

Japan Labor Review

Volume 2, Number 1, Winter 2005

Special Edition

Changing Corporate Governance and Labor-management Relations

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The Spring 2005 issue of the *Review* will be a special edition devoted to **Diversification of Employment and Issues concerning Human Resource Management.**

INTRODUCTION

Changing Corporate Governance and Labor-management Relations

The revision of the Commercial Code in 2002 enabled Japanese firms with a certain number of employees to choose one type of corporate governance from among various options. The revision and the responses toward it by Japanese firms lead certain conclusion to the argument concerning corporate governance which had been discussed since the late 1990s. This issue of *Japan Labor Review* features articles addressing corporate governance in Japanese firms to discuss the influence of changes in corporate governance on labor-management relations.

The first article by Professor Hiroyuki Itami provides his logical inferences concerning the possible impact of the revised Commercial Code on the corporate governance of Japanese firms. Itami stated that the revision itself does not have any substantial direct impact, and that the newly provided option where governing structure is concerned will not trigger any considerable change in the corporate governance. According to him, it is the risk of hostile takeovers by foreign firms that will have a certain influence on corporate governance.

The second article by Professor Takashi Araki deals with features of share ownership, management and employment relations in Japan. In his article, he characterizes the traditional Japanese corporate governance system as an employee-centered stakeholder model which relies heavily on practices. After examining recent changes that might affect the traditional governance model, he argues that, in spite of these changes, there are countertrends and countermeasures against the one-sided progress towards the shareholder value model. He concludes that stakeholder model in Japan is not likely to be drastically morphed into the shareholder value model at least for the time being.

The third article by Professor Hiroshi Osano and Mami Kobayashi, postdoctoral fellow of the COE program, points out possible future direction of corporate governance in reaction to ongoing external changes. This article aims to clarify which company-employee relationship is compatible with such changes. Professor Osano and Kobayashi argue that changes in corporate governance in response to these external changes can

be classified as either changes in external or internal governance. This article concludes that company-employee relationship should be reformed in line with these changes.

The fourth article by Fujikazu Suzuki, Deputy Director General for RENGO-RIALS, focuses on the role of employees in corporate governance. A constant theme in the debate surrounding reform of corporate governance in recent years has been how to include “voices outside the company” in corporate governance. Suzuki argues that it is important to establish systems to reflect “voices within the company” in corporate decision-making and monitoring mechanisms. He is concerned about the voices of employees, whose vocational lives depend on decisions made by management. This article examines the changes in the role of employees as members of corporate society and the issues labor unions raise on behalf of employees.

Considering that the mechanism of corporate governance in Japan is still in the process of being reformed, it is difficult to say that the model of corporate governance has been established. It seems that Japanese firms will continue to seek the compatible model with each firm. I believe corporate governance structure exercises great influence on labor-employee relations, thus future developments should be carefully monitored.

Hiroyuki Fujimura
Professor, Hosei University

Revision of the Commercial Code and Reform of the Japanese Corporate Governance

Hiroyuki Itami

Professor, Graduate School of Commerce and Management, Hitotsubashi University

1. Revision of the Commercial Code and the “Counterattack” of the Stock Market

Commercial Code revised in the 2000s

In 2002, the Commercial Code was substantially revised. The revision enabled Japanese firms to choose freely one type of corporate governance from among various options. One option is the traditional governing structure, with a traditional board of directors, together with traditional auditors. Another important option is what is called the “committee system,” whereby three committees (nomination committee, compensation committee, and audit committee) consisting mainly of outside directors are placed above the board of directors, the committees being in charge of designating directors, drawing up proposals for their compensation, and auditing them, respectively.

The revision makes it legally possible for Japanese firms to allow outside directors to gain control of the board of directors through committees, a system adopted in the U.S.A only as a restriction imposed by the stock exchange on listed companies, not by the corporate law. In so far as the revised code in Japan now allows what U.S. corporate law does not require legally, it is understandable that the latest revision of the commercial code in Japan should be called more “U.S.-style” than the U.S. corporate law itself. However, adoption of the committee system is no more than one option, and is not compulsory.

The revised commercial code has not only opened the door to the revision of corporate governance practices but has also made it legally possible to do corporate acquisition through share exchanges, and will allow, from 2005 on, exchanges of shares between Japanese firms and a Japanese subsidiary of foreign corporations. In other words, foreign companies will in practice be able to buy out Japanese firms via this share exchange method.

These revisions of the commercial code undeniably show a tendency to bring into Japan the shareholder-oriented corporate governance which is practiced in the U.S. In this sense, the 1990s were the decade when American standards were seen as global standards, and Japanese corporate managers felt a psychological pressure not to lag behind the “global standard” in any aspect of management, not only in the field of corporate governance practices. Possibly, when the bubble boom collapsed, Japanese managers might have lost the confidence they had in the 80s when they boasted of “Japan as No.1.” And this psychological change seemed to bring about revision of the commercial code in a somewhat hasty and fairly drastic manner.

This article is aimed at providing the author’s logical inferences concerning the possible impact of the revised commercial code on the corporate governance of Japanese firms. My conclusion is that the revision itself does not have any substantial direct impact, and that the newly provided option on the governing structure will not trigger any considerable change in the corporate governance practices of Japanese firms; rather, it is the risk of hostile takeovers by foreign firms that will have a certain influence on corporate governance. In the following pages, I will explain the logic which has led me to this conclusion.

Counterattack of Stock Market

Japanese firms in the 1990s seem to have sought corporate governance with clear emphasis on the interest of shareholders, as a means of avoiding the criticism of inattention to the shareholders. Behind this behavior lie not only the simple loss of confidence caused by the overall sluggish economy after the collapse of the bubble boom and the subsequent compulsive compliance with the standard global emphasis on the interests of shareholders, but also the occurrence of a phenomenon in the 1990s which might be called the “counterattack of the stock market.” While Japanese firms up until the 1980s had been allowed not to pay enough attention to the interests of shareholders, the Japanese stock market situation in the 1990s seem to have forced the Japanese firms to heed the shareholder’s voice.

Pressure came from two quarters – a sharp fall in stock prices due to the burst of the bubble boom, and the subsequent prolonged depression in stock

prices. These created seeds of great discontent among investors. First, the burst of the bubble boom brought about a sizable plunge of the Nikkei Average below one-third of the highest score marked in late 1989. It seems quite natural that investors, who had suffered from huge capital losses, should press firms for a larger dividends. But firms on their side might feel that the investors barked up the wrong tree, in that firms did not necessarily receive new funding from investors when the stock prices were high during the bubble boom. And it was the investors, definitely not the firms themselves, that benefited from selling at the highest price during the bubble years. Of course, some firms did equity financing at a high stock price and acquired enormous funds, but those were not a majority.

Nevertheless, a fair recovery of stock prices would have eased the situation, but the stock prices hovered at a low level for a long period. This meant that new investors coming to the stock market in the 1990s were unable to earn capital gains as large as they had expected in the 80's and before.

The double hardships of investors in the Japanese stock market in the 1990s were utterly unthinkable given that the market until the 1980s had been the most profit-making market in the world on a time-scale of decades. The high investment performance was backed up by large capital gains thanks to a long-term rise in stock prices. As is generally known, the dividend payout ratio of Japanese firms is low, and so is the dividend yield. But investors had enjoyed a rise in stock prices large enough to make up for the low dividend payout and yield, a rise made possible by Japan's economic growth. Because capital gains were huge, investors did not have enough justification to take a firm stance in complaining to firms. Put differently, corporate managers were not under close scrutiny from investors.

In other words, capital gains which had satisfied investors until the 1980s were no longer available in the 1990s. Instead, huge capital losses were created, which generated protests by investors against corporations. Japanese firms, in short, encountered a "counterattack" by the stock market.

What is more, two additional factors which tended to heighten criticisms by investors arose in the 1990s. One is that banking institutions suffering from non-performing loans unloaded cross-shareholdings of affiliated companies. The unwinding of cross-shareholdings was a consequence of

banks' efforts to secure profits by materializing paper gain from stocks they had held. The main purchasers of such unloaded stocks were foreign investors, in particular foreign institutional investors. They followed practices prevailing in their own countries or in the U.S.A., and loudly demanded satisfactory distribution of profit from Japanese firms. The shift in the composition of shareholders from quiet long-term ones, that is, Japanese banks, to loquacious foreign institutional investors had an impact in enhancing shareholders' influence on firms.

The second factor emerging in the 1990s was the adoption of the market-price valuation method for corporate accounting. Quite a few companies suffered appraisal losses when their stockholdings were evaluated at market value. The generation of losses lowers corporate profit, and serves as a cause of further stagnation of stock prices. It is also likely to discourage firms from holding stocks which have a substantial impact on accounting profit. One reason for banks to unwind their stocks, apart from realizing appraised gain in stockholdings, was to adjust their asset portfolio so as to avoid volatility of profits. Once firms have started to avoid holding shares, this in itself serves as selling pressure in the stock market, and leads to a continued downturn of stock prices. Consequently, investors find it more difficult to make capital gains, and bring stronger pressure on firms.

In this way, Japanese firms in the 1990s were put in a situation to face counterattack from the stock market and strong protests from investors.

The situation might be, I suspect, somewhat "confusing" for a majority of Japanese firms. Certainly as a legal entity incorporated under stock corporation system and as publicly traded company which are listed on the stock exchange, it seems so natural to listen to the voices of the shareholders as the most important stakeholder. However, the actual corporate aims of many Japanese firms consistently throughout the postwar period have been, though implicitly, employment stability for their employees and the development of the firms themselves. Satisfaction of shareholders has been only a reluctantly accepted constraint. It seems that many corporate managers believed that all they needed was to secure a state of affairs satisfactory to their shareholders, and did not see it the aim of the business management to expand the proportion of profits allotted to shareholders and to increase the aggregate market value of the firms by

heightening stock prices. The belief that companies belong to the employees who are committed to them, rather than to the shareholders has been tacitly agreed upon as a self-evident truth among Japanese corporations. I express this concept as “employee-sovereign,” and have claimed for many years that the concept, in a long term, is conducive to the benefit of shareholders, and is thus highly rational from the economic viewpoints (See, for example, Itami [1987] or Itami [2000b]).

It was in the 1990s that this tacit agreement among Japanese firms came under counterattack from shareholders in the wake of a sluggish stock market.

With the economy remaining stagnant in the 1990s, Japanese firms looked as though they, after all, kept adhering to the concept of employee-sovereignty. While the value added of companies continued to hover low, they gave priority to the distribution of value added to labor (i.e., frequent pay hikes), so that the labor’s share in the value added increased, whereas the corporate profit after payment to labor shrank or remained low. This resulted in a reduction in sources for distribution to shareholders. To maintain the level of dividends in this situation, internal reserve funds were liquidated (or stocks were sold to secure profits). The distribution of value added to labor and to stockholder in the 1990s literally illustrates the principle of employee-sovereignty. (See Itami [2000a])

However, this practice was overdone and should be called as overrun of the employee-sovereignty principle. Since value added remained low, distribution to labor should have been determined accordingly. But in the decade of the 90’s, wage hikes beyond the productivity increase were a rather regular practice among Japanese firms. And these pay hikes occurred at the time when the counterattack from the stock market was becoming real. The late 1990s was a period when Japanese firms were exposed to still harsher voice from the “counterattack.”

2. Essence of Corporate Governance and Dangers of the Committee System

The True Focus of Reforms of Corporate Governance

Given that an economy would be brought to a standstill unless a return

on capital were secured and capital continued to circulate within the economy with fair return, the protests of investors were quite rational in some ways. However, what does not make sense is that, though they should call for an increase, even if not substantial, in their share of corporate profits, people often hastily rushed to the conclusions that the basis of corporate governance must be returned to the shareholders' sovereignty, and that the governing system must be reformed to allow shareholders to check on every aspect of corporate behavior.

In other words, even though Japanese firms are now exposed to a counterattack from the stock market, this does not necessarily mean that the principle of corporate governance in Japan requires fundamental alterations. But in the 1990s, when corporate governance was much debated in Japan, it was also the time that the financial system across the country was unstable, and U.S.-style corporate governance focusing on the interests of shareholders was prevalent throughout the world due to the demise of the Soviet Union and the advent of a mono-polar U.S. hegemony. I have the impression that this series of unfortunate developments encouraged what was a rational protest from the stock market to develop into the full-scale revision of the commercial code aiming at a sweeping reform of Japanese corporate governance practices.

Should the counterattack from the stock market, in fact, go as far as demanding a fundamental change in the principle of corporate governance, that is, the abandonment of Japan's tacit agreement, employee-sovereignty? This is very doubtful. And the doubt grows when we begin to think about the essence of corporate governance.

I believe that the crucial point in practice in reform of corporate governance is to establish a vigilant watch on corporate management.

It may help understand the issue more easily if we make an analogy with governance of a nation: the establishment of a check mechanism on policy makers is vital in maintaining the health of the governance structure. In a democratic country, elections play such a role. Similarly, in the case of corporate managers, keeping a watch on top managers or executives—whether their behavior is ideally conducive to the long term development of the economic organization – forms the bedrock of corporate governance, and further, how to restrain top management when its business conduct gets

out of hand; if so, how to dismiss the managers responsible; and in the very first place, how to select managers who are most likely to conduct sound business management.

In sum, the most crucial point of corporate governance is to explore a suitable checking function and ways of appointment and dismissal of top management. This question is universally relevant across the countries; and the essence of corporate governance lies neither in the question of countermeasures against misconduct nor in securing satisfactory margins of profit for shareholders, as is often contended.

In Japan, however, where managers have paid too little attention to the interests of shareholders, these are now highlighted as a central issue in corporate governance. But in the light of the fundamental question of what governance is required for sound corporate development, top priority should still be given to the monitoring of top management.

And it seems that virtually no checking mechanism for top management existed in Japanese firms in the 1990s. One might say that this was a by-product of an unspoken consensus of employee sovereignty among Japanese firms.

In order to practice employee sovereignty principle under the legal system of joint stock corporation, many Japanese firms have made efforts to minimize the influence of shareholders. In other words, that they have made efforts to keep shareholders as silent as possible. For example, firms sought other companies who would cross-hold shares and keep silent, while the board of directors was filled from within the company. On top of that, an odd common sense prevailed that the best general shareholders meeting was a short one.

Thus it is not surprising that there is a criticism that this behavior on the part of Japanese firms has vitiated the mechanism of “checking of corporate managers by shareholders” provided by the commercial code. The disempowerment may not be a particularly serious problem so long as other checking mechanisms, apart from that laid down by the code, function properly. These include, for example, monitoring by main banks.

However, with Japanese firms accumulating internal funds and becoming less dependent on bank loans for financing, the main bank system is becoming less effective in monitoring firms. As a result, one

major checking mechanisms has disappeared. To keep shareholders silent was not absolutely wrong by itself, but the real trouble begins when the absence of any effective checking mechanisms is allowed to go unattended.

How can the vacuum in the mechanism for checking top management be filled in? This is the primary issue that we should focus in the debate on Japanese corporate governance.

Seen with this focus, how much impact do the revisions of the commercial code made throughout the 2000s have?

Doubtful Aspects of the Committee System

At present, not many firms have actually chosen the committee system under the revised commercial code. In 2003 when this option became available, 60-odd firms including quite a few well-known companies shifted their governing structure to the new scheme, but it seems that far fewer firms did so in the following year. In sum, currently less than a mere 5 percent of all firms listed on the Tokyo Stock Exchange have adopted the system.

The true feeling of firms hesitating to go for the system seems to be a suspicion that an appropriate top management team may not be able to be formed if the nomination committee – which is in some ways the most important committee in that it holds the power of designating directors – is organized with an absolute majority of outside directors. A ground for the suspicion comes from doubt about the impossibility of outside directors having sufficient information to evaluate every inside director. Firms are wondering if it is in practice possible to entrust them with such an important aspect of personnel assignment.

Even if they organize things so as to provide information from relevant offices within the firms or from incumbent top managers, another problem remains unsolved, concerning whether qualified persons can be secured as outside directors. This problem concerning the supply of outside directors may be even more crucial, in that, although they might be in good supply if, say, 100 or so firms needed them under their committee system, if a thousand firms adopted the system, it would be doubtful if suitable and effective outside directors could be mobilized.

Even so, the supply problem may possibly arise only at the initial stage

after implementation of the system; outside directors, perhaps, will be supplied from various sources in the long run. Some claim that adoption of the system itself serves as pressure creating a supply of such personnel. This may be true. However, even if the problem of appropriate supply of outside directors can be solved in the long run, when one thinks about the question of whether or not the nomination committee authorized to retain or dismiss board members employs the proper mechanism to execute the envisaged tasks, a potential danger is seen to be embodied in the committee system.

The potential risk becomes real when the system is abused through the nomination committee's being taken advantage of to consolidate the power base of the very top people who are actually in power now. Although the committee is set up to monitor top management, it is highly likely to be exploited as a device to maintain the power of that management.

Since the nomination committee holds the power in practice to appoint members of the board of directors, the person who bestrides the committee will be in paramount authority in the firm. The nomination committee consists of both internal and outside directors, though the latter make up a majority of the members. Thus, so long as outside directors in the nomination committee have been persuaded, the power to retain or dismiss any directors will be readily available to the person who can do this persuasion. Who, then, is responsible for actually searching out and contacting candidates for outside directors of the committee?

This is, inevitably, the actual power holder in the current top management team, that is, either the chairperson or the president. The pattern remains exactly identical to the controversial traditional system of boards of directors in which internal directors are dominant, and the person currently in paramount authority holds the actual power to nominate them. It is identical in the sense that the person currently in the highest position of the company has the power to nominate members of the "nomination committee" which is supposed to have the final authority in determining membership of the legal governing structure of the company.

Under the committee system, therefore, the nomination committee alone is able to impose checks on (in particular, to dismiss) the person currently in the highest position. This means that the only possible means to dismiss the

person is a rebellion of outside directors.

A majority of firms which have adopted the committee system have three to five outside directors. And in many cases, these outside directors in the nomination committee are personal friends of the authority in the highest position. Is it in fact possible for them to have any substantial incentive, or information, such as to make them bother to rebel against the person in power in order to exercise their duty as members of the nomination committee?

