems such as soft budget problems concerning bank loans[2] and conflicts of interest arising when securities companies affiliated to banking institutions are responsible for issuing corporate bonds. Also, the unloading of cross-shareholdings between banking institutions and firms has been progressing, particularly among fast-growing firms, and the firms whose shares are still held by banks are those which have no alternative but to look to banks for fund raising.

Where the transformation of production technology and organization is concerned, the evolution of the module and openness methods has been particularly conspicuous in recent years. The module method sorts the various parts that comprise a final product into several packages determined by convenience and relation within the production process, and then designs such parts within the framework of each package. Its goal is to deconstruct complicated production processes and product structures into various independent modules for the sake of efficiency. The openness method, on the other hand, is to standardize the interfaces of various parts in a single module, making it possible to connect different parts made by a single firm or different parts made by different firms.

Further development of these production methods will alter workers' attitudes to share information. In the traditional Japanese manufacturing sector, different parts were designed and produced for each final product, so the parties involved, chiefly affiliated firms and skilled workers, always made small adjustments on various parts. But in places where the module and openness methods have been adopted, such adjustments prior to production are not very important; rather, strategic concept making is in high demand.

With the prolonged recession in recent years, high unemployment rates have been reached, and fewer youth and an increase in the elderly population will lead, in the long run, to a shortage of young workers and an excess of elderly ones. The demographic change will mean that production system will have to be altered to match the new demographic structure,

[2] Also known as soft budget constraints, indicating a tendency to rescue inefficient firms by generously providing additional loans.

and, together with the collapse of the "myth of consistently high land prices" and the change in the financial structure centered on indirect financing, will substantially impact how individual workers accumulate their assets. The result of these changes will be an alteration in the pattern of firm ownership, which in turn will serve as a factor in changing corporate governance. At the same time, the recent deterioration in educational levels and academic standards may well result in a poorer quality of workers. This will raise the question of whether future information sharing should remain the same as it is now.

Intensifying global competition will result in a shift of manufacturing production sites, impacting the form of production system and corporate strategies. On the other hand, unrestricted international capital movement will, through an increase in the proportion of foreign shareholders of Japanese firms, pressure these firms to accept a form of corporate governance based on the logic of Western countries.

As seen in a series of frequent companywide attempts to cover up misconduct in recent years, there is an urgent need for firms to establish a whistle-blowing scheme to prevent such misconduct. Most of the corporate scandals were exposed to the public only through whistle-blowing by employees engaged in ordinary duties within the companies or by individuals employed by business partners. These whistle-blowers are ignorant of corporate scandals until they have built a close relationship with their own company and share its interests and its information concerning business. Thus, a risk is always involved for workers who blow the whistle, in that they have engaged in the business of the company in question and thus could be considered as accomplices in the misconduct. Even if they escape being considered accomplices, they will suffer if their skills are unique to the company. Under such circumstances, the focus is to make it easier for insiders to blow the whistle.

3. Adaptation and Changes in Corporate Governance

This section is devoted to discussion of changes in external and internal corporate governance undertaken by Japanese firms in response to the external changes mentioned above.

3.1 Changes in External Governance

Let us first consider changes in external governance. Changes in the financial system, in particular, have a great impact here.

One of the authors of this article and Keiichi Hori of Ritsumeikan University conducted an empirical study on financial relations between firms and banking institutions, and we will use this study as the basis to explore changes in this field. The study[3] uses corporate balance sheets for fiscal 1998, and predicts determining factors in activities to procure funds, including bank loans, loans from main banks, choice of principal underwriter for corporate bond issues, and shareholdings by main banks.

