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in Japan and the United States**

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Institute for Technology, Enterprise and Competitiveness, Doshisha University
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Sanford M. Jacoby

Howard Noble Professor of Management, Public Policy, & History
University of California, Los Angeles
Los Angeles, CA 90095-1481
United States
Tel: 310-825-2505
Fax: 310-825-0218
E-mail: sanford.jacoby@anderson.ucla.edu

and Omron Fellow
Institute for Technology, Enterprise and Competitiveness (ITEC)
Doshisha University

Abstract:

These days, Americans seem to take their corporate governance model for granted. Shareholder interests are what matter. But this essay traces the history of corporate governance to show that such models change over time. And they are different in other nations, such as Japan. I argue that American-style corporate governance has resulted in wage inequality, risk shifting, and poor management. And financial reforms, despite the recent major scandals, have not gone far enough.

Keywords: corporate governance, risk, inequality, Japan, employees, managers

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Corporate Governance, Risk, and Inequality in Japan and the United States

Sanford M. Jacoby ¹

Corporate governance is an esoteric topic to which most Americans pay little attention, even after the business scandals of the last few years. Yet corporate governance is of vital importance for those Americans who work for corporations, own stock in them, or are affected by their decisions. That includes nearly everyone, because corporate decisions influence everything from the food you eat to the air you breathe.

So, what exactly is corporate governance? It comprises the laws and practices by which managers are held accountable to those who have a legitimate stake in the corporation. Defining who has a legitimate stake is less straightforward than it sounds. Shareholders are a key constituency, and in the United States their interests are represented by the board of directors, who, in turn, supervise management. But shareholders include speculators who flip a stock in a single day as well as long-term investors who hold a stock for years. Do the two groups have equal stakes in the corporation? And what about employees? Many employees have spent both time and money investing in skills that can only be utilized at a particular company (what economists call firm-specific human capital). Do their human-capital investments endow employees with a legitimate stake in the enterprise?

Nations have supplied different answers to these questions, giving rise to diversity in corporate governance systems. In Germany, the law insists that employees are stakeholders whose interests must be represented on corporate boards of directors. This is called co-determination. Large Japanese corporations balance the interests of shareholders along with those of employees, banks, and business-group members. Employees are considered part of the corporate community, along with shareholders, although there is no legal requirement to do so. The United States and other common law nations assign an exclusive role to shareholders as the only group whose interests must be considered by boards of directors. This is the “shareholder value model” of governance.

Shareholder-value systems are designed to produce high returns for shareholders and the executives whose pay is linked to stock prices. In 2000, CEOs of the largest U.S. public companies received 531 times more compensation than their average employee. French CEOs received 16 times more; in Japan they received 10 times more. ²

Such a system of corporate governance, then, has a direct bearing on pay inequality. A shareholder-value system also tends to ask ordinary employees to bear more of the risk associated with business. Corporations are quicker to lay workers off when there is a decline in demand for the company’s product or service, whereas European and Japanese companies--and also some privately-owned U.S. companies--

carry more of the burden of protecting employee jobs during downturns. Because shareholder-value companies view workers more like commodities than assets, they have higher employee turnover, invest less in employee training, and are less willing to make long-term financial commitments to employees, as, for example, with retirement benefits. In other words, recent developments in American society of the past twenty-five years--greater inequality, greater insecurity at the workplace--have been fueled, in part, by our corporate governance system.

It's important to understand that systems of corporate governance are not carved in stone. They can and do change as different stakeholder groups seek to shape the internal balance of power. In other words, corporate governance is politically constructed and historically mutable. The current German and Japanese stakeholder systems are actually rather recent innovations. They emerged in the immediate postwar years, when enthusiasm for democracy was high and the status of business leaders and owners -- who cooperated with wartime governments-- was low. Both Germany and Japan forged social compacts that included a stakeholder role for labor in corporate governance. Today those contracts are being renegotiated, partly due to changing domestic politics and partly to globalization, which makes corporations more sensitive to fickle foreign investors. Yet change is slow in Europe and Japan because stakeholders in those countries--as well as many business executives-- remain skeptical that the shareholder-value model makes sense for them.

The U.S. corporate governance system also has gone through major changes over the years. Prior to the 1980s, executives paid attention to shareholder interests but they defined those interests differently than today. Allocating corporate resources to retained earnings (for internal expansion) and to employee pension and health benefits were viewed as being good for shareholders in the long term, even though it might mean that less money flowed to shareholders in the short term. CEOs, unlike their contemporary counterparts, were more likely to have come up through the ranks and more likely to view the corporation as a community of stakeholders than as shareholder property.