It is natural to assume that, unlike somebody whose future prospects rely utterly on the fate of the company, friends or acquaintances outside the company will usually have neither incentive nor the information to make them rebel. There is still, of course, a possibility that certain insiders will find the current top manager incompetent, seek to persuade nomination committee members to take action, and give them any necessary information. But, even in this case, such a move by insiders is highly likely to be detected by the person in power. This is even more obvious if some committee members are acquaintances of that person. How many employees dare to take the risk of passing on information which only inside workers can obtain to outside directors? The scenario of sound functioning of the committee system, in short, is over-optimistic.

It is not sufficient to point out the potential risk hidden in the mechanism of the nomination committee; any system encompasses risks. Rather, the focus of the question lies in whether the adoption of the committee system is an improvement over the old system. It is necessary to compare the new system with the old option, that is, a traditional board of directors consisting mainly of internal directors, in the light of its effectiveness as a checking function and the “possibility of a successful rebellion” against the person who is in effect in paramount authority (who can dominate the nomination committee itself.)

One should consider that even under the conventional system, the power to nominate internal directors is in the hands of the person in the highest position in the company. Thus, since members of both the nomination committee in the new system and the board of directors in the traditional one are designated by the top management of the company, the checking function may not work properly either way. The question here is which is

more likely to rebel against the top manager when necessary (that is, when the idea of stripping him of the position is becoming dominant) – the nomination committee, or a board of directors consisting mainly of internal directors.

In my opinion, in terms of the information and incentives necessary to defy the top management, a board of directors consisting mainly of internal directors is more likely to take action, in that their fate has been, and will be affected by the fate of the company throughout their business lives, and that such internal directors have empathy with the large number of employees working together with them. The circumstances of those directors may be far more likely to persuade them – rather than outside directors who have no strong ties with the company – to take defiant action against the person in the power. As for the information required for defiant action, inside directors are in an advantageous position compared to outsiders, since they are physically close to the authority and able to see what he does within the company.

What is more, quite a few firms are now carrying out reforms such as adopting a system of operating officers under the conventional board of directors, and in fact the number of directors has been declining. This seems to facilitate rebellion within the board of directors. For example, if a board consists of 25 directors, 13 members must secretly unite to rebel against the person in power, whereas if a board comprises 11 directors, only six members are needed to do so. There is a great difference between 13 and six in secretly preparing for a rebellion.

In other words, under the conventional system of board of directors comprising mainly internal directors, the president or chairperson, namely the person in power, are ultimately in a situation as if they were subject to a final check for their retaining their position by directors who have gone through the ranks within the company. This in fact conforms to the tacit understanding in Japanese firms that I described as “employee-sovereignty” in the previous section. All the more reason, then, that defiant action by internal directors, if such a thing happens, is likely to attract support within the company.

Of course, I do not believe that such defiant action can take place easily. Nevertheless, I know of some such cases in the past. Judging from these

cases, and looking into the actual membership of nomination committees under the newly adopted committee system in certain companies, I have a feeling that outside directors under the committee system are much less likely to undertake defiant action against the top management.

Certainly, the shift to the committee system obliges the top management the accountability to outside directors, which will serve as a source of new checking function. Thus, the real question is which is more effective as a checking mechanism, accountability to outside directors or the threat of the traditional board's rebellion. This question is difficult to judge, but at least it does not seem that the committee system is clearly superior with respect to the efficiency in checking the top management.

Judging from the paucity of practical effects, and the question of inadequate supply of outside directors, it cannot be logically inferred that the corporate governance of Japanese firms will change substantially thanks to the availability of the committee system, nor does it seem that the system will be adopted widely with substantial function, beyond "window-dressing" or cosmetic propaganda for the capital market.

Discipline by Threat of Hostile Takeover Bids

A possibly more effective device than the committee system as a mechanism to check top management is the threat of the takeover of Japanese firms by their foreign counterparts via the stock-swap system which is to become available in 2005.

It seems that an increasing number of business managers feel threatened by such hostile takeovers. In particular, under current circumstances with low average levels of stock prices of Japanese firms, foreign companies need only provide a small number of their own stocks in order to effect hostile takeovers. Currently, in other words, many foreign firms are able to buy out Japanese firms without ignoring to any considerable extent the interests of their own shareholders.

The threat to the top management through hostile takeover bids is a classic mechanism in Western countries to check the top management via the stock market. This mechanism works in two different ways: first, by facilitating the self-discipline by the top management whereby the threat of buyout places discipline on corporate managers, and the managers naturally

pay careful attention to their business; and secondly, via the replacement of the top managers as a result of an actual buyout. Replacement does not have to take place frequently and a small number of occasional replacements would be enough to strengthen the function of the first mechanism. In other words, the potential threat of hostile takeover bids should really exist to make two types of the mechanism work properly. And now it may be going to be applicable for the first time in Japan also.

However, even if the potential threat of buyouts facilitates appropriate corporate management, its effect would tend to be biased toward the corporate managers to pay more attention to increase the aggregate market value of the company in order to reduce the risk of being bought out. That is, one of the greatest concerns of top management is likely to do management reform which will contribute for higher stock price higher in the market. Of course, it is a good thing to conduct business management to improve strategies for corporate growth and to heighten the possibility of growth in future, which will have a beneficial effect in turn on both employees and shareholders, but the threat may carry a risk of tempting corporate managers to steer the company in order to pursue a short-term interest, i.e., to increase the size of profits distributed to shareholders. And this is not necessarily compatible with favorable long-term prospects for the company.

What is more, another thing requiring attention is a possible expansion of cross-shareholdings to act against the threat of buyout. In view of the fact that the expansion of cross-shareholdings among Japanese firms in the 1960s was occasioned by the threat of buyout by foreign companies due to capital liberalization at that time, one cannot ignore the possibility that history will repeat itself. This risk may not be so great since the introduction of current value accounting system has made the volatility of corporate profit due to cross-shareholdings much greater and thus made cross-shareholdings less attractive than before.

In sum, the threat of hostile takeover bids would move Japanese companies to take various counter measures to avoid takeover. Being a straightforward menace to the corporate power structure, takeover threat would have much greater impact on corporate governance in Japan than the committee system.

3. One Proposal for Top Management Checking Mechanism

Checking from Inside and Outside

As is obvious from the discussion so far, I do not believe that the creation of the new option for the governing structure of Japanese firms can be expected to fundamentally improve their corporate governance.

A firm has two characters at the same time intrinsically: on the one hand, as a financial entity or community of money, it can be considered to belong to its shareholders; on the other, as a entity of persons or community of people, it can be considered to belong to its employees. If one accepts frankly this bilateral character, I think that corporate governance reform aimed at shareholder-only top management checking mechanism as in the revised commercial code is, in principle, inadequate from the beginning. A checking mechanism which does not reflect the internal voices of employee is particularly inadequate for Japanese firms which have always relied tacitly on the principle of employee-sovereignty.

Even more, as explained in the previous section, the committee system seems extremely inadequate as an option in filling the void in the checking mechanism created by the silencing of shareholders.

In any reform of the mechanism for checking top management, it is crucial, I feel, to create a device to check it from both within and without.

My suggestion is to take advantage of core employees for the internal checking mechanism. Employees, above all, are the core members within the business organization, and if they play the part of sovereign with the corporate citizenship, they should have the right to check the top managers in accordance with the weight of their shared sovereignty. This would be quite understandable if one considers that citizens of a nation play a major part in a mechanism for checking the rulers of the nation with their right to vote in election. In this light, what I shall now advocate in detail below is a “referential confidence vote system” by the core employees of the firm, especially middle managers.

On the other hand, since corporations are in some ways public institutions, it is also necessary to reflect widely the voice of public in the mechanism for checking top management. For this, it will be useful to

establish a “management auditing committee,” made up mainly by the people outside the firm. As for the ideal participants in this committee from outside the company, it will be appropriate to select outsiders who have both the capacity and information to judge the quality of top management. Examples include highly reputed top managers of companies with little stake in the company in question, and academic experts or others who seem qualified to evaluate top managers.

In addition, former top managers of the company may well be counted among such “outsiders.” Retired top managers, rather like the Senators of ancient Rome, are familiar with the circumstances of the firm, and are, in many cases, have intimate knowledge of the personal integrity and intellectual capacity of candidates for new top managers. Naturally, if they dominate the checking mechanism, the system will invite the criticism that it is a “gerontocracy,” but their participation in the auditing committee together with a larger number of top managers from unrelated companies, academic experts and other outsiders will not do much harm; rather, it can be expected to make a great contribution.

The “management auditing committee” is in no way identical to a nomination committee. It is not in charge of the nomination of directors nor auditing the entire body of the board of directors. Rather, it is responsible for auditing only the very top people in the top management rank, usually one or two highest ranking executives.

Shareholder representatives should, of course, participate in the management auditing committee, but the manner of their involvement is somewhat difficult, the reason being that they are insiders in one sense and outsiders in another. If we think core employees as the most typical insiders of the firm, shareholders should be counted as a combination of insider and outsider in the following sense.

They are insiders in that they are an indispensable component of the firm as providers of capital which has promised not to flee from the firm no matter what. A firm as an economic entity inevitably has the nature of a community of capital, and since shareholders are the source of the core capital, they are insiders. And if we are to divide shareholders into core and non-core shareholders, the former can absolutely be counted as insiders.

On the other hand, shareholders, in particular non-core shareholders, can

be regarded as outsiders for a firm as an economic entity in that they can easily walk away from the company at any time by selling the stocks they hold. They are sometimes no more than simple providers of capital, requiring no more than an appropriate return on capital. When they call for the distribution of profit, their voice comes from outside, that is, the market.

Under the current legal framework, such double-faceted shareholders have full powers in checking corporate managers. Although they are insiders and outsiders simultaneously, the law defines them as insiders and assigns them the final authority to appoint and dismiss top management. This is, taken at face value, a fairly problematic situation. However, this is the commercial code, whether before or after the 2000 revisions.

Whatever the case may be, it seems to be a general rule that both insiders and outsiders should undertake the checking of the top managers. In this light, many deficiencies can be immediately apparent in the checking mechanism the current corporation law provides. That is why additional reform is required.

Three-Layer Structure of Nomination, Confidence, and Approval

Institutional reform to include both insiders and outsiders in top management checking mechanism as described in the previous section means, in my opinion, establishing a system with a three-layer mechanism for the nomination, approval, and dismissal of the top management.

The first layer involves nominating candidates in the management auditing committee consisting mainly of outsiders. The second involves conducting a vote of confidence by core employees. And the third involves, in the conventional manner, selecting directors to be in the board at the general shareholders meeting. (Here, as elsewhere, top managers mean chairperson and president, who are literally in the highest rank in the company.)

Under the traditional commercial code, the board of directors nominates candidates for new top managers, while members of the board are approved at the general shareholders meeting. This two-step process is now divided into three steps of nomination, confidence vote, and approval. The management auditing committee is responsible for the nomination of the candidate for top managers within the board of directors, while core

employees undertake a vote of confidence on the candidates. Including the candidates, the entire board needs the final approval by the general shareholders meeting as the last step. This completes the three-layer structure of the system. This is three-layer not only in terms of process, but also in terms of the number of parties involved. In other words, shareholders, employees, and outsiders all take part in each process.

In more detail, the nature of the three steps is as follows.

The first step is the “nomination” of candidate managers.

The management auditing committee comprising mainly outsiders nominates one single candidate each, and no more, for chairperson and president, respectively.

Main tasks of the committee are, as the name implies, to audit the job performance of the present top managers and nominate candidates as their successors in the next term, for the final approval by the general shareholders meeting. Since it is assumed that the top managers double as representative directors, the nomination is to take place as the term as their directorship ends. In cases where the committee finds the incumbent top managers incompetent from their audit, the committee is also responsible for suggesting dismissal.

The committee comprises of outside corporate managers, academic experts, shareholder representatives, retired top managers of the company in question, and other suitable outsiders. The incumbent top managers are not eligible for the membership of the committee, although they should be given an opportunity to give their opinion to the committee concerning the candidates to be nominated. This is because they are most likely to be in a position to know of the quality of the potential contenders. Representatives of the employees are not eligible for the auditing committee membership, either. This is because the essential point of the committee is to provide outside check and insiders’ duty is to provide outsiders with enough information, not to decide on the candidates.

The most important aim of establishing this management auditing committee which nominates the candidate top managers is to obviate the risk of the current top manager becoming the absolute power, and to secure the healthy selection process of top managers with enough outside checks. At the same time, in order to avoid the complete dominance of outsiders

alone, shareholders who play double roles as insiders and outsiders are incorporated into the nomination process, together with retired top managers who are expected to provide internal information with objective eyes.

What is more, the incumbents are given the opportunity to express their opinion concerning potential successors at the management auditing committee, so as to ensure the meaningful impact of internal information. Their role is largely limited to offer information; it would not be healthy if they became too engaged in the nomination itself.

Nevertheless, it is still important to devise means of securing the influences of the former and incumbent top managers on the realistic selection of the new top managers. Selection may become overly unrealistic if nobody provides meaningful information to the committee about the quality and characteristics of potential contenders and the needs of the firm. It is of course not appropriate if the influence of the current managers is overwhelmingly or exclusively dominant, as is often the case in many Japanese firms today. That would lead to negative genetic selection, so to speak. The presence of considerable influences of the current managers, however, is a good thing in itself.

The second step of the three-layer process of top management selection is the “confidence vote” on the candidate managers by representatives of core employees.

The method of choosing these “representatives” can take various forms, but the discussion here assumes that they are middle-level managers above a certain level and long-term employees who have been in the company for more than a certain number of years. The confidence vote would be formally done at the request of the board of directors which will use the result as a reference opinion. Vote is a secret ballot on the nominee from the management auditing. The voting timing is to coincide with the time when the term of directors is renewed. The result of the vote is reported to the board of directors (and may be publicly announced), and the board takes the result into account in deciding the next board members (including the candidate top managers) to be approved by the general shareholders meeting.

However, it would be appropriate not to make the result of this

confidence vote legally binding. Both the board of directors and the general shareholders meeting use the result as a reference, but are not bound by it. Although the vote is used a reference only, depending on the result of the vote, the board of directors can, at its discretion, redo the selection process back from the first step, nomination by the auditing committee.

The purpose of the referential confidence vote by the core employees is to give institutional guarantee of a concrete practice to the principle of employee sovereignty. In short, this aims at institutionalizing the voices of core employees. Since the current system lacks this step, the principle of employee sovereignty remains obscure even though it lies at the tacit foundation of the firm. By not making the voting result legally binding, however, we can avoid legal contradiction with the current corporation law, that is, the legal infringement of shareholders' rights. In that respect, the proposed idea might be termed "soft institutionalization."

The reason why the right to make a confidence vote is confined to representatives of core employees, not employees as a whole, is that their knowledge and ability to evaluate the suitability of the candidate top managers differ considerably among themselves and it would be inappropriate to give all the employees the same voting right.

The third step of the proposed three-layer top management selection is the "approval" at a general shareholders meeting.

The board of directors reports the result of the confidence vote to a general shareholders meeting, calling for approval for a proposed list of new members of the board and the candidate top managers (of course, members of the new board of directors). While the name of the candidate top managers must be clearly stated here, it may be unnecessary to require approval of the meeting for candidate top managers, as under the current system. It may be sufficient for the approved board of directors to make the final decision on who should be the top management of the firm.

If the proposed list of members of the board is rejected, even in part, at the general shareholders meeting, the whole process, in principle, starts from the beginning – nomination. However, in an emergency, it may be possible that the general shareholders meeting determines new members of the board forthwith, and the new board of directors takes responsibility for the selection of the top managers. In other words, in case of emergency, it is

permissible to omit steps of the nomination by the management auditing committee and the confidence vote by core employees.

Although the general shareholders meeting is not legally bound by the confidence vote by core employees and the result of the vote is simply passed on to the meeting as information, it is quite naturally expected to have an impact on the decision by the general shareholder meeting. In cases where the general meeting opinion differs from the result of the vote, however, the former should be given priority.

This third step of the process is basically the same as the system under the current corporation law; the only difference lies in the presence of the report on the confidence vote to be used as a reference. This third step being the institutionalization of shareholders' voices, it completes the three-layer structure incorporating the opinions of all three parties (outsiders, employees and shareholders). The first two steps are not institutionalized under the current system.

Why “reference” and “a vote of confidence”?

The most controversial aspect of my proposal would be the vote of confidence by core employees to be used for a reference. I have heard many objections against this proposal, like that its adoption would politicize the workplace, or result in vote-catching populist behavior by the incumbent top management, and so on. However, bearing in mind the magnitude of the faults arising from the current unsatisfactory state of the top management, i.e., the absence of checking mechanisms, I still maintain that the system, though there are some deficiencies, should be adopted.

But then, why is the vote of confidence used as a “reference”? Why is it a vote of “confidence” instead of a “selection”? And why is the right to vote confined to core employees, rather than employees as a whole?

First, why should core employees take part in the process in the form of a vote of confidence conducted at the request of the board of directors, the result bearing no legal binding?

One reason for this approach is to put the mechanism within the framework of the current corporation law. Another and more important reason is the fact that if the vote had legal binding power, it would immediately mean that core workers had the right to reject candidate top

managers. In so far as a joint stock corporation exists as a legal entity as a community of capital, granting employees the right to reject would seem to involve a fundamental problem, not just a problem of legal procedures. The mechanism whereby the vote is one of “confidence” with no binding force, but the result is published in the form of a report to the general shareholders meeting, is intended as a deterrent to top management; if a candidate top manager receives a large amount of non-confidence votes, the announcement of the result will have a considerable negative impact on his governing power and selection prospect.

Second, why is it proposed that a vote conducted after nomination of a particular candidate should express mere “confidence,” rather than direct election with more than one candidate? This is because it is rather doubtful whether core employees have information sufficient to narrow down a wide range of potential candidates to the most appropriate one, or whether they are capable of evaluating the qualification for top manager and selecting a single person via a direct election.

The burden on voters is quite different depending on whether they simply give a yes-no judgment on a nominated candidate, or whether they choose one single person from among an unspecified number of candidates. The suggestion here is to furnish a solution to the above questions of the “information” and “burden” by leaving the actual nomination to the management auditing committee but giving employees the responsibility for giving confidence to the nominee.