Analyses of data concerning bank loans and loans from main banks indicate that firms facing the prospect of low growth and whose financial situation was not healthy chose bank loans. Also, main banks still played an essential role as fund suppliers to relatively small firms. The study also revealed that securities companies affiliated to main banking institutions, rather than securities companies affiliated to non-main and other banking institutions, actively serve as principal underwriters for firms with healthy finances. A wealth of internal information about a firm is commonly used for financing and settlement services, and the services related to underwriting of corporate bond issues. Thus, if the main bank system functions properly — theoretically, in terms of its information production ability — securities companies affiliated with main banks rather than those affiliated to non-main or other banking institutions will underwrite corporate bond issues for firms with fewer pledged assets, with potentiality for high growth, and with a low credit-risk rating. In reality, however, the empirical study does not show such a "certification effect." As for determinants for shareholdings by main banks, firms with a lower potentiality for growth have a higher percentage of shareholdings by main banks.

Based on the above, and in the light of the possible future course of the accounting system and institutional reforms of the financial market, we will next consider the future ideal external governance of Japanese firms.

First, an important factor in the external governance of firms with a low credit-risk rating and a poor financial situation is the monitoring function

[3] See Osano and Hori (2002), and Hori and Osano (2002).

of main banks as required for traditional bank loans. However, when main banks are unable to break off with, but must continue financing such firms, the monitoring function will not work properly. On the other hand, among firms with a high potentiality for growth, cross-shareholdings are likely to be less common, so the possibility of encountering hostile takeover bids in stock markets is likely to serve as an important function of governance.

Next, for firms with a medium credit-risk rating and low potentiality for growth, the monitoring function of main banks as required for traditional bank loans will be important. On the other hand, for firms with a medium credit-risk rating but a high potentiality for growth, the monitoring function can be considered less important. But cross-shareholdings are likely to be less common, and the danger of encountering hostile takeover bids in stock markets is likely to constitute an important function of external governance. Further, regardless of the potentiality for growth, the stocks of these firms are likely to attract institutional investors, who can be expected to apply soft pressure on management by, for example, monitoring and exercising voting rights.

Finally, for firms with a high credit-risk rating, the monitoring function of main banks will not be able to play a major role; instead, governance in the form of the danger of hostile takeover bids and soft pressure on management by institutional investors may well be expected.

We have already seen how the monitoring function of main banks is required for traditional bank loans for firms with a low credit-risk rating, a poor financial situation, and a low potentiality for growth. This is particularly so for small and medium-sized firms. If resource and capital are to be transferred to firms in emerging industries and the restructuring of corporate organizations is to be encouraged in firms for which governance through the capital market is applicable — in particular, large firms in mature industries — it may be desirable to rely on business takeovers or handovers, hostile takeovers, or other forms of corporate governance that utilize the functions of the capital market rather than the monitoring function of main banks as required for traditional bank loans.

Now let us take a look at external governance by institutional investors. Mutual funds (investment trusts), pension funds and foreign investors have been in the forefront in recent years among various types of institutional investors. In portfolios of actively managed mutual funds,[4] shares are bought and sold frequently in accordance with company worth and whether or not shares are undervalued, so that such funds cannot serve as long-term stable shareholders. In the case of indexing management[5] of mutual funds, on the other hand, the portfolio of shares in the funds remains the same unless there is an alteration to the issues constituting the market index, but any increase in the number of cancellations will require the selling of shares incorporated in the funds in proportion to the market index; thus this type of fund cannot be a long-term stable shareholder either. In contrast, operating assets for pension funds tend to increase over time, so that the indexing type of funds can be expected to serve as stable shareholders in the long run.[6] Current Japanese corporate pension funds seem likely to change their nature to "activist" funds which highly value discussion with corporate managers and actively commit themselves to corporate governance. But, European and U.S. investors, in particular their pension funds, will be the most promising in this regard. Since Japanese firms whose shares are held in European and U.S. pension funds are reportedly in general good-standing, it is firms with higher credit-risk ratings that will be subject to such governance.

3.2 Changes in Internal Governance

This section will examine the direction of changes in internal governance. When the mechanism of external governance does not work properly, it is necessary to strengthen the mechanism of internal governance, for which the American style has been favored until recently. In American-style internal governance, boards of directors including outside directors play a central role. In Japan, too, the revised Commercial Code effective April 2003 allows firms to adopt either a new method (the

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[4] Active management of mutual funds sets a target market benchmark or index, and is aimed at obtaining returns exceeding such market indices as the Nikkei Stock Average or TOPIX.