And third, why should the representatives to participate in the confidence vote be limited to managers of at least a certain rank or employees with a certain length of tenure? This is because the qualifications of voters should be taken into account.

In order to make a right decision over the suitability of top managers, voters must have pertinent information at hand. The information required is classifiable into two types. One concerns long-term requirements for the management of the firm in question, that is, information concerning what kind of management is needed in the future. This provides important criteria in judging the qualifications and career of a prospective top manager. And the other type of information is related to the personal characteristics of potential candidates, that is, personal information in reference to the

suitability of candidates.

In this light, employees who have reached at least at a certain rank of managerial post (e.g., general section chief or higher) are likely to have fuller information than, say, shareholders. They are at the core of practical knowledge of the business management, and possess quite a lot of internal information. What is more, many of them have had potential top managers as their direct superiors and are thus in positions to learn directly the personal characteristics of potential candidates.

What is more, from the standpoint of commitment, they normally have a stake in the long-term prospects of the company. The fact that their number is numerous is a merit. With so many of them, there is little room for the top manager to practice manipulation. This is a marked contrast to the ease of counter-manipulation against the members of the board of directors by top managers under the conventional system, and against the outside directors under the committee system. Voting by secret ballot protects the anonymity of voters and thus also prevents counter-manipulation.

There are three reasons why employees with years of service (for example, 20 years or longer) are added to the representatives of core employees. The first is that they have accumulated a substantial amount of information throughout their long service. The second is their commitment to the company; their opinions do matter, in so far as they have served the company for so many years. And the third reason is that their incorporation among the representatives will enable the opinions of labor union members to be reflected in the opinions of the representatives. Since the labor union system in fact exists, it would seem necessary to reflect the opinions of union members in some form or other.

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Corporate Governance Reforms, Labor Law Developments, and the Future of Japan's Practice-Dependent Stakeholder Model*

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1. Introduction: Japan's Practice-dependent Stakeholder Model and Challenges it Faces

Law and reality often disagree. The Japanese corporate law presupposes that a corporation is a shareholders' property and the role of management is to maximize the interest of shareholders. Unlike German co-determination law which opens the supervisory board to employee representatives, Japanese law does not give employees or their representatives any status as a constituent of the corporation. Unlike many advanced countries, until the 2003 revision of the Labor Standards Law, Japanese labor legislation did not require any just cause for dismissals and maintained the employment at will doctrine prescribed in the Civil Code. Thus ostensibly Japanese law resembles more the Anglo-Saxon market-oriented model.

In practice, however, it has long been held that employees are the corporation's most important stakeholders. The following comments made by the two leading corporate law professors at the University of Tokyo in the early 1990s illustrated the common perception of Japanese corporate governance at that time:

“There has been a consensus among most corporate law professors that, irrespective of the principles and theories stated in the corporate laws, in practice, larger companies are administered by prioritizing interests of employees including both blue and white collar workers.”¹

“The [German co-determination] system [which attracted attention both in the US and Japan in the 1970s] was not accepted and supported in the United States and Japan. The reasons were, however, quite different.

* This article relies heavily on Araki 2004a and Araki 2004b but focuses on recent changes and reflects updated data. The author is grateful to Ronald Dore who read the previous manuscript and gave invaluable comments.

¹ Egashira 1994, 3.

In the United States, shareholders are the owners of the corporation, and thus the employees' participation in the corporate administration is unacceptable. In Japan, by contrast, it is because employees are already the owners of the corporation."²

A report "Corporate Governance Principles—A Japanese View" published in 1998 by the Corporate Governance Forum of Japan, an advocate of American style corporate governance reforms, confirms the same perception. In its report, the Forum states:

"global competition might be interpreted as a survival race between two corporate systems for higher managerial efficiency: one system seeking a singular value for shareholders, and the other pursuing multiple values including those of employees."³

"What should be done in Japan first is to share the recognition among the people that shareholders are owners of corporation and the purpose of corporation is to pursue interest."⁴

Such employee-centered corporate governance was made possible by the following reasons related to the three parties involved in corporate governance, namely shareholders, management, and employees. First, because of cross-shareholdings and the existence of a stable body of shareholders, the primary concern of shareholders has not been the dividend on the stock but the long-term relationship with the trading partners, and thus they have not actively intervened in corporate governance. Second, directors are mostly promoted from within, and quite a large proportion of board members bear the double functions of director and employee (*jogyoin kenmu torishimariyaku*), and thus management and employees have shared views and interests. Third, long-term or so-called "life-time" employment has made the management deem employees as members of the community rather than mere materials or factors for corporate activities, and voluntarily established forums for labor-management consultation lead the Japanese industrial relations to cooperative ones.⁵

Compared with the German stakeholder model which is sustained and

² Kanda 1992, 28.

³ Corporate Governance Forum of Japan 1998, 8.

⁴ Corporate Governance Forum of Japan 1998, 10.

⁵ As for the details of Japan's traditional corporate governance, see Araki 2004a.

sanctioned by legislation,⁶ the distinctive characteristic of Japan's stakeholder model is its reliance on practices or nonlegal norms. Main pillars that have sustained the Japan's stakeholder system such as the cross-shareholdings and existence of a stable body of shareholders, the internal promotion of board members, long-term employment and labor-management consultation, are simply practices or custom. In this sense, the Japanese corporate governance can be called as the "practice-dependent stakeholder model."⁷

Such practice-dependent model would be vulnerable to the changes surrounding corporate governance. Indeed, significant structural changes are occurring concerning the share ownership, management and monitoring mechanism, and labor and employment relations in Japan. The system of cross-shareholding is dissolving. In particular, in order to write off bad debts and to limit a bank's shareholding so as not to exceed the amount of its own core capital required by the 2001 regulations, major banks have been forced to sell the shares they have held in their trading customers. Drastic corporate law reforms facilitating corporate restructuring have occurred since the late 1990s, and the 2002 revision introduced the American model of a board of directors with great emphasis on external directors. The media repeatedly reports on the collapse of the concept of lifetime employment. Union density continues to decline.

Then, is Japan's traditional employee-centered stakeholder model heading towards the shareholder-centered model? To answer this question, this article first examines the recent changes in share ownership in Japan. Then it reviews the features of conventional management institutions and the drastic legislative changes affecting them. Next it looks at recent changes in long-term employment practice and collective labor relations, and recent labor law developments dealing with such changes. Finally, some evaluation of the current situation and likely evolution of corporate

⁶ The German stakeholder model is legally sanctioned by legislation such as Montan-Mitbestimmungsgesetz vom 21. 5. 1951, Betriebsverfassungsgesetz vom 11. 10. 1952 and Mitbestimmungsgesetz vom 4. 5. 1976 which require co-determination at the level of company (Aufsichtsrat) and by legislation (Betriebsverfassungsgesetz) which gives a works council (Betriebsrat) a co-determination right at the level of establishment.

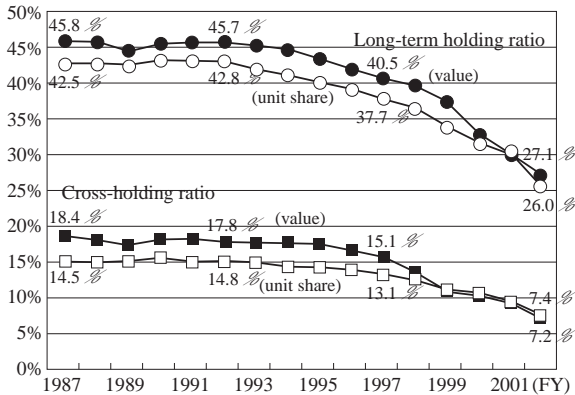
⁷ See Araki 2000a, 259; Araki 2000b, 87; Araki 2004a. Similar observations are made by Dore 2000a, 182, 215 and Milhaupt 2001, 2083.

governance in Japan will be provided.

2. Changes in Share Ownership

The distinctive feature of traditional corporate governance in Japan has been the stable and long-term shareholders and wide-spread cross-shareholding.⁸ However, since the 1990s cross-shareholdings and long-term shareholdings, especially those between banks and their customer corporations, are shrinking in a rapid pace (see Figure 1).⁹ This was caused, in particular, by the continuous decline of stock prices which induced many companies to sell unprofitable stocks and the 2001 Law Restricting Banks' Shareholding calls for banks to reduce shareholdings so as not to exceed the amount of its own capital by the end of September 2006. This Law forced banks to sell their shares in customer corporations and triggered a reciprocal sell-off of bank stocks by the customers.

Figure 1: Cross-Shareholding and Long-term Shareholding Ratios



Source: Kuroki 2003

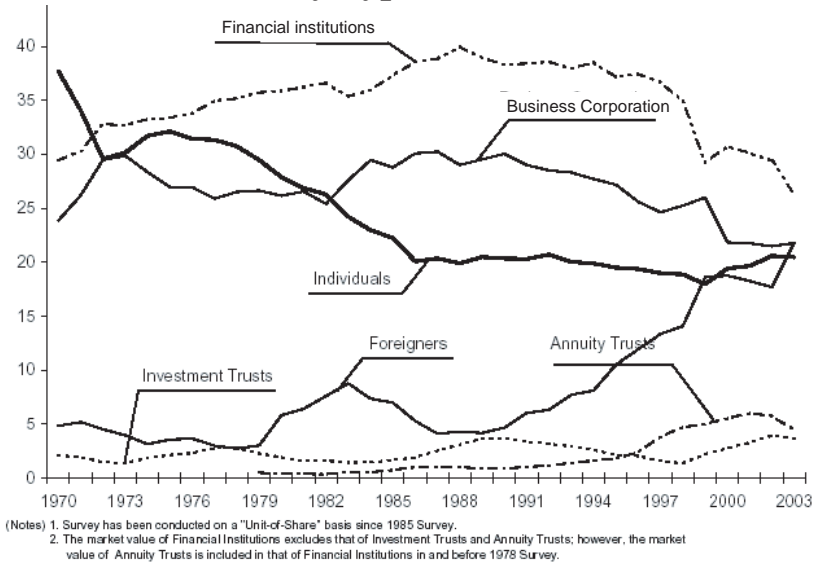
Other important changes in the structure of share ownership are the increase in individual investors and foreign investors (see Figure 2). In accordance with the decline in the ownership of financial institutions and business corporations, individuals emerge as important investors. Unlike traditional Japanese shareholders, foreign investors will require more

⁸ As for the details of the backgrounds of long-term and cross-shareholding in Japan, see Yamakawa 1999, 5; Araki 2004a, 49ff.

⁹ See Kuroki 2003.

shareholder-value-oriented corporate governance than ever. Since their investments tend to concentrate in larger companies,¹⁰ their attitude can

Figure 2 Distribution Percent of Market Value Owned by Types of Shareholders



Source: TSE 2003

have more impact towards corporate governance than their real presence.

3. Corporate Management and Monitoring System

3.1. Traditional Dual Monitoring Model and Introduction of a New Model Utilizing Outside Directors

Until 2002, Japan had a unique dual monitoring system: both the board of directors and auditors monitor corporate management (dual monitoring system, see Figure 3 "Traditional Model"). As for the monitoring by the board of directors, it is said to have an inherent defect in that the monitors (i.e. the directors) themselves engage in corporate administration. Furthermore, since ordinary directors, who often bear dual functions as both junior board members and managerial employees in respective

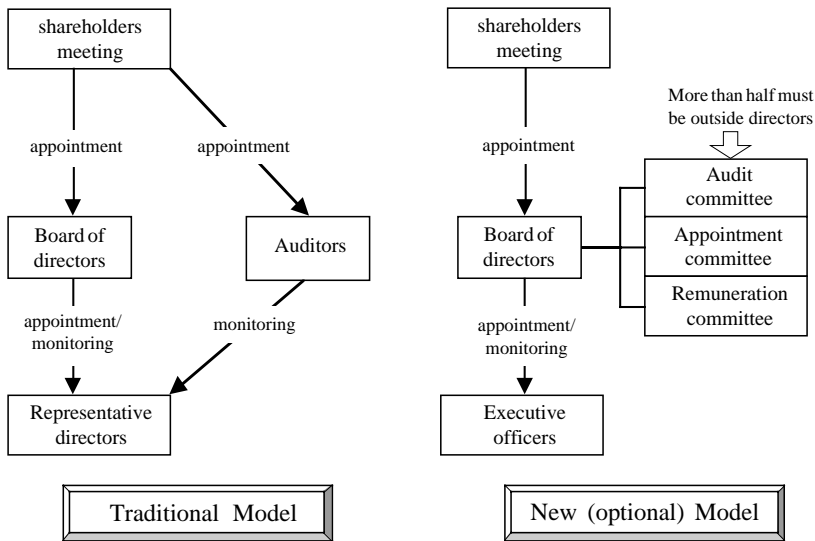
¹⁰ Ministry of Finance, Policy Research Institute 2003, 2-3-1 Overview of shareholders' structural change.

departments (“*jugyoin kenmu torishimariyaku*” or “directors-with-employee-functions”),¹¹ are in reality subject to the representative directors, it is impractical to expect them to supervise their “boss.”

In the past, therefore, various efforts were made to strengthen the power of auditors and ensure their independence. However, the reforms of the auditor system still fell short of expectations.¹²

In this context, in 1998, the Corporate Governance Forum of Japan proposed a quite radical reform plan: to allow parties to abolish the auditor system by adopting an American-style ‘board of directors’ system utilizing external directors.¹³ The proposal was mostly adopted by the 2002 revision of the Commercial Code and related laws.

Figure 3 : Tow Competing Governance Models



The new model introduced by the 2002 revision is called *iinkai-to setchi gaisha* (company with three committees), as opposed to the traditional governance model now known as *kansa-yaku sonchi gaisha*

¹¹ According to the Top Management Survey (Inagami and RIALS 2000, 87), half of all board members are directors-with-employee-functions. According to another survey (Romu Gyosei Kenkyu-jo 1999, 2), 73.3% of the annual salaries of these dual-function directors is remuneration for the employee function and 26.7% is for the directorship. See Araki 2004a, 55,

¹² See Araki 2004a, 57,

¹³ Corporate Governance Forum of Japan 1998, 43.

(company retaining auditors). To adopt the new model, it is required to establish three committees: an audit committee, an appointment committee and a remuneration committee. There must be more than three directors on these committees, and the majority of them must be outside or non-executive directors. Upon adopting this new governance model, the company's auditors or board of auditors are replaced by the audit committee. Such company must have one or more executive officer(s) (*shikko-yaku*, in effect a CEO). The directors and board of directors concentrate on monitoring and the corporate administration is entrusted to the executive officers (see Figure 3 New (optional) Model).

This American-style, single tier monitoring model with three committees is only available for large companies whose capital is more than five hundred million yen or whose total debt on a balance sheet is more than twenty billion yen and for other companies which are regarded as large companies by the law. For these large companies, it is not compulsory but optional to adopt this model. Therefore, large companies can either maintain the traditional dual monitoring system or, by modifying the articles of incorporation (memorandum of association), adopt the new governance model. In this sense, Japan has entered an era of competition between two different governance models.¹⁴

3.2. Impact of the New Governance Model on Industrial Relations

The new model which introduces outside directors potentially alters the nature of management and affects labor management relations because the current management is internally promoted and this practice has significantly contributed to Japan's cooperative industrial relations and employee-centered corporate governance.

In most larger companies in Japan, management and a majority union conclude a union shop agreement. Under the union shop agreement, all employees are obliged to join the union. This means that current executives were members of the enterprise union in their 20s or 30s when they were rank-and-file white-collar workers.¹⁵ Furthermore, according to the Top

¹⁴ Egashira 2002, 412; Kanda 2004, 163.

¹⁵ Since an enterprise union in Japan organizes workers in the same company irrespective of their jobs, both blue and white collar workers are organized in the same union.

Management Survey, 28.2 percent of top management had previously been not only union members but also leaders of an enterprise union.¹⁶ In a sense, labor-management relations in Japanese enterprises are the relation between present union members and former union members (sometimes between current union leaders and former union leaders). This brings about a consciousness that both labor and management belong to the same community, assists labor and management to find common interests, and leads Japanese management to take a consensual – rather than an adversarial – approach.

In corporations adopting the traditional governance model, nearly half of board members are directors-with-employee-functions. By accepting such dual functionality, it can be said that Japanese corporations have established a channel to voice employees' opinions to corporate management.

However, in the corporation adopting the new governance model, the majority of the committee members must be outside directors representing the interests of shareholders.¹⁷ If widely adopted, the new governance model might have a significant impact on the internal promotion system and labor and employment relations.

So far, however, the number of companies which have adopted the American-style new governance model is rather limited. According to the survey by the Japan Corporate Auditors Association as of September 2004,¹⁸ only 97 listed companies adopted the new governance model although they include such leading corporations as *Sony*, *Toshiba*, *Mitsubishi* and *Hitachi*. In another survey conducted in April 2004 by the Japan Corporate Auditors Association,¹⁹ only 0.2 percent of the surveyed companies plan to adopt the new governance model and 1.4 percent of them are considering the matter. 86 percent of the surveyed companies do not intend to adopt the new model.

¹⁶ Inagami and RIALS 2000, 339.

¹⁷ However, it is not required to make more than half of the board members outside directors. In fact, according to the survey on the companies adopting the new governance model in 2004, the average number of board members is 10.31 and that of outside directors is 4.54. Nihon Kansayaku Kyokai (Japan Corporate Auditors Association) 2004b.

¹⁸ Nihon Kansayaku Kyokai (Japan Corporate Auditors Association) 2004a.

¹⁹ Nihon Kansayaku Kyokai (Japan Corporate Auditors Association) 2004b.

Many Japanese managers prefer the old system on the grounds that it makes for management effectiveness to allow a manager to exert his/her leadership, flexible administration to suit the situation in individual corporations, and effective and expeditious corporate administration.²⁰ The scarcity of suitable candidates for the positions of outside director has further hindered the adoption of the new governance model. As a result, the majority of listed corporations continue to maintain the traditional corporate governance model.

4. Changing Employment Security and Legislative Developments

Employment security has had a high priority in Japanese corporate governance. Employees in Japanese companies have been seen not merely as a factor of production which can be adjusted in accordance with fluctuating economic needs. Instead employees have been treated as important constituents of the corporation.