[5] Indexing management of mutual funds is a portfolio strategy of buying and holding shares in proportion to the composition of the market index.

[6] However, the ongoing low interest rates and low stock prices have been increasing corporate pension liabilities, resulting in a shortage of pension funds allocated for future pension payments. In this situation, such pension funds tend to sell off the stocks they have been holding as part of the process of many Employees' Pension Funds returning management of and payment from the funds to the government to alleviate the shortage. But this seems to be a transitional phenomenon.

committee system) which centers on the participation of outside directors as seen in the U.S. system, or the traditional method with further reinforcement of the audit committee system. The revised Commercial Code requires large firms which have adopted the new method to establish three committees within their boards of directors — an audit committee, a nomination committee (a body to nominate corporate managers), and a compensation committee (a body to determine the compensation level for directors). Each committee must consist of three or more directors, and the majority of the directors must be from the outside. Also, the code stipulates that firms which are to establish audit committees should do away with traditional auditors. At the same time, it stipulates that the post of executive officer who would be responsible for actual business execution should be created. On the other hand, the revised code states that firms which adopt the traditional method must have a minimum of two outside auditors, who will make up a majority of the audit committee, with their term extended to four years.

Is it possible that a wide range of Japanese firms will adopt such boards of directors, incorporating outside directors, in the future? And if so, will they function properly?

As stated in the previous section, mutual funds (investment trusts), pension funds, and foreign investors have come to the fore in recent years among various types of institutional investors. It is highly likely that these institutional investors, particularly foreign investors, will prefer U.S.-style internal governance, and call for the adoption of a board of directors under the new method with outside directors. Incidentally, under the new method boards of directors will have to establish a nomination committee, responsible for the selection of management directors, and a majority of the committee members must be outside directors. If outside directors no longer support the managers during their term, the managers will be forced out of their positions. Hence, it seems likely that only firms with many related firms from which they appoint people as their outside directors are more inclined to adopt the new method; in the other firms, the current managers are likely to resist to the adoption of a board of directors under the new method.

What is more, even when the new method is actually applied, it will be necessary to produce incentives for outside directors, who are independent from management, to properly supervise corporate managers. In reality, this will be extremely difficult to do.[7]

In the U.S., there have been debates over whether or not outside directors will exercise their full powers. In particular, since November 2001 when Enron, a conglomerate in the energy industry, collapsed due to deceptive accounting, a spate of similar accounting frauds have been made public involving WorldCom, a telecommunication company; Xerox, a manufacturer of office equipment; and other major U.S. companies. This has rekindled doubts about the effectiveness of outside directors. However, one should note that this problem is also associated with the accounting system itself; with matters concerning conflicts of interest with company auditing; and with conflicts of interest with securities analysts of investing banks and securities companies, and thus does not necessarily arise from the system of outside directors itself.

In summary, the new method of establishing boards of directors is most likely to be adopted by firms that have many related companies, from which the former firms can appoint outside directors. But it remains debatable whether this will immediately lead to greater supervision from the boards of directors on corporate managers, and serve as a disciplinary control.[8]

Another significant method of internal governance — one carrying, in the same way as boards of directors, increasing weight in recent years — is the system of remuneration linked to business performance that is applied to directors, middle-level managers, and so on. Adoption of remuneration contracts linked to stock values will interlock the interests of directors, middle-level managers and other workers with those of shareholders, and will provide them with a powerful incentive to improve the stock values of the company in question. In particular, the adoption of stock options, whereby managers and core engineers and employees of the company are granted the right to acquire company shares at a certain price, and linking this with corporate performance will be essential to create powerful

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[7] For this point, see Xu Peng (2002).