However, in the last ten years, circumstances surrounding employment have changed dramatically. Traditional lifetime employment is said to be at an end. After the collapse of the bubble economy in the 1990s, the unemployment rate has gradually, and rapidly since 1997, increased and repeatedly reached new records, hitting 5.4 percent in 2002. Reflecting the increased need for corporate restructuring, case law started to relax the economic dismissal regulations. However, several countermeasures to protect employees' interests developed in the last few years. This part reviews the traditional employment system and its recent changes.

4.1. Long-Term Employment Practice and Employment Security

Japan boasted a low unemployment even after the two oil crises. Japan's system of lifetime or long-term employment respecting employment security has been sustained by various social institutions: case law restricting dismissals, state employment maintenance policy, and social norms respecting employment security.

²⁰ Ministry of Finance, Policy Research Institute 2003, Table 3-24.

Although the Japanese labor legislation did not require a just cause for dismissal, courts established a case law rule called the “abuse of the right to dismiss” theory which regards a dismissal without a just cause as an abuse of the right to dismiss making such a dismissal null and void. Therefore, an employer is *de facto* required to demonstrate the existence of a just cause. Courts have interpreted “just cause” very strictly, and tended to deny the validity of the dismissal unless there was serious misconduct by the employee. The courts have considered all of the facts favorable to an employee's case and strictly scrutinized the reasonableness of the dismissal.

After the oil crises in the 1970s, the courts established the so-called four requirements for economic dismissals. Namely, a dismissal for economic reasons lacking the following four requirements should be regarded as an abusive dismissal and thus null and void. The four requirements are: (1) there must be business-based need to resort to reduction of personnel; (2) dismissals must be the last resort to cope with the economic difficulties and thus the employer must take every possible measure to avoid adjustment dismissals.²¹ (3) the selection of those workers to be dismissed must be made on an objective and reasonable basis; and (4) the employer is required to take proper procedures to explain the necessity of the dismissal, its timing, scale and method to the labor union or worker group if no union exists, and consult them regarding dismissals in good faith.

Government employment policy²² has also greatly contributed to employment security. After World War II, Japan's employment policy started with remedial measures such as unemployment benefit programs and job-creation measures to absorb unemployment through public works or government provided unemployment countermeasures. From the mid-1960s, however, in accordance with the spread of the practice of long-term employment, the importance of employment policy moved towards preventive measures such as providing various subsidies to enable

²¹ Before resorting to dismissals, employers are required to take other measures such as reduction in overtime, reduction in regular hiring or mid-term recruitment, implementation of transfers (*haiten*) or ‘farming out’ (*shukko*) with respect to redundant workers, non-renewal of fixed-term contracts or contracts of part-timers, and solicitation of voluntary retirement.

²² See generally Araki 1994, 385; Takanashi 1997, 5; Takanashi 1999, 7; Ohtake 2004, 26.

employers suffering from economic difficulties to retain their workers without resorting to adjustment dismissals. In particular the Employment Adjustment Allowance (a subsidy now known as the Employment Adjustment Assistance Allowance) was frequently utilized for employers who were compelled to temporarily shut down operations due to economic downturn and this program significantly contributed to the maintenance of employment security. The main focus of employment policy is to maintain employment and prevent unemployment, rather than to absorb unemployment which has already occurred. This is consistent with Japan's vocational training policy, which does not stress public vocational training for the unemployed to facilitate their finding new jobs, but prefers measures to support companies in conducting on-the-job or off-the-job training, which enables the employers to retain their workers.

The view that dismissals are condoned only as a last resort is widely and deeply rooted in Japanese society. For instance, in 1993, faced with the recession triggered by the collapse of the bubble economy, some Japanese employers canceled their tentative employment agreements with new graduates who were yet to begin their employment. These unilateral cancellations drew public attention and were exposed through wide media coverage as violating social norms. The Ministry of Labor publicized the names of the companies that had canceled their tentative agreements to hire, which subjected these companies to the social stigma attached to such actions. It would be more appropriate to state that case law and government employment policy has been a outgrowth of the prevailing practices respecting the employment security.

4.2. Changing Employment Security and New Developments in Regulations on Contingent Workers and in Case Law on Dismissals

4.2.1. Increasing Mobility in Employment and Labor Market Deregulation

Employment is becoming more unstable, and atypical or non-regular employment is increasing. In 1990, non-regular employees made up 20.2 percent of the Japanese work force, whereas in 2004 this had risen to 31.5 percent (See Figure 4). To cope with increased lateral mobility, the Japanese government has provided a series of measures to activate the

4.2.2. New interpretation Relaxing Economic Dismissal Restriction

Recently, there has been a noteworthy development in case law concerning economic dismissals. Traditionally, as mentioned above, the validity of economic dismissals depends on whether all four requirements are met or not. If one of four requirements is not satisfied, the dismissal has been regarded as an abuse of the right to dismiss.

A recent decision rendered by the Tokyo District Court²⁶ rejects this interpretation because, it says, there is no solid legal ground for insisting that all four requirements must be satisfied for economic dismissals. According to the Tokyo District Court, what the court should determine is whether a dismissal is abusive or not. The so-called “four requirements” are merely “four factors” to analyze abusiveness. Therefore, according to the position of the Tokyo District Court, if one of the “four factors” (for example, consultation) is not met, such an economic dismissal can still be held legal and valid by taking all other factors surrounding the dismissal into consideration.

This new approach by the Tokyo District Court has provoked heated discussion and particularly severe criticism from labor-oriented lawyers. However, more and more decisions by courts and scholarly opinions support a “four factors” rule rather than a “four requirements” rule. They consider the inevitable necessity for corporate reorganization to cope with structural changes in the economy.

Having stated that, from a comparative view, even if the “four requirements” rule becomes “four factors” rule, restrictions nevertheless will still be more stringent than in the United States²⁷ and probably more so than in Germany.²⁸

²⁶ The *National Westminster Bank* case (3rd Provisional Disposition), 782 *Rodo Hanrei* 23 (Tokyo District Court, January 21, 2000).

²⁷ In the United States, the classic employment-at-will doctrine is certainly eroding and is being modified by case law. Stringent anti-discrimination laws also restrain American employers from arbitrarily dismissing employees. However, compared to situations in European countries and Japan, American employers still enjoy more freedom to dismiss employees and there is hardly any restriction on economic dismissals. See Summers 1995, 1036; Schwab 2003, 177.

²⁸ Though German law requires detailed procedures for economic dismissals including establishing a “social plan,” if employers follow those procedures it seems easier to reduce redundant employees in Germany than in Japan. As a matter of practice, economic dismissals accompanied by a settlement payment are widespread. *E.g.* Neef 2000, 8.

4.3. Countermeasures Protecting Employees' Interests

It is noteworthy that several countermeasures against the promotion of corporate reorganization and increase in labor mobility have been adopted for protecting employees' interests in the last few years.

4.3.1. Labor Contract Succession Law of 2000

To facilitate corporate restructuring and reorganization to cope with the sluggish Japanese economy, the so-called "corporate division scheme"²⁹ was introduced by amendment to the Commercial Code in 2000. However, it was feared that the corporate division scheme could be easily abused for downsizing or streamlining of redundant workers and employment security would be severely damaged. Therefore, to protect employees' interests in the event of corporate division, the Labor Contract Succession Law (LCSL) was enacted with effect from April 1, 2001. Under the LCSL, employment relations are, under certain conditions, automatically transferred to the newly-established corporation.³⁰

Since the LCSL prescribes automatic succession of employment relations to a newly established or succeeding company, the LCSL can be seen as a Japanese version of the EC directive on transfer of undertakings. However, there are significant differences between the EC directive and the LCSL. The most important difference is that the LCSL application is confined to divisions of corporations, whereas the EC directive covers not only merger and division of corporations but also transfer of undertakings. Under the Japanese law, unlike EU law, automatic and mandatory transfer of an employment contract is not required in the event of transfer of undertakings.

Compared to the situation in the United State where no employment

²⁹ Prior to the 2000 revision of the Commercial Code, corporation division was carried out through transfer of business or undertakings. However, in order to transfer business, the transferor corporation must obtain individual consent of all creditors as well as those of workers transferred to the transferee corporation. Such cumbersome procedures were thought to have hindered corporate restructuring and reorganization in Japan. The 2000 revision of the Commercial Code introduced simplified procedures for the division of corporation. When a corporation division plan is approved by the shareholders meeting by special resolution, corporation division becomes legally binding on all parties concerned without obtaining their individual consent, though dissenting creditors can express objection and seek liquidation.

³⁰ As for the details of the LCSL, see Yamakawa 2001, 6; Araki 2003, 27; Araki 2004a, 69.

protection is provided in the process of corporate restructuring,³¹ it is notable that the Japanese legislature thought it necessary to provide certain protection for employees in the event of division of corporation. In the process of enacting the legislation, a fair balance between the necessity of promoting corporate reorganization and the protection of employees was sought and the midway between the EU and US approach was adopted.

4.3.2. The 2003 Revision of the Labor Standards Law

The 2003 revision of the Labor Standards Law (LSL) made the case law rule on abusive dismissals an explicit provision in the Law. A new provision (Art. 18-2) was inserted into the LSL: “In cases where a dismissal is not based upon any objectively reasonable grounds, and is not socially acceptable as proper, the dismissal will be null and void as an abuse of right.”

In the tripartite Council Deliberating Working Conditions which *de facto* determined the contents of the government’s bill, the labor side sought to introduce provisions declaring the “four requirements” rule on economic dismissals. However, as mentioned above, the “four requirements” rule is developing into a “four factors” rule, and thus the management side strongly opposed stating a “four requirements” rule in the Law. Consequently, no agreement was made in the tripartite council for establishing a new provision concerning economic dismissals.

The bill drafted by the government had put the following sentence before the above-quoted provision nullifying abusive dismissals: “Employers can dismiss their employees providing that the Law and other enacted laws do not restrict their right to dismiss.” However, labor unions, opposition parties, the Japan Federation of Bar Associations and other bodies raised objections, contending that this sentence could give the impression that employers have a free hand in dismissals. Government parties yielded and eliminated the sentence.

The 2003 revision of the LSL also introduced provisions requiring clarification of grounds for dismissals (Art. 89 No. 3) and obliging the employer to deliver a certificate stating the reasons for dismissals upon the

³¹ Schwab 2003, 183.

employee's request even during the period between the notice of dismissal and the date of leaving employment (Art. 22 Para. 2).

Labor unions and labor scholars had long argued for the necessity to enact laws expressly requiring a just cause for dismissals, because of the lack of transparency in a contradictory situation where enacted laws did not require any just cause but case law de facto did. However, their proposals had never been adopted by the legislature in the past. This time, the plan to revise the LSL to clarify the dismissal rules was raised by the Koizumi cabinet and its Council for Regulatory Reform. They intended to relax the case law rules which, they thought, were so rigid that they hindered structural changes entailing mobilization of the workforce.

Since the labor unions were arguing for a strengthening of dismissal regulations, naturally they strongly opposed relaxing the case law rule by new legislation. As to a new proposal to introduce monetary solutions to resolve dismissal disputes, which was also suggested by the Council for Regulatory Reform and requested by the management side, the tripartite council could not reach an agreement and no legislative proposal was made on monetary solutions. In the result, what the tripartite council agreed was to write down precisely the above-mentioned basic principle of the case law, namely an abuse of the right to dismissal being null and void, without mentioning rules on economic dismissals or monetary solutions.

The government proposal (LSL Art. 18-2) stated as follows: "An employer may dismiss a worker where his right to dismiss is not restricted by this Law or other laws. Provided that a dismissal shall be treated as a misuse of that right and invalid, where the dismissal lacks objectively rational grounds and is not considered to be appropriate in general societal terms." However, during deliberations in the Diet, the first part of the proposed Art. 18-2 which declares the employer's right to dismiss was feared to have the declaratory effect of encouraging dismissals. As a result, the first part was deleted and the enacted Art. 18-2 reads "A dismissal shall, where the dismissal lacks objectively rational grounds and is not considered to be appropriate in general societal terms, be treated as a misuse of that right and invalid."

Considering the crystallization of non-written case law as an explicit provision in the LSL, the omission of the part of the Bill stating the

employer's right to dismissal, and other revisions requiring clarification of dismissal reasons (Art. 89 No. 3) and notification of them to dismissed workers (Art. 22 Para. 2), the overall direction of the 2003 LSL revisions was in fact to counterbalance increasing mobility of the workforce.³²

5. Industrial Relations, Employee Participation and Corporate Governance

The prominent feature of Japan's industrial relations is stable and cooperative relations between labor and management. Japan's current stable industrial relations can be understood as the result of the following three factors: (1) Japan's enterprise unionism; (2) widespread joint labor-management consultation practices; and (3) internal management promotion practices, which has already been mentioned.

5.1. Enterprise Unionism

Enterprise unionism is a system in which unions are established within an individual enterprise, collectively bargaining with a single employer, and concluding collective agreements at the enterprise level. According to the statistics as of 1997, 95.6 percent of unions in Japan are enterprise-based unions and 91.2 percent of all unionized workers belong to enterprise unions.³³

An enterprise union organizes workers in the same company irrespective of their jobs. As a result, both blue and white collar workers are organized in the same union. Enterprise unions normally confine their membership to regular workers though there are no legal obstacles which prevent enterprise unions from organizing part-time workers or temporary workers.

Although there are several historical reasons for the dominance of enterprise unionism, the main reason is that it has served well as a key component of Japanese employment relations. Under the long-term employment system, dismissals are avoided at all cost. In exchange, workers accept the flexible adjustment of working conditions. In the highly

³² The opinions on the effect of the 2003 revision is divided. Compare Hanami 2004, 13 and Nakakubo 2004, 14.

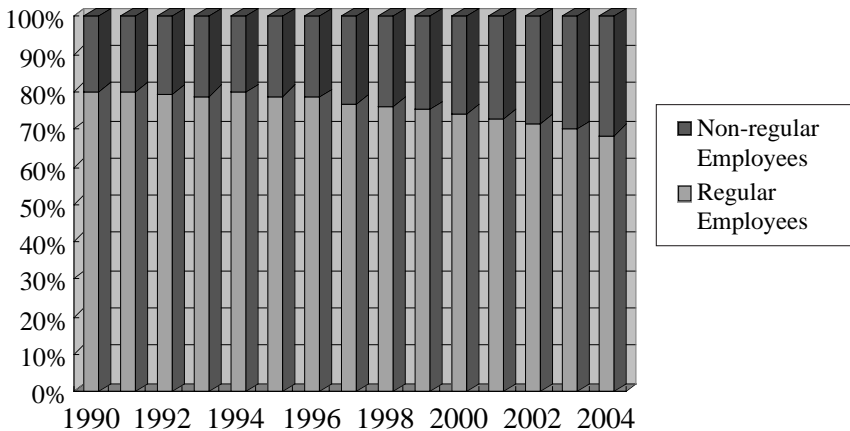
³³ Ministry of Labor 1997.

external labor market.²³

The regulations on fixed-term contracts in Japan were originally quite relaxed. Unlike many European countries where objective grounds are required to conclude a fixed-term contract, in Japan no objective ground is required to conclude and renew fixed-term contracts. The sole legal restriction on fixed-term contracts was that the agreed term of the contract should not exceed one year. Therefore parties to a contract could not agree to a two year term, although it was and is completely legal to conclude a 6 month contract and to renew it three times. However, the 2003 revision of the Labor Standards Law further relaxed the upper limit of the agreed term from one year to three years.²⁴

Worker dispatching businesses engaged in labor hire were first legalized in Japan by the enactment of the Worker Dispatching Law (WDL). After several moderate revisions in the 1990s, the 1999 revisions of the WDL generally liberalized worker dispatching by lifting the general prohibition. The 2003 revisions further legalized worker dispatching to production sites, which was prohibited under the 1999 revision.²⁵

Figure 4: Ratio of Regular/Non-regular Employees



Source: Ministry of Public Management, Home Affairs, Posts and Telecommunications, Labor Force Survey

²³ Araki 1999, 5.

²⁴ Nakakubo 2004, 4.

²⁵ Mizushima 2004, 12.

developed internal labor market, employees are transferred within a company and receive in-house education and on-the-job training. The promotion and wages of each employee are decided mainly by that individual's length of service and performance. In this context, industrial-level or national-level negotiations have made little sense. Enterprise unions and enterprise-level collective bargaining have been the most efficient mechanism in reconciling the requirements of an internal labor market with the workers' demands.

When unions have their basis in a particular company, they tend to be more pragmatic than ideological and more conscious about their own company's productivity and competitiveness.

Enterprise unionism has several defects, such as weak bargaining power, the lack of a universal impact across the industry or nation, and the lack of social and political influence on national labor policy.³⁴ To compensate for the weakness in bargaining power and lack of industry or nation-wide impact of collective bargaining, union leaders devised in 1955 a unique wage determination system called "*Shunto*" (the spring wage offensive).³⁵ Joint labor-management consultation at the industrial and national level and official tripartite deliberation councils where the content of government labor policy and drafts of labor legislation is deliberated and decided also function compensatory mechanism for the limited influence of enterprise unions.³⁶

³⁴ Sugeno and Suwa 1996. Hanami severely criticizes enterprise unions for having ignored the interests of non-regular employees who have mostly remained unorganized. See Hanami 2004, 4.

³⁵ Under the *Shunto* system, every spring, industrial federations of enterprise unions and national confederations set the goal for wage increases and coordinate the time schedule of enterprise-level negotiations and strikes across enterprises and industries. According to the schedule, strong enterprise unions in a prosperous industry are chosen as a pace setter to commence negotiations and set the market price for that year. Other unions then follow suit. The market prices established in *Shunto* have also been reflected in the public sector where strikes are prohibited, and also in regional minimum wages which are revised every fall by the tripartite Minimum Wages Council within the framework of the Minimum Wages Law. In this manner, the *Shunto* strategy has compensated for the limitations of enterprise unionism in terms of bargaining power and establishing social standards across companies. For details of the historical development and economic analysis of *Shunto*, see Takanashi 2002.

³⁶ Araki 2004a, 72.