[8] Major studies which survey a wide range of articles concerning the functions of boards of directors include Bebchuk, Fried and Walker (2004). For theoretical analyses of the functions, see Hermalin and Weisbach (1998), Osano (2002a), and Almazan and Suarez (2003).

incentives to improve stock value.[9] The stock option system could serve as an important incentive for potential corporate managers to start up new companies, and spark a willingness to work among core engineers and employees. It could also lay the basis for the smooth acceptance of management reforms and M&As among corporate managers, core engineers and employees of mature or declining companies, as a successful reform or an M&A will substantially raise the stock value of existing firms, even if they are mature or declining, making it possible for managers and core workers to welcome corporate reforms or M&As.[10]

Internal governance should also be designed to avoid corporate misconduct and other incidents which, once revealed, would result in compensation costs, suspension of business trading and operations, and other enormous losses. What, then, are the possibilities of incorporating the whistle-blowing system as a form of internal governance?

The first possibility is to establish an independent auditing body responsible for accepting whistle-blowing activities. Like outside directors, the establishment of such an auditing body at a level independent of and equal to corporate managers will encourage managers to direct individual workers towards business improvement before more serious harm is done. At the same time, to get managers involved positively in improving individual business performance, it is necessary to authorize auditing bodies to penalize managers who do not strive for improvement. Also, auditing bodies should be given auditing powers and rights strong enough to ascertain whether the information from whistle-blowers is true. And finally, auditing bodies must protect the anonymity of whistle-blowers, so that their jobs and work environment can be safeguarded, and that the improprieties are handled without damaging the value of the corporation. However, as seen in the earlier discussion of outside directors, if an independent body imposes severe penalties on corporate managers when misconduct is discovered, there is the risk that the managers may remove

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[9] However, Hall and Murphy (2002) claim that the wide use of stock options in the U.S. is simply a means of taking advantage of an accounting system whereby stock options are not counted as expenses. On the other hand, Oyer and Shaefer (2004a, 2004b), and others argue that U.S. firms make use of stock options not only for accounting reasons but also on the grounds of economic rationality.

[10] For the theoretical aspect of this mechanism, see Osano (2004).

the body from the overall corporate organization. What is more, even if the establishment of an independent auditing body is written into law, corporate managers may in practice be likely to set up a less independent body to evade severe penalties.

Another possibility is to launch an auditing function using employees and other insiders. In this case, the stock options mentioned earlier may be effective. Any employee who understands that, unless a certain piece of corporate misconduct is rectified the value of the corporation will undoubtedly be marred in the future, may well blow the whistle and encourage his colleagues to strive to rectify the problem so share prices do not drop in the future. However, if exposure of corporate wrong-doing might lower the value of the corporation, the stock option system may tempt employees, conversely, into a conspiracy to conceal the scandal. Even so, under this system, provided corporate value increases in the future due to management's swift handling of the scandal and through corporate reforms, M&As or other measures, it is still possible that the employees who discovered misconduct may prefer disclosing it rather than covering it up.

4. Changes in and Adjustment of the Labor System

4.1 How Changes in External Conditions Directly Impact the Labor System

When considering the effect that the transformation of production technologies and system will have on employment relations, questions such as how information should be shared among employees, and to what extent prior coordination should be done are necessary to be addressed. How to share information and deal with prior coordination seem to vary depending on industry.[11] Differences arise since the need for and the impact of, the module and openness methods vary among industries. For instance, firms in the automobile, machine tools, precision machinery, and some electronic component industries need to conduct prior coordination among employees because employees automatically share information among themselves and need to coordinate with each other. Therefore it is possible that the existing division of labor in Japanese-style manufacturing may

[11] For these discussions, see Aoki and Ando (2002), and Okuno and Nakaizumi (2001).

well continue to be effective.[12] On the other hand, in industries where automatic information sharing and prior coordination among employees are not needed as much as before thanks to the progress of the module and openness methods, such as the computer industry and the processing and assembling sector of the electricity industry, the traditional division of labor, which was effective when their approach to manufacturing was based on the Japanese style, is less advantageous under current circumstances. Firms in these industries need to change their division of labor to succeed in global competition.

Declining or mature industries are those which, due to the cost of labor and raw materials, are not suitable to manufacture their products in Japan, and also those whose products are no longer in high demand domestically. Resources and capital need to shift smoothly from these industries to emerging industries. As global competition intensifies, the maintenance of a division of labor which may have been effective in a Japanese-style manufacturing climate will hinder this shift. Hence, in these industries, the division of labor needs to be revamped to facilitate mobility of the labor market.

The demographic change — a decrease in the young population and increase in the graying population — will lead to, in the long run, a shortage of young workers and an increase in elderly workers. This change will highlight the need to reform production system to make better use of female and elderly workers in the future. Thus, firms, particularly those in the tertiary industry, are expected to reform their division of labor in ways that promote mobility of the labor market.

On the other hand, the declining academic standards and educational levels, both of which are observable on all educational levels, may result in a decline in the quality of future workplaces, as well as a decline in the ability of middle-level or higher managers and engineers.[13] Above all, the

[12] However, firms in sectors where the ability to solve problems by employees and designers who are on-the-spot is being undermined, on average, due to the rapid upgrading, increasing complexity, and the growth of equipment size, may be better off thoroughly adopting the module method. For this, see Chuma (2002).

[13] The definition of academic standards is somewhat controversial, though it is true that academic standards in the traditional sense have deteriorated, and the hours that pupils and students spend studying outside school have decreased, compared with various groups in other countries. For this issue, see Nishimura (2001) and Ito and Nishimura (2003).

decline in educational levels may result in producing employees, designers and other workers being unable to solve problems that may arise. Thus, if in-company education and training are insufficient, corporate competitive strength is likely to be weakened in industries that highly demand a prior coordination among workers. Also, firms in industries which need to hang on to highly skilled employees may possibly be better off pursuing the development of skills unique to the companies themselves. It is hoped that the "more relaxed education policy" launched by the Ministry of Education, Culture, Sports, Science and Technology will be abandoned so that the decline in academic standards will be reversed, and that foreign managers and engineers will be made full use of.

In industries where prior coordination among employees is essential, individual employees are more likely to participate in covering up a scandal even in companies with a whistle-blowing system, since they rely on their companies for their jobs. Despite this, if companies cannot ignore the loss and damage incurred by misconduct, corporate managers may prefer letting their employees report misconduct before it aggravates the corporate situation, rather than forcing them to take part in the concealment. On the other hand, in industries where information sharing and prior coordination among employees is not essential, as well as other human skills which are unique to individual firms and in their cultivation of which each firm must invest in, it will be difficult to "lock in" employees as accomplices to a corporate scandal. Because labor mobility is quite high and the cost in terms of losing one's job is small in these industries, firms will find it difficult to ask their employees to cover up scandals in exchange for safeguarding wage levels and jobs which would be threatened if the scandal was exposed and damaged business performance.

4.2 Desirable Adjustment of Employment Relations

When changes in external conditions trigger reforms of corporate governance and have a direct impact on employment relations, how should employment relations adjust themselves to the impact? Is the adjustment compatible with the changes made in corporate governance? And is there any possibility that the current employment relations in Japanese firms are themselves inimical to reform of corporate governance?

This section aims to investigate these questions from four perspectives: (i) the need to devise new incentives for employees; (ii) establishing compatibility between protecting employees' assets with designed incentives; (iii) increasing mobility of the labor market and the internal promotion system; and (iv) corporate scandals and the whistle-blowing system.