5.2. Joint Labor-Management Consultation

At plant and company level, Joint labor-management consultation is an established practice in Japanese industrial relations and this complements collective bargaining over terms and conditions of employment. According to the survey in 1999, 41.8 percent³⁷ of all surveyed establishments have such consultation bodies.³⁸ In unionized establishments, the figure is greater at 84.8 percent. In many countries, labor-management consultation was not voluntarily established. Therefore, the state intervened and forced companies to establish works councils or other channels for communicating and informing employees. In Japan, by contrast, labor-management consultation is voluntary and operates without any legal supports.

The origins of this system are to be found in the period of conflict after the Second World War. By the mid-1950s, leaders on both sides of industry had become increasingly unhappy with the tendency towards adversarial relations and had begun to look for new, more pragmatic and cooperative relations. In 1955, the Japan Productivity Centre was established by business circles under the auspices of the Ministry of International Trade and Industry (MITI) and the American authorities in order to promote joint consultation and productivity improvements. Left-wing union confederations, especially *Sohyo*, were skeptical and regarded the movement as a new type of rationalization or exploitation. However, the confederation of moderate unions (*Sodomei*), agreed to participate on the conditions that consultation should not be used to bypass unions and that their opinions should be fully respected. Thus, three basic principles were agreed. One, labor-management consultation should be promoted in order to increase productivity. Two, productivity increases should enhance employment security, with any problems of surplus labor being resolved by transfers and the like rather than by lay-offs. Three, the fruits of increased productivity should be distributed fairly between the firm, employees, and customers, in accordance with the conditions in the national economy.

³⁷ The figure is smaller than that in the previous survey in 1994 (55.7%). This is mainly because of the difference in the size of surveyed establishments. The 1994 survey sampled establishments with more than fifty employees and the 1999 survey sampled those with more than thirty.

³⁸ Ministry of Labor 1999.

On this basis (and after the defeat of the leftist union movement during the major dispute at the *Miike* coal mine in 1960), pragmatic and cooperative labor relations gradually became established in Japanese industrial relations. Labor and management voluntarily established consultation arrangements and developed extensive communication channels. Employers provided information to employees and their unions, and unions cooperated with management in increasing productivity. However, it should be remembered that joint consultation has been sanctioned the union's right to bargain.

5.3. Recent Developments in Industrial Relations

In industrial relations, there have been no drastic legislative changes except for the very recent revision of the Trade Union Law in November 2004.³⁹ However, recent changes in the environment surrounding industrial relations have led to calls for the reconsideration of the worker representation system.

5.3.1. Legislative Developments Promoting Corporate Restructuring

First, from the late 1990s, the Japanese government took a series of measures to promote corporate restructuring or reorganization and market-oriented management in order to cope with the prolonged economic slump. In 1997, a stock option system was introduced and the previous prohibition of genuine holding companies was liberalized by the revision of the Anti-Monopoly Law. The year 1999 saw the advent of the Industrial Revitalization Special Measures Law which encouraged and supported business revitalization and the Industrial Rehabilitation Law which prevented bankruptcies and rehabilitated companies in failing circumstances. In the same year, the stock exchange and transfer systems were introduced to facilitate forming the holding company system. As already discussed, the corporate division scheme was introduced in 2000 to promote corporate reorganization and an option to adopt a US-type corporate governance was introduced in 2002.

³⁹ The 2004 revision of the Trade Union Law strengthens the power of labor relations commissions and expedites the remedial procedures of unfair labor practice cases. However the revision did not change any part of the representation mechanism.

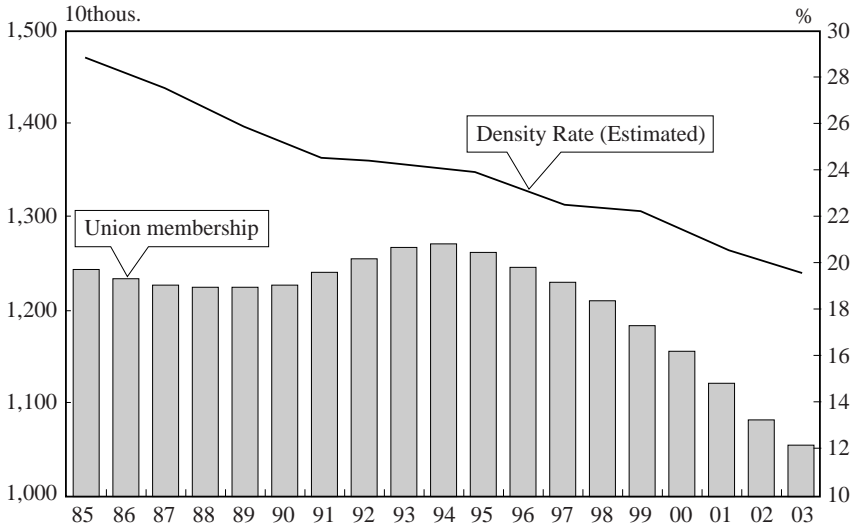
This series of legislative changes aimed to promote corporate reorganization, which inevitably affected industrial relations. A trend emerged whereby a company is divided into several units and each unit becomes an independent company, while the headquarters of the original company becomes a holding company governing the newly created subsidiaries. When an enterprise union does not respond to such corporate reorganization, there will be an absence of collective bargaining because there may be no union members in the newly established company. One recent legal debate concerns whether a union that organizes workers in the subsidiary company can legally request collective bargaining with the holding company. According to the traditional interpretation, when there is no evidence that the holding company has actually intervened in and decided the working conditions of the subsidiary, the holding company does not bear the duty to bargain with the union organizing workers in the subsidiary company. However, since the holding company can decide upon the existence or abolition of the subsidiary as a decisive shareholder, some scholars argue for the holding company's duty to bargain.

5.3.2. Declining Union Density and Emerging New Representation System

Second, the unionization rate has continuously declined since 1975 and finally reached below 20 percent (19.6% in 2003, see Figure 5). Further, the diversification of the workforce has led to questions as to the representative legitimacy of enterprise unionism. Traditionally enterprise unions solely organized regular employees and non-regular workers such as part-time workers and fixed-term contract workers remained unorganized. However, currently 30 percent of all employees are non-regular employees. The target of corporate restructuring in the 1990s concentrated on middle management employees. Employees promoted to middle management are supposed to leave unions. Therefore they are provided little protection by labor law and labor unions. These circumstances require reconsideration of the channel conveying employees' voice. Some scholars contend that Japan should introduce an employee representation system like the works council in Germany (*Betriebsrat*) which represents all the employees in the establishment

irrespective of union membership.

Figure 5: Union Membership and Density Rate (Estimated)



Source: Ministry of Health, Labor and Welfare, Basic Survey on Labor Unions

The 1998 revision of the LSL introduced a new representation system called a *roshi iinkai* (labor-management committee). Half of the members of this committee must be appointed by the labor union organized by a majority of workers at the workplace concerned, or with the person representing a majority of the workers where no such union exists. The labor-management committee must be established when the employer intends to introduce the discretionary work scheme (management planning type),⁴⁰ which functions as a Japanese counterpart of the white-collar exemption from overtime regulations. The labor-management committee is the first permanent organ with equal membership for labor and management that represents all the employees in the establishment. Therefore, this committee can be regarded as the embryonic form of a Japanese works council, although the jurisdiction of this committee is currently confined to regulation of working hours and its establishment is

⁴⁰ There are two types of discretionary work scheme: professional work type and management planning type. For details, see Araki 2002, 94 and Shimada 2004, 56.

not compulsory.

Since the procedures to adopt the discretionary work scheme are very complicated, currently there are very few labor-management committees. However, the 2003 revision of the LSL simplified the procedure to introduce the discretionary work scheme. Previously, decision making in the committee was by unanimous agreement, but under the revised LSL, it can be achieved by four-fifths majority among the committee members. Although it remains to be seen whether the labor-management committee will become more common and solidify as a system of employee representation, the introduction of this embryonic form of representation by recent legislative change is noteworthy.

6. Conclusion: Future of Japan's Practice-Dependent Stakeholder Model

6.1. Current Situation of the Japan's Practice-Dependent Stakeholder Model

As mentioned at the outset, Japan's employee-centered stakeholder model relies heavily on a number of customary practices such as long-term cross-share ownership, internal promotion of management and acceptance of dual-function directors into the management board, long-term (lifetime) employment, and voluntary joint labor-management consultation.

This article has reviewed how these practices formed and sustained the traditional stakeholder model in Japan. It then examined recent changes that might affect the traditional governance model. It is true that considerable changes are taking place. As for the structure of shareholdings, cross-shareholdings are being dissolved, and foreign investors are increasing. The revision of the corporate law in the 1990s to facilitate shareholders representative suits necessitates a style of corporate governance which is more conscious of shareholder value. After the collapse of bubble economy, together with a shift from indirect finance via banks to direct finance, the importance of Japanese banks in corporate governance has been reduced. In these circumstances, it is no surprise that shareholder value has surfaced as a new criterion.

Drastic revisions to the corporate law have given large companies the

option of adopting a US-type corporate governance system utilizing outside directors, which might also change the nature of the management. The employment system in Japan is also experiencing transformation. In the last decade, Japan repeatedly achieved the worst-ever unemployment figures. Lateral mobility has increased and the state's labor market policy has tilted toward the activation of the external labor market. Courts have started to relax restrictions on economic dismissal. Stable regular employment has gradually shrunk and currently non-regular and contingent workers account for 30 percent of all workers. In the area of collective labor relations, the decline in union density and the diversification of the workforce is progressing and might require reconsideration of the traditional collective labor relations system.

Compared to a legally-sanctioned stakeholder model like that in Germany, Japan's practice-dependent stakeholder model is more vulnerable to environmental changes. Although a socio-economic system consisting of interdependent institutions is transformed into another only with difficulty,⁴¹ in an era of disequilibrium, when several institutions change simultaneously, such change might occur. Therefore, the question is whether or not the aforementioned changes will lead to fundamental institutional changes that transform the current stakeholder model into the shareholder-value model.

6.2. Future of the Japanese Corporate Governance

Given the existence of countermeasures working against shareholder value-oriented governance, and various research results discussed below, the most likely outcome is that the current stakeholder model will survive for the time being. Recent changes and developments can best be viewed as the realignment of the priority of various stakeholders' interests in the framework of the stakeholder model. A number of countermeasures and tendency may be cited.

First, although cross-shareholdings are dissolving, more than 80 percent of surveyed companies still maintain cross-shareholdings and they recognize the merit of forming stable and long-term trading relations. The 2001 revision of the Commercial Code limits directors' liability in a

⁴¹ Aoki and Okuno 1996, 1.

shareholders representative suit. Although the 2002 corporate law revisions introduced the US-style governance model, the vast majority of Japanese corporations maintain the traditional model. As for employment security, the enactment of the Labor Succession Law in 2000 was a systemic countermeasure to protect employees' interest in the face of increasing corporate reorganizations. The 2003 revisions of the Labor Standards Law that incorporate the case law rule on abusive dismissals have a symbolic significance to explicitly confirm the norm consciousness of employment security in Japanese society. Declining labor unions and workforce diversification call for new forms of worker representation. In this regard, a labor-management committee system introduced in 1998 attracts attention as to whether or not it will develop into a Japanese version of the works council representing all employees in the establishment. These developments serve to sustain the stakeholder model centered on employees' interests or at least put a brake on the radical transformation into the shareholder value model.

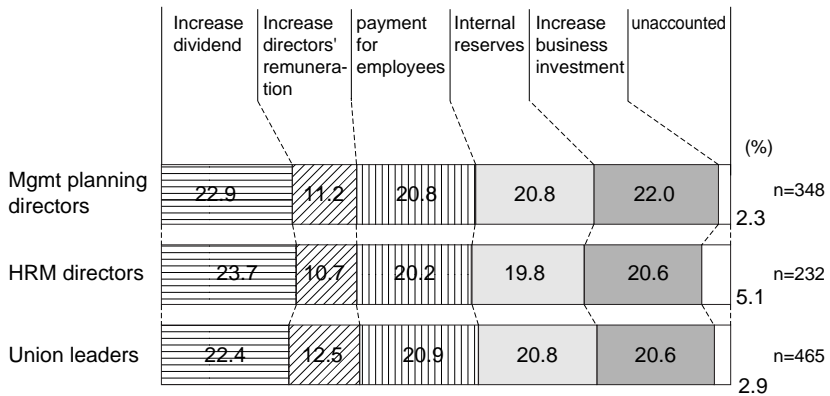
Second, several recent surveys prove that, the stakeholder model is still supported widely in Japanese society despite some moves towards a shareholder-value model.

According to one survey,⁴² when a corporation has increased profits, they are not supposed to be distributed solely to shareholders but to be distributed almost evenly to shareholders, employees, internal reserves, and business investments. Such a view is supported not only by union leaders but also by management planning directors and HRM directors (see Figure 6).

According to the same survey, when asked about "recent changes within your company in the last three years," about 70 percent of the respondents indicated that their company had "adopted performance-based or achievement-based HRM" or had "adopted corporate restructuring or reorganization measures," but only 26 percent of them responded that their company "paid special consideration to the shareholders in management decision-making."

⁴² the JPC-SED 2003 survey.

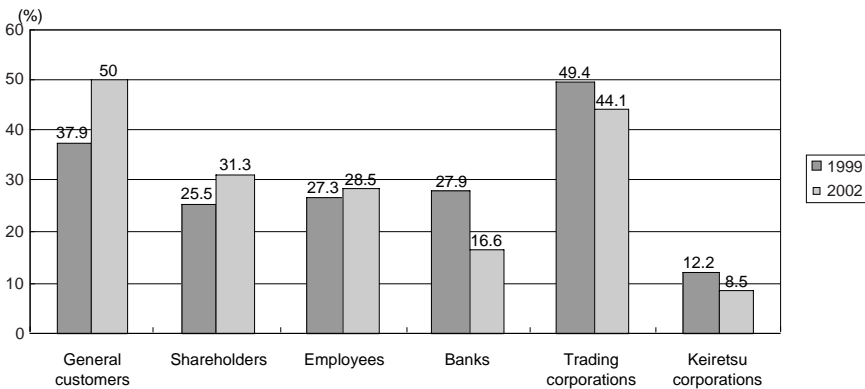
Figure 6: To Whom the Increased Profit Should Be Distributed



Source: JPC-SED 2003.

Another Survey⁴³ found that while banks and trading companies have become less important and customers and shareholders regarded as more important between 1999 and 2002, employees are still regarded as an equal stakeholder. Indeed, there is evidence that their perceived importance is rising (see Figure 7). As for the external control of corporate governance, it is also notable that customers and product markets are seen as more important than shareholders or the stock market.

Figure 7: Who is the Important Stakeholder?

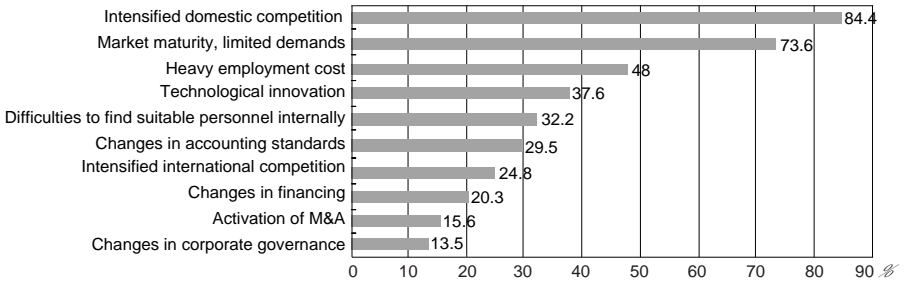


Source: Ministry of Finance, Policy Research Institute 2003.

⁴³ Ministry of Finance, Policy Research Institute 2003.

The Japan Institute of Labor examined the factors affecting restructuring and downsizing decisions. Prominent factors are not changes in corporate governance (14%) but intensified competition in the domestic market (85%) and ‘limited demand due to market maturity’ (74%) (See Figure 8).

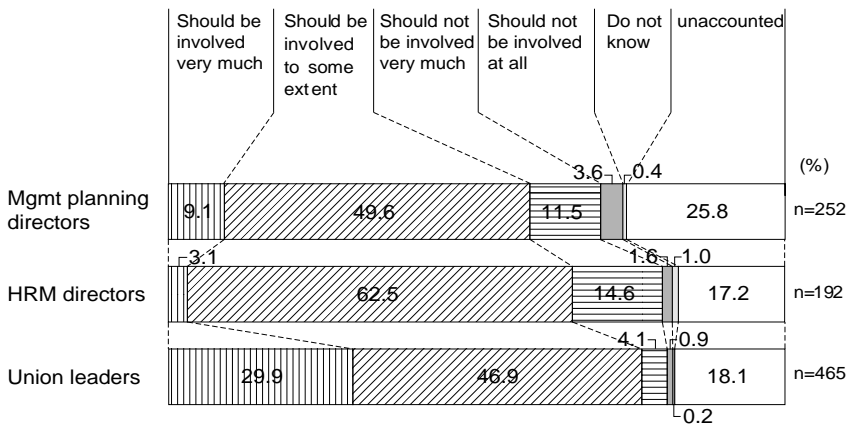
Figure 8: Factors Affecting the Corporate Restructuring Entailing Staff Downsizing



Source: Japan Institute of Labor 2002.

In terms of industrial relations, the JPC-SED 2003 survey showed that a majority of directors think labor management consultation does not hinder management decision-making. Moreover, not only the majority of the union leaders but also 58.7 percent of management planning directors and 65.6 percent of HRM directors replied that labor unions should be involved in management decision-making into the future. The negative responses are quite small in number (see Figure 9). This survey was conducted in July and August of 2001 when the Enron and WorldCom scandals had not yet come to light and US-style corporate governance was receiving its greatest accolades in the Japanese media. It is remarkable that, at such a time, labor and management at the workplaces still recognized the value of union involvement. This seems to reflect the deep-rooted consciousness in Japan that employees are an important constituent of corporations.

Figure 9: How Far Labor Unions Should Be Involved in Management Decision-making in the Future



Source: JPC-SED 2003.

Given these survey results together with the various countertrends and countermeasures for protecting employees' interests in the course of corporate restructuring, the author considers that Japan's stakeholder model will not be drastically modified in the near future. Current changes in shareholder structure and management machinery certainly require the reconsideration of priority orders of various stakeholders' interests. Shareholders' interests cannot be ignored any more and employment security is no longer an absolutely supreme value in corporate governance. However, such reconsideration seems to be occurring within the framework of the stakeholder model, and it is not likely that the model will completely convert into the shareholder value model at least for the time being.