Conventional mechanisms which have served as incentives for employees include the seniority wage system, retirement allowances and corporate pensions which are paid when employees leave the companies, and the internal promotion system. Although the practice of regular pay hikes and the introduction of wage systems linked to workers' performances are being reassessed in an increasing number of firms in recent years — to the extent that the significance of the seniority and other traditional wage systems has been reduced, however, the traditional mechanisms still seem to persist in Japanese firms when compared to their Western counterparts, in particular among blue-collar workers.[14] As for white-collar workers, some studies argue that the system of regular pay hikes has eroded more in Japanese firms than in Western firms, and that the Japanese wage system is linked to the short-term performance of workers.[15] Either way, deferred wage payments and the internal promotion system seem likely to lose credibility in the future with the increased probability that firms will face bankruptcy or hostile takeovers due to the deterioration of the main bank system and the ongoing unwinding of cross-shareholdings. What is more, at firms in industries where information sharing and prior coordination among employees are less essential, it might be more effective to offer employees a larger amount of pay in conjunction with their recent achievements, rather than to increase the amount of pay in accordance with achievement evaluated on a long-term basis. Meanwhile, firms belonging to declining or mature industries, where resources and

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[14] In general, regular pay hikes are not, or rarely, applied to blue-collar workers in firms in Europe and the U.S. On the other hand, it seems common for white-collar workers to receive wage hikes in accordance with in-company qualification grades, together with regular pay hikes linked with annual evaluations. Although it is said that the regular pay hike scheme is becoming less common even among white-collar workers in the U.S., it apparently survives in quite a few firms. See Koike and Inoki (2002) and Koike (2002).

[14] See Koike (2002)

capital are expected to be withdrawn swiftly and smoothly, should initiate mechanisms which enable their employees to shift to emerging industries, and which encourage corporate managers and employees to press ahead with reform of corporate management.

In this situation, which mechanisms to secure incentives for employees are possible? The answer seems to vary in practice depending on industry.

At firms in industries where it is extremely necessary for employees to share information automatically and to synchronize it in advance, it seems desirable to maintain the traditional labor system which has been so useful for Japanese-style manufacturing. This implies that it is desirable to give incentives to employees in the form of wages and other rewards according to their long-term achievement. In this light, the seniority wage system and deferred wage payments such as retirement allowances and corporate pensions seem to still be effective if combined with an internal promotion system. However, attention should be paid to factors such as the deterioration of the function of main banks and the unwinding of cross-shareholdings which diminish the future credibility of a system that defers wage payments. Thus one may conclude that incentives in the traditional form of remuneration will be much less effective for employees. At the same time, if the mobility of the workforce develops further, the possibility of receiving higher wages in other industries will make the system of deferred wage payments less attractive, and create a situation where the more competitive workers are more likely to be headhunted. To deal with such issues, it is necessary to adopt a wage system that is to some extent linked to an employee’s short-term achievements. This will provide more opportunities for existing employees to earn higher incomes. However, in such firms it may be difficult to evaluate competent workers, because if they are evaluated highly for work done in a shorter period, some employees may become jealous, demanding “fairness,” and the work environment will deteriorate. Therefore, firms in these industries must rely to some extent on the traditional system of wage payment in deferred terms. An empirical study by Miyajima, Haramura and Inagaki (2003) shows that firms using the life-long employment and seniority wage systems tend to be reluctant to reform their governances — those who stand by deferred wage payments are likely to resist such reforms. Even so, their study also notes that firms with performance-based payment systems, together with life-long employment, tend to be positive about such reforms. Therefore it appears the way in which a system of deferred wage payments is incorporated into a system that evaluates individual performance will determine how corporate governance is reformed.

On the other hand, the adoption of a wage system strongly linked to an employee's achievements, or making stock options available to core engineers and employees or other measures seems reasonable in firms in industries where, as a result of the adoption of the module and openness methods, employees do not need to share information automatically or to synchronize it in advance. The introduction of these systems would be compatible with the deterioration of the functions of main banks and the unwinding of cross-shareholdings. At the same time, even if various problems such as jealousy or demands for "fairness" arise from the deterioration of the work environment as a result of the introduction of new measures, the advantages in strengthening incentives and in linking employees' and shareholders' interests will likely outweigh the disadvantages.

Firms in industries where it is desirable that resources and capital be withdrawn swiftly and smoothly should draw up a mechanism providing incentives for employees to move out to emerging industries, and for the firms themselves to press ahead with reforming corporate management. And it seems faster and more efficient to carry out the redistribution through the market, rather than in accordance with the interests of various stakeholders. Since such a re-distribution is in effect the redistribution of resources and capital according to the interest of shareholders, incentives should be devised linking the interests of shareholders to those of employees, who are considered to be the most influential stakeholders of the company. Such a mechanism of incentives will serve to induce employees to accept management reforms and M&As, such as the selling-off of business operations. Taking into account that a successful management reform or M&A through the selling-off of business operations and other measures will substantially increase the share price, a possibly ideal device for creating incentives would be to link the interests of employees and shareholders as closely as possible by granting employees stock options or taking advantage of the stock ownership scheme for employees. At the same time, it is necessary, when an M&A is implemented, to reflect the interest of managers by having the concerned existing corporate managers buy out the operations via MBO (management buyout) or other methods.

The next issue is the relation between protecting employees' assets and the design of incentives. Those employed have mostly relied on three components for their long-term asset formation: the purchase of real estate with the goal of having increased income in the future, funded plans for a public pension scheme, and the formation of pension resources via retirement allowances and corporate pension payments. Of these components, real estate purchased with a housing mortgage can be classified as an asset with fast growth potential but with a certain risk. Retirement allowances received after leaving a company are, together with funds in liquidity, the main source of "high-risk and high-return" fund operations, therefore investment in such "high-risk and high-return" financial assets started after retirement. When the economy was on an upward trajectory, these components were fairly solid, to the extent that one could say that employed workers at that time faced no uncertainty in their asset formation until they left their company on reaching mandatory retirement age.

However, since the bursting of the economic bubble, the three major pillars mentioned above which should have served as the main components of asset formation for employees began to involve great risks. What is more, with Japan's international competitiveness deteriorating and a financial crisis developing, inflation and a lower Japanese yen may develop in the near future. To protect employees' assets in this situation, it would be wise for them to invest in growth funds while they are still working, though such funds may involve certain risks. To grant stock options to employees and to make use of the stock ownership scheme would be quite useful — although there is a risk if the firms' financial state is not healthy — in directing employees' assets to investment in growth funds. However, for workers to concentrate their investments in their own firm will mean an immense loss should the company go bankrupt. In this light, when the company has no particular reason for using investment activities as an incentive, or, for example, when employees make a decision about the accumulation of funds in defined contribution pension plans, the company should advise them to avoid investing in their own company, and consider diversifying the risks involved in their investment activities.

Concerning mobility in the labor market and the internal promotion system, it is necessary to build a mechanism which facilitates the swift and smooth transfer of resources and capital from declining and mature industries to emerging ones, and which encourages individual workers to freely develop their ability. In this regard, efforts should be made in the former industries to introduce new personnel from the outside or boldly promote internal personnel so as to accelerate corporate reforms.

On the other hand, at firms in industries where it is extremely necessary for employees to share information implicitly and to negotiate it in advance, it seems desirable to maintain a system whose purpose is to keep employees within the company. However, even here there are certain factors that need to be kept in mind. The first is, as seen in the empirical study by Miyajima, Haramura and Inagaki (2003), the possibility that an entrenched labor system, in which employees are settled firmly in their jobs, may hinder reform of corporate governance. In this regard, they suggest that the adoption of a wage system which reflects an individual's ability and achievement may to some extent help the entrenched labor system facilitate reform of corporate governance. In addition, there is also the possibility that higher wage levels in other industries may undermine the advantages of the entrenched labor system, resulting in the hemorrhaging of competitive workers to such industries. Even so, at firms in industries where employees must share information implicitly and to negotiate it in advance, provided workers slightly above average are satisfactory, firms may also resort to a strategy whereby the work environment, other than wage levels, is improved, and hire workers seeking such an environment who are competitive enough be just above the average worker. Even in this case, it is necessary for top management to have excellent strategic minds. Thus, the problem of how to train and select workers for executive posts remains unresolved. If executives are selected through internal promotion, companies will target outstanding employees for training, which may cause jealousy and demands for more "fairness" among other employees. At the same time, if outside directors occupy an increasing share on the board of directors, the best post that most internally-trained, outstanding employees can rise to is that of operating officer. Therefore it will be necessary to give operating officers more authority, which will attract employees who wish to be promoted to higher positions. Of course, this problem can be avoided if the cost of headhunting an outsider for executive position is extremely high, but even then, employees may become demoralized, or the headhunted executive may be unfamiliar with the internal situation. Generally speaking, since a majority of Japanese firms are currently successful in industries which require employees to share information implicitly and to negotiate it in advance, they may have to concentrate on training and promoting potentially executive-level employees on a trial-and-error basis.