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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 loans² 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 study³ 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 management⁵ 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

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

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

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

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).

¹⁵ 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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Corporate Governance Reform and Industrial Democracy in Japan

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1. Introduction

One consistent theme in the debate surrounding reform of corporate governance in recent years has been how to include “voices outside the company” in corporate decision-making and monitoring mechanisms. A series of recent revisions to the commercial law has legally enhanced the roles of external auditors and directors, and companies have been quickly adjusting in response. External auditors and directors, however, are selected at meetings of general shareholders, and the “voices outside the company” are essentially the voices of shareholders and investors. Ensuring transparency in corporate management for those outside the company and safeguarding against tyrannical managers are certainly important. If the disclosure of information to shareholders and monitoring by shareholders are important, then disclosing information to employees, those most directly affected by management decisions, and ensuring that their “voices” are reflected in corporate management seem even more important. Are the “voices within the company” adequately reflected in corporate management? Are the voices of employees, whose vocational lives depend on decisions made by management, being ignored? These are crucial questions, and their relevance is becoming more acute to employees who are facing a wave of severe corporate restructuring and reorganization.

This article seeks to address the following questions: What position have employees occupied as members of corporate society? How is their position changing? What issues should labor unions raise on behalf of employees?

2. Corporate Democracy and the Position of Employees in “Corporate Society”

Community-like Characteristic of Japanese Companies

For employees, companies constitute a “corporate society” with a real substance as a social entity rather than simply being an abstract entity — such as a combine of capital as defined under the commercial law. It has been noted that modern Japanese companies, in particular large ones, possess a strong communal character, and their presence as a corporate society is widely felt. Scholars, mainly sociologists, have produced a number of empirical research studies and subsequent theories concerning this issue (Matsushima 1962, Hazama 1964, Dore 1973, and Inagami 1981, for example). From time to time, general observers outside Japan also have noted that a unique feature of Japanese corporations when compared to their counterparts internationally is that they take on communal characteristics similar to local communities as opposed to a function-specific organization. For example, OECD researchers who visited Japan in 1975 reported that the idea of a company as a community had taken root as a social norm within the companies themselves. According to their report, “Both managers and workers regard companies as the single most important social unit, that is, a community,” and “Workers are essentially seen as members of a company rather than a workforce hired for their labor” (OECD 1977). The report noted that this corporate social norm essentially constituted a de-facto fourth pillar supporting Japanese labor-management relations in addition to the “three pillars” of “lifetime employment, seniority-based wages, and enterprise unions.”

Hazama (1996: 112-113) provides general explanations for the formation of a corporate society with a strong communal characteristic in postwar Japan. First, one result of the separation of capital ownership and management caused by the dissolution of the *zaibatsu* (the great family-controlled banking and industrial combines) was that corporate management came to be conducted by employee groups headed by managers promoted from within the company. Second, decisions concerning work conditions were increasingly made within the company, and consequently managers and workers came to share common interests.

Third, labor unions, which were sanctioned after the war, carried out anti-dismissal struggles, and this resulted in the establishment of the practice of long-term employment. The number of long-term stable employees consequently increased, and this made it even easier for companies and workers to share common interests. Fourth, the social gap between managers and workers diminished as more and more managers were promoted from within and status distinctions within the companies were eliminated. Managers and workers came to share a spirit of comradeship and mutual cooperation rather than a sentiment of class antagonism.

Membership in the corporate community, however, is not necessarily open to all employees. It is essentially limited to regular employees who have entered a long-lasting “relationship with the company (*shaen*)” after going through a rite of passage called the company entrance ceremony (*nyushashiki*). Members of the corporate community are expected to make a tacit long-term commitment to their company in exchange for long-term employment and a secure livelihood. Non-regular employees employed on a short-term basis with a limited commitment to their company cannot become a member.

Despite this exclusive character, there is no social or class distinction between white-collar and blue-collar workers within the corporate community as far as regular employees are concerned. Moreover, in general, there is no significant disconnect between senior and entry level; the designations of regular employee, middle-manager, and top-manager are continuously connected by a system of in-house promotions. Most corporate executives, excluding president and chairman, are employee-executives, and they tend to display strong “employee-like” characteristics both in terms of professional duties and compensation (Inagami 2000: 42).

In many cases, presidents — who stand at the top of management—were employees before reaching their position through in-house promotions, and it has been noted that they have a firm view of themselves as leaders of employee groups. Although the material is rather dated, a 1986 survey of presidents of major corporations by the Nihon Keizai Shinbunsha¹ asked corporate presidents the following question: “From

¹ Questionnaires were sent to presidents of 163 listed companies and life insurance companies, and 113 provided effective responses (effective response rate: 69.3%).

which group of people do you find it most important to secure support?” The highest proportion (63.2%) responded employees, while corporate executives was the second most frequent answer (18.4%). The great majority of the presidents attached importance to a consensus in their company. Only 11.5 percent chose shareholders, and few chose former executives (corporate elders), important business clients, and major banks with which the company does business (Nihon Keizai Shinbunsha 1987: 95). In fact, there have been cases in which corporate presidents were forced to resign after losing support from their employees. The Mitsukoshi case of 1982 and Okuma Steel Mill case of 1988 are examples from sometime ago, and the drama of the resignation of the president of Snow Brand Milk Products Co. in 2000 in the aftermath of a scandal involving contaminated products is a more recent example.

Enterprise Unions and Corporate Democracy

The community-like characteristic of Japanese corporate society and the long-term employment system upon which it leans, and the management policy characterized as being employee-friendly did not emerge because of the compassion of managers. They are historical products of an intense battle between labor rights and management rights that was fought from the early postwar years to the end of the 1950s.

The first four years after the war was the period of joint management councils when labor rights, supported by the burgeoning radical movement, sometimes overshadowed management rights. It was not rare for joint management councils to play all three functions of collective bargaining, complaints resolution, and production committee, and the influence of labor unions on management and personnel rights was relatively far-reaching. Joint management councils aggressively pursued democratization of companies, including elimination of status distinctions, and made social structures within companies more egalitarian.

This period ended at the close of the 1940s as GHQ shifted its policies, management began to recover some of its strength, and a policy shift within the labor movement developed. The first half of the 1950s saw an intensification of the confrontation between labor and management, the latter of which insisted on the supremacy of management in decision-

making, and very large dismissal disputes frequently broke out. Even though unions were unable to claim victory in most of these disputes, management also suffered considerable losses such as damaged labor-management relations and a decline in workplace morale. Based on these experiences, management and labor gradually came to form an implicit consensus that it was beneficial, and hence rational, for both to avoid dismissals to the extent possible. Moreover, the labor-management consultation system recommended by the Japan Productivity Center when it opened in 1955 gradually spread and took root during the era of high economic growth in the 1960s, laying the foundation for today's labor-management relations based on mutual trust.

Enterprise unions developed out of this process and constituted the mechanism of corporate democracy which is embedded in corporate society. In the same way a company functions as a basic social unit, enterprise unions, which are not self-contained, isolated organizations, constitutes a basic unit of labor organization (Suzuki 2000). The system of industrial democracy in postwar Japan reached its present shape by following a peculiar trajectory: its basic units, labor unions, have been organized into federations at industry, regional, and national levels and are connected to each other through alliances, and industry-specific unions, regional organizations and national centers, each playing various roles outside the company through centralized, multi-layered networks. This shows the potential for the system of corporate democracy to develop openness toward the outside. Fulfilling this potential is what is needed at this present moment.

From the vantage point of today, the proposal for corporate democratization based on a "balance of power among capital, labor and management" by the Corporate Democratization Research Group which was created in 1947 within Keizai Doyukai (the Japan Association of Corporate Executives), was a momentous event. According to the proposal, the principle of stockholder majority rule (which accorded shareholders one vote per stock) as the highest level of corporate decision-making was to be rejected, and in its place a general council represented by capital, labor and management was to be established. Keizai Doyukai found the proposal too radical to adopt and published it only in a form of study group report. Still,

the kernel of Banjo Otsuka's proposal, the chief architect of the proposal, later became reality, that is an ideal form of corporate management in which professional managers administer companies based on the principle of separation of capital and management, (Otsuka 1947). The idea of a "balance of power among capital, labor and management" has never been translated into an institutional form, but balancing the interests of shareholders with those of employees is a major concern of managers in Japanese-style management (Aoki 1984 and The Japan Institute of Labour 2000). Therefore, it can be argued that a condition resembling a balance of power has emerged. However, this balance of power is by no means stable. As the "voices outside the company" emanating mainly from shareholders become louder, it appears that the situation is becoming more fluid, and a period of increased instability seems to be drawing near.

Companies Assign Priority to Employees

Companies have a number of stakeholder groups (interest groups) such as shareholders, creditors, customers, employees, corporate customers, *keiretsu* (affiliated) companies, local communities, and the government. What sort of priority is given to employees relative to these other groups? We can start by examining findings from recent surveys on priorities companies place on different stakeholder groups. Depending on how it is asked or to whom it is asked, this question will generate a wide range of responses. Hence, responses from members of the general public as well as responses from those representing corporate management should be examined.

The "Survey of Companies concerning Corporate Governance" conducted by Zaimu Sogo Seisaku Kenkyujo (Policy Research Institute, Ministry of Finance) in November 1999 and December 2002 presents the latest data on company priorities.² The respondents are heads of departments in charge of business administration and management. It is reasonable to assume that their opinions more or less represent a consensus

² For the 2002 survey, questionnaires were sent to 2,577 listed companies in December 2002, and effective responses were obtained from 876 (effective response rate: 34%). For the 1999 survey, questionnaires were sent to 2,486 listed companies in November 1999, and effective responses were obtained from 1,219 (effective response rate: 49.0%).

within their companies.

In the 2002 survey, the group that received the highest response rate as an important stakeholder group was “general customers” (50.0%), followed by corporate clients (44.1%), shareholders (31.3%), and employees (28.5%). Compared to the results of the 1999 survey, a marked increase was shown in two groups: general customers (12.1% points increase from 37.9% in 1999) and shareholders (5.8% points increase from 25.5% in 1999). The response for banks with which the company does business, in contrast, dropped dramatically (11.3% points decrease from 27.9% in 1999). The proportion of companies emphasizing employees remained almost flat (27.3% in 1999).

Findings from this survey suggest that an increasing number of companies are moving toward placing emphasis on general customers and shareholders. During the three years since 1999 when the first survey was taken, many general public safety and health scandals have been revealed, such as an accident at an atomic power plant, an explosion at a chemical plant, a food poisoning case, and a cover-up of automobile recalls. Companies have been forced to respond to these scandals, including devising measures to prevent recurrences, and this might explain the increased emphasis on general customers.

What priorities do members of the general public who consume products and services offered by companies and who live in local communities place on each of the stakeholder groups? In 2002, the Japan Institute for Social and Economic Affairs conducted a survey targeting those registered as members of the institute’s social survey network (“The 6th Consumer Survey on ‘Views on Corporations’”).³ To the question, “Which group should companies place the most importance on in the future?,” the overwhelming majority (91%) responded end-users, followed by employees (78.2%) and local communities (49.8%). Shareholders, a combination of individual shareholders (7.6%) and institutional investors (4.7%), received only 12.3% of the responses, lower than business users (17.4%). The majority of the respondents were workers (54.7% were

³ Questionnaires were sent to 4,987 of those registered as members of the social survey network of the Japan Institute for Social and Economic Affairs in November and December of 2002, and 3,753 gave effective responses (effective response rate: 75.3%).

employees, and 6.5% were self-employed or free-lancers), and 38.7 percent were non-workers (unemployed, housewives, students, etc.). Workers and non-workers did not differ greatly in their responses to this question. Many of the non-workers are presumed to be economically dependent on their spouses or parents, and hence share common interests with employees.

It is probably natural for consumers to emphasize the importance of end-users. This parallels the tendency of corporate management to emphasize general customers. The only difference between corporate management and consumers was how they viewed shareholders and employees. Stock investments still occupy a very small place in Japanese family financial assets,⁴ and the majority of consumers do not have any direct stake in the stock market. For them, stable employment is a much more immediate concern. This is probably why they choose the idea that companies should place priority on employees over shareholders. It is reasonable to regard the views of consumers as a reflection of two of their interests —as workers employed by companies and as consumers who have a family and live in local communities. Employees have the potential to bring into companies the perspective of society at large, which places consideration on end-users and local communities.

3 ‘Corporate Society’ Besieged amidst Corporate Restructuring

Restructuring, Corporate Reorganization and Changes in Work and the Workplace

The 1990s is often succinctly referred to as “The Lost Decade.” In terms of business cycle, however, the decade can be divided into three periods: the slump in the first half of the decade (1992-1994), recovery in 1995-1996, and the slump in the second half (the second quarter of 1997-1999). The second slump, triggered by the Hashimoto Cabinet’s policy failure accompanied by the outbreak of the financial crisis in the fall of 1997 and the escalation of deflation, was far more serious than the one in

⁴ According to the Statistics Bureau, the Ministry of Internal Affairs and Communications, *Family Income and Expenditure: Savings and Liabilities 2002*, the proportion of securities in the current savings balance per household is 7.5%.

the first half of the decade. As the business environment continued to deteriorate, large companies that once had been regarded absolutely secure went bankrupt, and drastic employment adjustment measures, such as workforce reductions through voluntary retirement and dismissals, were implemented at a growing number of workplaces. At the same time, major corporate reorganizations including integrations and the closure of businesses and company divisions and the transfers of business occurred.

Corporate reorganization is not a new phenomenon. The repeated changes in the industrial structure in postwar Japan amount to — at least in respect to the corporate side of the story — a history of corporate reorganization. However, the corporate reorganization that is currently unfolding is quite different in that it is taking place in the context of efforts to adapt to a “difficult time,” an unprecedented period of external challenges as international competition intensifies and the contraction of the domestic market amidst prolonged economic stagnation.

In particular, the current corporate reorganization is affecting employment not due to readjustment resulting from business expansion but rather as a minus-sum game of business contraction. A survey by RENG0-RIALS (RENG0 Research Institute for Advancement of Living Standard) asked RENG0-affiliated branch leaders at the workplace level about recent changes in their workplace and work.⁵ The results present a picture in which employee morale is increasingly deteriorating: workplaces are undermanned, and work is becoming more grueling; workers’ satisfaction with wages and promotions is diminishing while their trust in their companies is on the decline (RENG0-RIALS 2003a).

In the survey, union branch leaders were asked for their views on changes taking place in the type of work employees were performing and how their company treated them and the attitude of union members. In respect to changes in work, a high proportion of the respondents selected “I agree” for the following statements: the amount of the work is increasing (94.6%), the scope of the work has expanded (92.6%), better

⁵ The “Questionnaire on Changes in Corporate Organizations and Workplaces”: For the survey of union chapter officers, questionnaires were sent to 900 union officers at the workplace level via Rengo-affiliated industry-specific unions in October and November 2002, and 498 returned effective responses (effective response rate: 55.3%).

quality is being demanded (80.6%), assignments involving joint projects with other divisions are increasing (60.6%), additional knowledge and skills are required to handle the work (90.3%), professional responsibility is increasing (88.7%), and work is more severely monitored and controlled (85.2%). The overall picture is that work is becoming more challenging and stressful.

Concerning changes in treatment, a high proportion of the respondents chose “I agree” for work performance is being emphasized more in determining wages (74.6%), wage gaps are developing among employees with similar educational back grounds and service lengths (66.1%), and employees are promoted to a given position at increasingly different ages (75.5%).

Concerning employee perceptions, a large proportion of the union branch leaders felt that dissatisfaction concerning employment is increasing (73.8%). Between 70 to 80 percent disagreed that satisfaction with wages is increasing, satisfaction with promotions is increasing, trust in companies is increasing, professional morale is increasing, and personnel evaluations are receiving wider acceptance. Trust in companies, acceptance of personal evaluations, professional morale, satisfaction with wages and promotions are showing a downward trend in the workplace today.

Some surveys have already noted that the level of employee trust in their company has been wavering amidst corporate restructuring caused by the Heisei recession (for example, Kuwahara and RENGO-RIALS eds. 1997), and this tendency appears to be becoming even more salient. According to the “Survey on Corporate Employee Benefits/Welfare Systems” conducted by the Japan Institute of Life Insurance in 2002, one out of every four employees responded that he/she was “unable to trust the company.” Particularly at companies with 300 or more employees implementing a wide range of personnel cost reduction measures covering employment, wages, retirement allowances and employee benefits and welfare, unable to trust (30.5%) overwhelmed able to trust (28.6%) (The Japan Institute of Life Insurance 2003). The decline of trust in leading and large companies, which have been providing relatively “good employment opportunities” and hence contributing to the formation of the social norm

of mutual trust between companies and employees, can be seen as a symbol of the upheaval of Japanese “corporate society.”

4. Management Crisis and the “Voice” of Labor Unions

Worker Participation in the 1990s

How have labor unions, which represent employee interests, responded to the escalation of the crisis in “corporate society?” Let us examine the findings of the “Survey on Worker Participation in the 1990s” conducted by RENGO-RIALS which investigated the extent to which labor unions participated in corporate management and had a say in management crises.⁶

Firstly, when looking at the current situation of labor union participation in management via labor-management consultations, it appears that a framework for frequent labor-management exchange and labor-management relations based on mutual trust, which became entrenched after the 1970s, is still basically maintained.

As for labor-management discussions, over 80 percent of the unions responded that they had a standing labor-management consultation system to discuss management policy and managerial measures in which 80 to 90 percent of important management-related issues, including those involving corporate strategy, were discussed. More than half of the unions responded that they were actively involved in presenting opinions and responses on occasion, presenting opinions and having company plans revised on occasion, and being consulted on implementation for matters such as management policy, production plans, personnel plans, business operation plans, change in the corporate organizational structure, and contraction, closure, and initiation of businesses. Only a few responded that they were passively involved by being informed by companies about decisions either in advance or after the fact. On the other hand, the majority of unions responded that budgetary plans, finance plans, investment plans, sales plans and introduction of new technologies, were not items for discussion or that the unions were just informed either in advance or after the fact.