Finally, let us examine corporate scandals and the whistle-blowing system. Firms in industries where it is necessary for employees to share information implicitly and to negotiate it in advance have a low worker mobility and their employees have to have a considerable opportunity cost if they lose their jobs. Thus, employees in such firms are likely to refrain from disclosing corporate misconduct to avoid wage reduction or labor cuts which may result from going public with the problem and the subsequent deterioration of corporate performance. Nevertheless, as firms suffer tremendous deterioration in business performance when misconduct has been made public after a long period of concealment, it is desirable to deal with misconduct early before the damage spreads. Hence, it will be urgent for firms in such industries to create an infrastructure which makes it easier for employees to speak out about corporate misconduct. Despite this, and even if whistle-blowing may eventually contribute to profits, the whistle-blower may find him/herself unpopular among his/her co-workers. To avoid this, it seems necessary that some protective measures must be taken to withhold the name of whistle-blowers.

On the other hand, the mobility of workers is high at firms in industries where employees are not required to share information implicitly or to negotiate it in advance. Thus, the possibility of reduced wages and of losing one’s job, as would be incurred by the deterioration of business performance triggered by whistle-blowing, is small. If the concealment of improprieties in these industries is discovered and made public, employees are likely to blow the whistle since the concealment might mar their reputation and undermine chances of being employed at a different company in the same industry. Therefore, when it is possible to prevent misconduct and the resulting damage from spreading, in particular at an early stage, it is possible that corporate managers will tacitly encourage employees to report any information on potential misconduct. The partial payment of wages in the form of stock options and the use of a capital participation system may be one possible avenue here.[16] On the other hand, when wages will be strongly affected by future business performance, employees may be more likely to help in covering up corporate improprieties if the scale exceeds a certain magnitude.

Employees face the possibility of losing their jobs when disclosure of corporate scandals negatively impacts firms in declining and mature industries. To minimize the damage, it is necessary to secure the high mobility of workers, separate from establishing a whistle-blowing system. In addition, as an ex-ante measure, firms should create a climate where business reconstruction will proceed smoothly by selling off business operations or carrying out other types of M&As.

It is desirable that firms encourage employees to blow the whistle, in that such action means dealing with corporate misconduct at an early stage and thus contributes to the improvement of profits. For this, whistle-blowing activities will increase the corporate value of the company in the future, so the expected benefits to employees should be linked to the value of the corporation — although, when the situation worsens, such reward mechanisms will, conversely, create an incentive to cover up the problem. Since granting rewards for whistle-blowing is a delicate question, it will be interesting to see how reward systems can be designed that skillfully avoid the air of a trade-off.

[16] According to an empirical study by Alexander and Cohen (1999), corporate crimes happen less frequently at firms when a high proportion of shares are owned by corporate managers. This finding implies that the ownership of stocks by employees is likely to serve as an incentive in preventing scandals.

5. Conclusion

We began by discussing the external changes to the Japanese economy, and then moved to the resulting reform of corporate governance. On that basis, we considered the best approach to employment relations from four perspectives: (i) the necessity of devising new incentives for employees; (ii) consistency between protection of employees' assets and the new incentives; (iii) increased mobility of the labor market and the internal promotion system; and (iv) corporate scandals and the whistle-blowing system. We also attempted to shed light on employment relations that would not prevent reform of corporate governance from advancing.

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