⁶ Questionnaires were sent to 1,196 large and mid-size unions via RENGO-affiliated industry-specific unions in the private sector during December 1999 and January 2000, and 639 returned effective responses (effective response rate: 53.4%).

What is noteworthy is that many unions are active in expressing their opinions not only concerning matters directly related to employment but also management policy and business plans based on it.

Labor-management consultation meetings took place rather frequently (7.3 times a year on average), and corporate officers in charge of labor matters attended every meeting at most companies. Officers in charge of accounting and finance at three-quarters of the companies and presidents at a little over one-half attended almost every meeting. Clearly, the labor-management consultation system is regarded as the formal mechanism for important discussions between labor and management at many companies. Outside of this formal mechanism, there are also frequent informal working-level exchanges of information between labor and management, with 34 percent of the unions answering that they hold such exchanges frequently, and 38.7 percent said that they hold such exchanges sometimes. Over 70 percent of the unions maintained such exchanges frequently. The frequency of exchange between a given union and management is related to the union's ability to voice its opinions vis-à-vis management. When we divide the unions into three categories according to their ability to voice their opinions (high, medium and low) at labor-management consultation meetings, we find that the proportion of those holding working-level labor-management exchanges frequently is larger for the unions with more power to voice opinions than those with fewer exchanges. Moreover, unions without a labor-management consultation system held informal information exchanges even less frequently than those in the low category.

As revealed by a survey conducted by Labor Research Center in the early 1990s, since the second half of the 1970s a wide variety of activities, in addition to frequent working-level exchanges, have been instituted as ways for workers to regularly participate in management (Inagami ed. 1995). Using the same question employed in this survey, the 2001 survey by RENGO-RIALS asked what enterprise unions were doing to participate in management. The largest proportion of respondents answered yes to the statement, "Top union leaders receive disclosure of classified information concerning management" (63.2%), followed by "We have an effective say in management strategy" (50.1%) and "We hold regular informal meetings at the top level" (44.6%). About 40 percent answered in the affirmative to

“We essentially represent opinions of middle-managers” and “Union members can own company stock.” The proportion of those who answered “yes” to the statement “We have regular informal meetings at the top level” was 20 percentage points lower than in the Labor Research Center survey (64.0%), but the two surveys otherwise produced nearly identical results. Looking at the relationship between participating in management and ability to voice opinions, we find that unions with a greater ability to voice opinions tended to answer “yes” for all of the activities listed in the question. In particular, nearly all unions in the “high” category responded affirmatively to “Top union leaders receive disclosure of classified information concerning management” (81.3%), “We have an effective say concerning management strategy” (72.3%) and “Unions make proposals concerning management” (80.1%). Unions with no labor-management consultation system answered in the affirmative fewer times than those in the “low” category. Unions with no labor-management consultation system do not actively participate in management.

From the results mentioned above, it becomes clear that there exists a mutually complementary relationship among the institutionalization of a labor-management consultation system, the ability of unions to speak out actively in the system, and regular exchanges of information and avenues to participate in management. It is important to note that the degree to which unions are seen as critical partners of management is linked to the trust given to them by management, demonstrated through disclosure of classified information.

Corporate Rebuilding/Personnel Rationalization Plans and the “Voice” of Labor Unions

The above survey on “Worker Participation in the 1990s” by RENGO-RIALS was conducted when the Japanese economy was bouncing back — after bottoming out in January in 1999 — from a serious recession, which had generated a minus growth in FY1998. It was a short period of recovery. However, few could sense that a recovery was actually taking place, and drastic employment adjustment measures were still being implemented at many companies. Nearly three-quarters of the unions were presented with corporate rebuilding and personnel rationalization

proposals of one sort by management during the five years before the survey (FY1994-1998). Almost all unions (over 90%) representing workers at companies whose balance had been in the red for more than two years during that five-year period responded that they had been approached with restructuring plans. Moreover, even at companies with no deficit, over 60 percent of the unions were approached with some sort of restructuring plans. It is apparent that corporate restructuring affected nearly all of the unions responding to the survey.

The proposed corporate restructuring and personnel rationalization plans included a wide range of specific measures. The most frequently cited in the survey was curb on new hiring (64.7%), followed by permanent and temporary transfers (52.7%) and closure and incorporation of business establishments and stores (48.4%). Other relatively common measures were the introduction of new personnel policies such as performance-based wages (45.2%), curb on wage increases (41.8%), reassignment (41.5%), and curb on overtime (41.5%). Employment adjustment measures traditionally used to avoid dismissals were relatively predominant. However, it is important to note that one-third of the companies proposed voluntary retirement (33.8%) even though dismissals was cited by few unions (1.5%). In particular, voluntary retirement was proposed at nearly 60 percent of the companies running a deficit for over two periods. Wage cuts were not very prevalent (10.5%), but the proportion of companies that proposed reductions in lump sum payments was considerable (31.3%). Nearly one-half of the companies proposed closures and mergers of business establishments as a part of their corporate rebuilding plans through selection and concentration. Similarly, one-fourth proposed corporate splits (25.9%).

As described above, management pushed very harsh restructuring plans. How did labor unions respond? Almost all answered that they entered into discussions and negotiations with management before the plans were implemented (91.6%). Nearly 80 percent drafted their own plan in response to management's, and close to two-thirds said that to some extent their plans were adopted with 14.5 percent being received by management while 50.3 percent were received with some modifications. Moreover, over two-thirds managed to revise management's plans (8.8%

saw their proposals result in a major revision and 59.3% in a partial revision). Unions with greater ability to voice opinions occupied a large proportion of those unions which drafted their own plans, succeeded in having their plans accepted by management, and succeeded in revising management plans. Nearly 60 percent of the unions (59.7%) evaluated the results of their negotiations with management as being successful in protecting work conditions and employment.

Naturally, these evaluations will be criticized as merely self-indulgent, as the union officials were evaluating their own work, and. Therefore it is also necessary to objectively evaluate the union proposed revisions. These are issues that need to be addressed in the future. However, one thing is certain — enterprise unions did actively try to make their “voices” heard and get involved in the decision-making process during the period of drastic corporate restructuring in the second half of the 1990s.

5. Reform Agendas toward Regeneration and Development of Industrial Democracy

Self-reforming Enterprise Unions and Developing a Basic Framework for Labor Participation in Management

Japan’s industrial democracy now stands at a crossroads. The estimated unionization rate in 2002 was 20.2 percent, with the rate in the private sector already dipping below the 20 percent line (17.5%). In terms of actual numbers, union membership fell below 11 million standing at 10,801,000, that is 412,000 fewer than in 2001 (Ministry of Health, Labour and Welfare, *Rodo Kumiai Kiso Chosa* [Basic Survey on Labour Unions], 2002). The rate of establishment of a labor-management consultation system, the main mechanism supporting employee participation in management in Japan, in businesses with a union has remained in the 80 percent range, but the overall rate has been on a downward trajectory because the rate of establishment of a labor-management consultation system for businesses without a union is dropping.⁷ Democracy in “corporate society” is currently facing a crisis. In the end, the crisis can be

⁷ According to the Ministry of Health, Labour, and Welfare’s “Roshi Komyunikeshon Chosa” (Survey on Labour-Management Communication), the rate of establishment of a labor management-

overcome only if labor unions, which created the system of corporate democracy that exists today, take initiatives on their own.

There are some major issues that must be considered when discussing the self-reform of enterprise unions (Suzuki 2000). First, before being able to increase their influence in managerial decision-making policies, unions must reinforce their strength, policy and action to force management to recognize their presence as a partner in an effort to create a management structure based on discussion and consensus. Second, in light of the increase of non-regular employees, such as part-time and dispatched workers, it is necessary for unions to work even harder to ensure they receive fair treatment in corporate society while actively working to unionize them. Third, it is necessary to consider a mechanism in which the interests of middle managers will also be heard. Developing a mechanism which includes the “voice” of middle-managers, who play important roles in the consensus formation at companies, has a strategic importance as well. Fourth, it is necessary to strengthen efforts such as negotiations and consultations at the corporate group-level in light of corporate group management through corporate splits and creations of subsidiaries and shift to management based on consolidated account statements. Fifth, it is necessary to develop a more robust response to corporate reorganizations, such as creating holding companies and corporate mergers, while beginning to establish new rules on labor-managerial relations.

However, there is a limit to how much individual enterprise unions can do. The “voices within the company” in “corporate society” must be translated into the “voices of society.” This is why RENGU and its

consultation system in businesses with 50 or more employees was 58.1% in 1989, 55.7% in 1994, and 51.0% in 1999. Comparing the rate of establishment between businesses with a union and those without a union (both businesses with 50 or more employees), the rate for businesses with a union was 77.8% in 1989 and 80.7% in 1994; the rate for businesses without a union was 38.7% in 1989 and 31.6% in 1994. The 1999 survey expanded its target to include businesses with more than 30 employees, and it presents only the overall rate of establishment in respect to those businesses with 50 or more employees. Therefore, it is impossible to chronologically compare changes in the rate of establishment for businesses with a union and those without a union from 1989 to 1999. However, the rate of establishment for businesses with a union in 1999 had increased since 1994 (84.8%), and therefore, the decrease in the overall rate can be presumed to be a result of a drop in the rate for businesses without a union. The rate of establishment for businesses with 30 or more employees without a union was merely 17.1%.

affiliated industry-specific unions are dedicated to developing of a basic institutional framework in which the voices of employees can be represented in management decision-making.

During the debate over the series of bills concerning corporate restructuring and revisions to the commercial law, RENGO called for establishing the right of employees to access information, be consulted, and participate in decision-making, and engaged in forming public opinion and parliamentary lobbying. In respect to corporate governance reform, RENGO has been stressing that in order to develop healthy industrial and corporate structures it is important to establish a system to air the opinions of workers. RENGO proposes that representatives of labor unions or employees be included as members of corporate auditing committees (RENGO 2003). It has also been advocating the creation of legislation concerning labor-management consultation and drafted the “Summary Outline of the Worker Representation Bill (Draft)” (RENGO 2001). The draft bill proposes instituting a “majority representation system” in which a “labor union to which the majority of workers at a workplace belong or a person representing the majority of workers at a workplace” is designated to conclude labor-management agreements and conduct consultations and exchange of opinions with management. The bill also contains a proposal for a “Japanese-style employee representation system” in which enterprise unions and employee representation systems function in a mutually complementary fashion.

Possibilities for Reforming ‘Corporate Society’

To realize the demands of RENGO as outlined above, labor unions must go back to the basics and must on their own make an effort to change the status quo. Even if a new law is created, it will not function unless unions actually try. In fact, there are some clues indicating how labor unions might be able to play an active role in the reform of “corporate society” responding employees’ opinions. This article concludes with a discussion of three examples as it is important, I believe, to recognize that possible seeds for future reform are emerging in the midst of the challenging reality.

The first example relates to how labor unions might participate in creating mechanisms concerning corporate social responsibility inside

companies. Opening the system of corporate democracy based enterprise unions to elements outside the company has been an important outstanding agenda item in the self-reform of enterprise unions. An exclusive and self-contained community cannot be accepted by society without making changes. In fact, the lack of safeguarding mechanisms to protect against management abuse within companies has been identified as a major problem in the series of corporate scandals in recent years. According to a recent survey of how union members view antisocial behavior and accounting rule violations committed by companies,⁸ most union members (69.8%) found antisocial behavior unacceptable, and only a small minority (10.9%) responded that they sympathize because these were done to protect the interests of the company. When asked how they would respond if they discovered their company was committing antisocial acts or accounting rule violations, the greatest percentage answered they would make an effort inside the company to stop the unethical behavior (43.8%), a substantial percentage (31.5%) answered they would consult with a labor union, while only a few (7.4%) said they would ignore what was going on. The results must be viewed with a grain of salt as the survey contains a bias; the respondents, who were union members approached via labor unions, might not have revealed their true sentiments. Still, it is difficult to deny the existence of union members who are deeply concerned about the social responsibility of companies and hope to see labor unions become actively involved in this issue. Several unions — such as the Japan Council of Metal Workers' Unions, the Japanese Federation of Textile, Chemical, Food, Commercial, Service, and the General Workers' Unions — have established a policy demanding that companies be socially responsible and have begun to take action. Enterprise unions also are getting involved in creating organizations related to corporate social responsibility or are participating in corporate compliance committees (IMF-JC 2003). Employees are always in the frontline and watch what is happening at the

⁸ Gendai Sogo Kenkyu Shudan and The Ohara Institute for Social Research, "21 Seiki 'Rodo Kumiai ni Mirai wa Aruka' Anketo Chosa" (Twentieth-first Century Survey: Do Labor Unions Have A Future?). Surveys were sent to 2,200 union members via 14 industry-specific unions affiliated with Gendai Sogo Kenkyu Shudan in November-December, 2002, and effective responses were obtained from 1,265 (effective response rate: 57.5%); the report of the survey was published by the Ohara Institute for Social Research in 2003.

low end of the corporate structure; they have the ability to speak out against management's claims because they know what is actually going on in their company. This is why some managers might be hesitant to allow workers to participate in corporate management. By actively making their "voices" heard and representing the voice of employees who demand realization of social justice within their company, labor unions will be able to not only advance corporate reform but also establish their presence as a social force.

The second example concerns responding to the issue of equal treatment for non-regular employees, now constituting over 30 percent of the workforce. The postwar labor union movement started with the demand, "Accept us as full members of corporate society," and now it is probably non-regular employees who hold this demand more ardently than any other groups. Translating their demand is of course a duty of labor unions. In addition, history shows that such an act will greatly strengthen labor unions. The unionization rate of part-time workers was a mere 2.7 percent as of 2002, but both the unionization rate and numbers of non-regular employees who are union members are gradually increasing while overall union membership has been dramatically declining. According to an estimate by RENGO, during the two-year period between October 2001 and September 2003, the member of industry-specific unions affiliated with RENGO increased about 260,000, and one-third of the increase was attributed to newly unionized part-time workers. It is important to step up efforts to unionize non-regular workers. Moreover, unions are making an effort, albeit slowly, to consult with companies over wage and personnel systems for non-regular employees. According to one study, at companies where such consultations do take place, management tends to make an effort to achieve balanced treatment between regular and part-time employees more so than at companies where unions do not take any action or are merely informed about company decisions (RENGO-RIALS 2003b). Labor unions should strive to collectively represent the views concerning equity of all employees, including non-regular employees. This will lead to an expansion and enhancement of the network of solidarity.

The third example concerns workers' views on labor unions, and here can be seen the possibility that labor unions might be able to increase their

influence. Many workers expect labor unions to play meaningful social roles, and a substantial portion are ready to respond to a call to join a union.

RENGO-RIALS sponsored a survey in 2003 entitled “Survey on Labor Unions”⁹ which asked workers, including non-union members, residing in metropolitan Tokyo, greater Kansai, and government ordinance cities about their image of labor unions and expectations concerning their roles. More than 20 percent (21.6%) responded that labor unions are absolutely necessary while 49.7 percent said that unions are somewhat necessary, i.e. more than 70 percent believe that labor unions are necessary.

Moreover, many workers hope that the presence of labor unions will help improve rights, work conditions, and the welfare of workers. In terms of the benefits to society as a whole, they cite protection of workers’ rights (73.8%), improvement of work conditions (50.1%), more gender equity over employment opportunities (24.4%), and closing the gaps in work conditions among different industries and companies (20.4%). Improvement in employee benefits, the welfare system and the work environment (53.6%), inclusion of employee opinions in corporate management (48.8%), reduction of unfair personnel evaluations (24.3%), curb on personnel reductions (23.1%), more gender equity over employment opportunities (20.9%) and maintenance of corporate ethics (15.2%) were noted as benefits for unionized workers.

Clearly, many workers see labor unions as a necessity. They believe that labor unions can bring many positive benefits and expect labor unions to engage in many activities. Moreover, 13.2 percent of non-unionized workers are willing to join labor unions (would like to join at 3.2% and would consider joining at 10.2%). Examined by employment type, 13.4 percent of regular employees and over 20 percent (22.4%) of contract and dispatched workers are willing to join. About 10 percent (9.7%) of part-time and casual workers also are willing to join. Significantly, nearly one-third of those who believe labor unions are absolutely necessary want to join a union.

⁹ In April, 2003, Questionnaires were sent to 2,000 workers at private companies residing in the Tokyo Metropolitan area and Government Ordinance Cities across Japan, and 1,693 effective responses were obtained (effective response rate 84.7%).

Perhaps, these three examples only amount to a very modest first step and a potential that is only latent. However, only by taking the first small step forward and fulfilling such latent potential will unions be able to change the status quo. What is demanded from labor unions now is a leadership that seeks out an opportunity for future development in the midst of a crisis. That opportunity is manifesting itself; it can be found in the desire for security and stability of vocational life amidst the upheaval that exists in corporate society.

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Japanese Labor-management Relations in an Era of Diversification of Employment Types: Diversifying Workers and the Role of Labor Unions

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1. Japanese Labor-management Relations Respond to Diversification of Employment Types

Since the 1990s, Japanese companies have embraced a new management environment that has been shaped by globalization of the international economy and a long-term recession, allowing them to make use of new and various kinds of workers. There has also been increasingly different ways to use labor — such as part-time workers, dispatched workers and subcontractors — while progress is being achieved in reforming personnel management, whose pillars include the introduction of MBO (management by objective) and performance-based wages. The trend toward individualization and diversification is expected to grow due to the combined effects of changes in how people perceive work as well as the rising number of people who choose diverse working conditions and employment patterns.

The increasing diversification of employment patterns in recent years has brought to the fore major issues concerning working conditions and labor-management relations. In terms of working conditions, the key issue is the difference in the working conditions of regular employees and non-regular employees. The wage gap between regular employees and part-time workers, who account for almost 70 percent of non-regular employees, has long been considered a problem, but recently it is attracting attention because this gap is widening. The renewed interest was spurred by the quantitative problem in which an increasing number of people are working under poor conditions amidst advancements in diversification of employment types, as well as the possibility that the wage gap is a significant reason for the sense of unfairness and dissatisfaction felt by workers as an increasing number of part-time workers take on work similar to that of regular employees.

Since this is a major policy issue that symbolizes the era of diversification of employment types, government, labor and management have made various attempts to solve this problem, and these attempts have simultaneously demonstrated the difficulty in solving the issue. Even though labor-management relations should play a critical role in deciding working conditions, one problem is that Japanese labor-management relations centered around company-based labor-management relations are not fully functioning in the current situation.

This article, therefore, will attempt to clarify the recent trends and issues in labor-management relations that are related to the diversification of employment patterns by reviewing the results of studies and research conducted in Japan, and to examine the future direction studies and research should take.

2. Advancements in Diversification of Employment Types and Declining Rate of Unionization

2.1 Widening Wage Gap

Let us review the wage gaps between regular and non-regular employees, as this is an issue resulting from diversification of employment types. Looking at employment patterns, the wages of non-regular employees are lower than that of regular employees in all categories excluding *shukko* (temporary transfer between companies) workers. A similar trend is apparent even after wages have been adjusted for working hours (Ministry of Health, Labour and Welfare (hereinafter referred to as MHLW) 2003, p.161 and p.295).

Furthermore, the gap in the hourly wage rate of part-time workers widened throughout the 1990s. According to the MHLW (2003), if the wages of regular employees is set at 100, then the wage gap between female regular employees and female part-time workers was 58.9 in 1990 and 54.3 in 2001. The larger the company, the wider the wage gap. The gap is larger in the tertiary sector than the secondary sector, and, with the exception of some industries, continues to grow.

The most frequently cited reason why companies hire part-time workers, dispatched workers and subcontractors is to cut personnel costs,

while the most often cited reason for hiring contract workers and *shukko* workers is job content. The percentage of companies that cited cutting personnel costs as the reason for hiring part-time workers grew significantly from 21 percent in 1990 to 65.3 percent in 2001 (The Japan Institute of Labour 2003). The percentage is also increasing for contract workers as well as dispatched workers (MHLW 2003, p.120, p.275; Ministry of Labour 1994 and 1999).

As described above, while, on the one hand, employment types have diversified as a result of companies adopting a personnel strategy to place the right people in the right jobs, on the other hand, companies have recently been making even greater use of diversification of employment types as a way to cut personnel costs. The widening wage gap in recent years can be attributed to such developments on the corporate side.

2.2 Declining Rate of Unionization

The proportion of workers joining labor unions in Japan has been declining for a long period of time. The estimated unionization rate calculated by the MHLW reached a peak of 55.8 percent in 1949 and hovered around 30 percent from the 1950s to the 1970s. In the early 1980s, the figure fell to the 20 percent level. In 2003, the estimated unionization rate dropped below 20 percent, 19.6 percent, for the first time since the survey began in 1947. Union membership hit a peak in 1994 with about 12.7 million people and has continued to decline since, with the figure being 10.53 million in 2003 (*Basic Survey on Labor Unions*, MHLW, annual report).

Previous studies have examined factors for the decline in unionization, and can be broken into two approaches (Tachibanaki 1993; Tsuru 2003). The first seeks to locate factors leading to the decline in unionization in the long-term changes in the industrial and employment structure, while the second approach looks for factors within the unions themselves.

With respect to the decline in the unionization rate, attention was first focused on the relationship between the unionization rate and macro changes in the social structure as demonstrated by the industrial and employment structure. According to Kuwahara (1981), who looked at changes in the labor unionization rate by industry, union membership in

manufacturing declined because of the shift in industrial structure from secondary to tertiary industry. Kuwahara also noted that a factor behind the decline in the unionization rate was the shift in employment to tertiary industry, where unionization is difficult due to high liquidity, corporate size and the existence of part-time workers.

As for the relationship between changes in the macro structure and unionization rate, Koshiro (1988) focused on the changes in employment structure and conducted a quantitative factor analysis based on the composition of workers. Koshiro identified five variables influencing the employment structure: (1) the ratio of employees in wholesale and retail services, (2) the ratio of female employees (feminization), (3) the ratio of part-time workers (increasing number of part-time workers), (4) the ratio of employees of major companies and (5) the ratio of white collar workers (white-collarization). Among these variables, Koshiro found that the ratio of female employees and the ratio of part-time workers have influenced the declining rate of unionization.

In contrast to the approach of highlighting changes in the macro structure, Freeman and Rebeck (1989) used a flow stock analysis to demonstrate the importance of new developments to explain the decline in unionization because changes in industrial and employment structure offer only a partial explanation for the decline in unionization. In addition, the unionization rate has not fallen in other countries that are also experiencing similar changes. Freeman and Rebeck noted that the most significant reason for the decline in the unionization rate is the falling percentage of labor unions that organize new workplaces. According to Freeman and Rebeck's studies, it is the substantial decline in organizing new union members since the mid-1970s, namely the decline in the "birth rate" of labor unions, that is the basic factor behind the decline in the unionization rate.

Furthermore, while acknowledging that the feminization and increasing number of part-time workers are reasons for the decline in the unionization rate, Tsuru (2003) stresses the fact that labor unions have made only weak attempts to unionize both in companies with unions as well as in companies without them. In regard to the unionization process, Tsuru noted that it is unlikely that resistance from employers will lead to a

decline in the unionization rate. He also indicated that unionization of non-unionized workers, who are the target of unionization, is not very popular and has been declining in recent years.

3. Different Kinds of Workers and Issues in Unionization

3.1 Current Situation of Unionization

As mentioned above, one reason why the unionization rate has fallen in recent years is the increased number of non-unionized, non-regular employees such as part-time workers.

The percentage of non-regular employees compared to all employees has increased from 30.7 percent to 50.7 percent for women and 7.6 percent to 14.8 percent for men in the past 20 years (1982-2002). In particular, this proportion has grown remarkably in recent years, especially in the past five years, as illustrated by the 8.5 percentage point increase for women and 4.7 percentage point increase for men (*Employment Status Survey*, Ministry of Public Management, Home Affairs, Posts and Telecommunications).

While the number of non-regular employees is rising, little progress has been made in unionizing them. Even though the number of short-term employees increased by 1.41 million (from 9.57 million to 10.98 million people) in the past five years (1998-2003), union membership among part-time workers only grew by 90,000 (from 240,000 to 330,000 people), and the estimated unionization rate edged up 0.5 percentage point from 2.5 percent to 3 percent (*Basic Survey on Labor Unions*, MHLW).

3.2 The Will and Pressure to Unionize

A major factor for the low unionization rate among part-time workers is that unions are not eager to organize these workers. Looking at data from the late 1980s, the number of labor unions that have already organized non-regular employees and the labor unions that intend to carry out further unionization account for only 25 percent, a mere one-fourth, of the total labor unions in companies that hire non-regular employees (Nakamura, Sato and Kamiya 1998). According to the Ministry of Labour (1991), less than one-fourth, or 23.3 percent, of all unions have already organized part-time workers or have plans to do so (Boyles 1993).

As shown in the 1998 survey (Ministry of Labour 1998), among companies that employ part-time workers, only 4.9 percent companies (totals based on industry and corporate size) unionize part-time workers, and the rest of all labor unions (95.1%) do not treat part-time workers as members. Looking at the breakdown of these figures, the most frequent response was “we do not take measures to unionize part-time workers” (84.7%). Other responses included “we are working to unionize them” (9.7%), “we treat them as quasi-members” (4.8%) and “we coordinate with organizations of which part-time workers are members” (0.9%).

The trend is also reflected in the membership criteria for part-time workers. According to the *Survey on Labor-Management Communication* (Ministry of Labour 1999), 13.9 percent of workers employed at a company with a labor union have not joined, and the figure for part-time workers is more than half, or 53.6 percent. Moreover, about 82 percent of part-time workers who have not joined a labor union said that they were not eligible to become members as their reason for not joining.

Two major reasons for the delay in unionizing part-time workers is that labor unions themselves have not attached importance to expanding their membership, and unionization is primarily geared toward regular employees. According to the *Report on the Survey of Labor Unions* (Ministry of Labour 1998), 23.9 percent of all unions are “tackling union expansion as a priority,” while 75.9 percent of unions are “not necessarily tackling union expansion as a priority.” Of these unions which are “tackling union expansion as a priority,” target groups are regular employees (72.2%), which is the highest, followed by part-time workers (22.3%). Other target groups include “management and professionals” (15.9%) among regular employees, in addition to “retirees upon reaching the retirement age” (11.6%), “temporary workers” (14.9%) and “dispatched workers from other companies” (3.0%) among non-regular employees.

There are a number of reasons why labor unions are not interested in unionizing non-regular employees. According to a questionnaire sent to labor unions, the most difficult obstacle they face when organizing or forming unions among part-time workers is the view that there is little need to join or form unions (Nakamura, Sato and Kamiya 1988; Boyles

1993). It has also been pointed out that if part-time workers are unionized, the unions will have to respond differently to their needs than they do to the needs of regular employees, such as lowering union dues and flexibly scheduling union activities. It appears that regular employees think this will increase the burden on them.

One obstacle that labor unions will face in advancing unionization is the trend among employers who are avoiding the unionization of non-regular employees. According to Nakamura et al. (1998), 46.3 percent of employers are either “strongly opposed to the unionization” of non-regular employees or believe that “unionization should be avoided if possible.” This figure exceeds the responses, “I am not sure of my company’s policy” (40.6%), “unionization is inevitable” (7.1%), and “I support unionization” (2.6%). Employers tend to avoid unionization because they do not believe unionization will bring about any concrete benefits for their company. While 59.3 percent of companies responded that “unionization brings absolutely no advantage to the company” in a corporate survey, 23 percent said “unionization will enable us to capture the opinions and dissatisfaction of non-regular employees” and 14.2 percent said “unionization will enable us to gather the diverse requests and opinions of non-regular employees,” both of which are low percentages (Nakamura, Sato and Kamiya 1988, with multiple responses for each).¹

It has been noted that the proportion of non-regular employees functions as a kind of “unionization pressure,” serving as a critical driving force for labor unions which are mainly geared toward regular employees. Nakamura et al. (1988) notes that unions with a high percentage of non-regular employees also tend to have a strong desire to unionize these workers. It is very likely that this trend became stronger after enactment of the amendments to the Labour Standards Law in 1999. Because these amendments clarified the standards for worker representatives concluding labor-management agreements, unionizing a majority of employees became a critical condition for labor unions to fulfill in order to maintain their influence.

¹ According to data compiled by Rengo (The Japanese Trade Union Confederation) (2002), discussing with employers the unionization of part-time workers is an important step toward unionizing them.

3.3 How Part-time Workers Perceive Unions

In understanding the nature of part-time workers as “workers,” or in other words, the image of the worker, no clear-cut conclusions are presented. Various studies have confirmed that part-time workers possess a different perception than male regular employees do, but there is no unanimity when it comes to interpreting the reality.

The classic image of part-time workers is that they are “non-union-oriented” as well as that they are passive toward or opposed to labor union activity. A study conducted by Zensen (Japanese Federation of Textile, Garment, Chemical, Mercantile, and Allied Industry Workers’ Unions) confirmed that part-time workers are not familiar with unions and that they have a low opinion of and little desire to participate in them (Labor Policy Department, Zensen 1980; Industrial Policy Bureau, Zensen 1991; Furugori 1985).

In contrast, a study conducted by Rengo showed that part-time workers are not necessarily non-union-oriented and are actually more positive about unions and make greater use of them compared to male regular employees (Tachibanaki 1993; Boyles 1993). For example, among union members, female part-time workers had a more positive evaluation than male employees of words such as “lightness,” “novelty” and “innovativeness” to describe the image of union organizations. Rengo also found that non-unionized employees and female part-time workers tend to be more positive about the image of unions compared to male employees.

Looking at how union members make use of labor unions, 41.2 percent of female part-time workers responded that union officials were the first person they consulted when they have a complaint about their workplace. This is characteristic when compared to the fact that less than 10 percent of male and female regular employees consulted union officials (about 40% of male regular employees answered they first approached their supervisor and colleagues, while about 20% of female regular employees responded they first consulted their supervisor and 60% answered their colleagues). Where an employee goes to discuss complaints about his or her workplace reflects the personal relationships at the workplace. In Japan, it is known that employees traditionally bring their complaints more often to their supervisors than to labor unions. Since this trend points to the weakness of

labor unions, the fact that female part-time workers seek out their union to settle their complaints is intriguing in understanding the nature of these workers.

4. The Role and Challenges of Labor Unions

4.1 Clearly Defined Jobs and Responsibilities for Non-regular Employees

As employment types continue to diversify, the “reversed workplace,” wherein the number of non-regular employees exceeds the number of regular employees, is no longer an unusual phenomenon in service industries such as retailing and food.

How have labor unions responded to this situation? Sano (2000, 2002) used case studies conducted in the service industries, which are making greater use of non-regular employees, to show how labor unions have set conditions for the scope of work which non-regular employees undertake. In department store A, the increasing number of part-time workers — whose knowledge of products and ability to service customers was limited, and their hours were restricted — contributed to the growing burden on regular employees. As a result of consultations with the employer, full-time, non-regular employees became contract workers under the union’s direction, and tasks were officially decided according to type of employment, with the aim of continuing to employ regular employees. At the same time, a flexible approach is allowed to decide the actual scope of the tasks. In some cases, in order to carry out work smoothly, non-regular employees assumed tasks that had been assigned to regular employees, and have gone beyond the non-regular employees’ scope of responsibility as agreed by labor and management.

4.2 Internalization and Externalization of Part-time Workers

Labor unions are responding to the growing number of non-regular employees mainly by organizing part-time workers and taking other steps for improving working conditions. How has this impacted workers and labor-management relations in the long run? Kamuro (2001) looked at labor-management relations in the manufacturing industry, which has a long history of using non-regular employees, to demonstrate the

consequences of the internalization of part-time workers.

Major electronics manufacturer A switched to using part-time workers instead of temporary workers in the 1960s, which led to an increase in the number of part-time workers. As the number of part-time employees grew, the union filed a complaint to introduce strong control over hiring and the work assigned to each type of employee, rejecting the employment of more part-time workers. Through this action, the union succeeded in creating a system whereby part-time workers who surpassed certain standards became “regular employees” and were unionized. The system offered greater employment security for these workers. They were “internalized” in the company in the sense that their working conditions and ways of working became closer to that of regular employees.

Nonetheless, as a result of increased mechanization and automatization since the 1980s, this manufacturer perceived the part-time workers who became regular employees as a rigid labor force due to the limitations placed on their scope of work and the restrictions on their working hours. With the appreciation of the yen beginning in 1985, this company made increasing use of outsourcing and external contractors.

5. Conclusion: Future Research on Labor-management Relations in an Era of Diversification of Employment Types

The prevailing view in recent discussions has indicated that the declining rate of unionization can be attributed to the unionization process of labor unions rather than changes in industrial and employment structure. What is required in the future studies includes case studies and quantitative studies that specifically intervene and elucidate the difficulties that labor unions encounter as well as the unionization process itself. Moreover, the desirable form of unionization is one where labor unions represent the interests of non-regular employees and improve their conditions. On this point, further research on the economic impact of labor unions is needed.

Furthermore, it must be assumed that the progress achieved by labor unions in organizing part-time workers will lead to shifts in employment toward other non-regular employees. In recent years, a growing number of

subcontractors and dispatched workers in lieu of part-time workers have been employed, particularly in the manufacturing industry. While it is difficult to imagine that these changes are the result of improved conditions for part-time workers in light of the current situation where wage gaps are widening between regular employees and part-time workers, previous research does show cases when companies made greater use of an external, atypical labor force instead of “internalized” part-time workers. Responding comprehensively to non-regular employees as a whole would pose a future challenge .

In addition, it is necessary to explore the image that labor unions have of workers as one of the themes in understanding labor-management relations from a long-term perspective. The fact is that there are workers who do not necessarily wish to become regular employees, which will be a major challenge to labor unions when they carry out their activities. Japanese labor unions have held onto an archaic image of workers —male, regular employees with an awareness of their rights and commitment to their work — and it has been difficult for them to take an active approach toward workers who do not fit this image.

As long as many Japanese labor unions are company unions, the issue of the diversification of workers, triggered by diversification of employment types, is unavoidable. In future research, analyzing the approach that labor unions should take in responding to diversification is an important research topic for understanding the basic nature of Japanese labor unions. Diversification of employment types is a perfect theme for studying the fundamental issue of diversity faced by labor unions.

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JILPT Research Activities

Northeast Asia Labor Forum

The Japan Institute for Labour Policy and Training (JILPT) sponsored “The 3rd Northeast Asia Labor Forum” in Tokyo on 28 October 2004. This was the third in a series of annual forums in which JILPT from Japan, the Chinese Academy of Labour and Social Security (CALSS) from China and the Korea Labor Institute (KLI) from Korea jointly participate. Research results are presented at these forums with the aim of achieving mutual understanding among the three countries as well as advancing research.

The themes for the forums are decided by the host country. The first forum held in Beijing in 2002, addressed the theme “Measures for Improving Employment in the Age of Economic Globalization.” The second forum took place on Cheju Island, Korea in 2003, and focused on “Women and Employment.”

This year’s forum, co-organized by three institutions, was held to discuss “The Current Situation and Issues Surrounding the Employment of Atypical Workers” and focused on the increasing number of atypical workers in response to the diversification of employment patterns. JILPT considers this question a major policy issue, hence it seemed an appropriate topic to be discussed among the three countries.

Below are the titles of the reports presented at the forum by researchers from each institution. The entire contents of these reports can be viewed on JILPT’s website (<http://www.jil.go.jp/english/index.html>).

JILPT

Ogura, Kazuya, Vice Senior Researcher. *“The Concept and the Current Situation of Atypical Employment – Based on International Comparative Studies.”*

Ono, Akiko, Researcher. *“The Current Situation and Issues concerning Utilization of Part-time Workers in Japan – A Case Study of Major Retailing Sectors.”*

CALSS

Yue, Songdong, Professor, Development and Research Center of the State Council. *“Atypical Employment in China: Recent Developments and Strategies for Establishing a System.”*

Zheng, Dongliang, Deputy Director-General, Institute for Labour Studies. *“The Character, Role and Policies concerning Flexible Employment in China.”*

KLI

Lee, Injae, Reserarch Fellow. *“The Definition of Diversifying Employment Patterns and the Concept of Atypical Employment in Korea.”*

Nam, Jaeryang, Research Fellow. *“The Current Situation surrounding Employment of Atypical Workers in Korea.”*