The Way it Was

Writing in the early 1930s, economists Adolf Berle and Gardiner Means observed that large American corporations had ceased being controlled by their owners and that control had passed into the hands of a new class of professional managers.³ The separation of ownership and control had taken decades to occur, as the fortunes of founding families were split up and as new shares found their ways into the hands of millions of individuals. Any one of these individuals did not own enough stock to sway

management decisions, nor did they own enough to make it worth their time to try. This left executives with discretion to do what they thought was in the corporation's best interests.

For many large American companies in the early decades of the twentieth century, a crucial problem was the 'labor question': the threat of militant unionism and worker unrest. Employers also worried about taxation, in particular, that the United States might follow Europe in adopting expensive unemployment, old-age, and health insurance plans. Gradually, employers crafted a solution. They stopped treating employees as commodities that could be hired and fired at will and began to seek worker loyalty through a bevy of programs known collectively as welfare capitalism. Welfare capitalism ranged from training schools and safety programs to recreational activities and company housing. New personnel departments took away the foreman's power to hire and fire and made employment more orderly and secure.

Some shareholders were leery of companies that were spending money on workers that could instead have been paid as dividends. So managers were at pains to point out that these expenditures more than paid for themselves by reducing employee turnover and union activity. As one manager said after the First World War, "in dollars and cents it pays to treat employees as they deserve." While there was a lot of hype attached to welfare capitalism, it did establish the principle that corporations had an obligation to shelter employees from certain kinds of risk--injury on the job, unemployment, illness-- and that this might require allocating resources away from shareholders in the short-term in order to secure loyalty--and profits--in the long term. A pioneer in welfare capitalism, medical company Johnson & Johnson, formalized this in a credo stating that shareholders would get a fair return only after the company had ensured outstanding treatment of customers, employees, and the communities where it operated. Today those principles are etched in stone at the company's New Jersey headquarters.

Come the 1930s, however, employers found themselves in a difficult situation. The Great Depression had forced companies to fire millions of employees and cut back on welfare capitalist programs. Feeling that employers could not be trusted, workers turned to unions and to government to protect them from future catastrophes. The ranks of organized labor swelled, while Congress enacted European-style programs such as old-age and unemployment insurance (social security) and minimum-wage laws. But the United States took a different approach than the European welfare states. The Social Security Act provided only modest pension and unemployment benefits, leaving the door open for employers--and some unions--to supplement these benefits with spending of their own. That kind of approach was the legacy of welfare capitalism and it became the basis for America's "mixed" (government- and employer-provided) benefits system.

Before the New Deal, American business had no serious contender for power and influence. Now it competed with a vigorous labor movement and a vastly-expanded federal government. During and after the Second World War, business groups and corporate executives worked hard to develop a new philosophy that would bolster their standing in the eyes of the American people. What businessmen came up with included rhetorical assaults on “big labor” and “big government,” more generous spending on employee benefits, and an application of the Johnson & Johnson credo to corporate governance.

In 1956, a group of Harvard social scientists led by Francis X. Sutton published a classic study of postwar business ideology called *The American Business Creed*.⁴ In it the authors observed that, “corporation managers generally claim that they have four broad responsibilities: to consumers, to employees, to stockholders, and to the general public....each group is on an equal footing; the function of management is to secure justice for all and unconditional maxima for none. Stockholders have no special priority; they are entitled to a fair return on their investment, but profits above a “fair” level are an economic sin.” This was a stakeholder philosophy of governance, in which shareholders were just one of several groups recognized by managers; it would be viewed as heretical by today’s proponents of shareholder value.

According to the Harvard study, managers in the 1950s insisted on their right to make decisions independent of shareholder pressure, within “a sphere of unhampered discretion and authority which is not merely derivative from the property rights of owners.” Managers also asserted their authority to plow surplus cash back into the enterprise rather than pay it to shareholders, a practice that they defended as “the way the American system works.” Apportioning profits between dividends and retained earnings (and other spending purposes) was viewed as “one aspect of the general function of balancing competing economic interests which devolve on corporate management.”

The new stakeholder philosophy had ideological purposes but it was more than mere words. The years from the 1950s through the 1970s were the highpoint of corporate social responsibility in the United States, as evidenced in the fact that by the 1970s, forty-eight states had passed laws permitting corporations to give funds to charities without specific charter provisions. Courts conceded that these social activities might hurt shareholders in the short run. But responding to the needs of various stakeholders was, in the words of legal scholar Margaret Blair, thought to be “good for the shareholders ‘in the long run’ because the health and well being of the communities in which companies operate was considered important for business.”⁵

Did the loose coupling of management and shareholders have consequences for employees? The postwar decades were far from being a golden age of industrial democracy. But it is hardly a coincidence that the era was one in which large

corporations treated workers as stakeholders in the enterprise-- not on a par with shareholders, to be sure--but definitely having a status in the corporate family. Employment was construed as a quasi-permanent relationship that endured through bad times and good. Corporations sheltered employees from risk in a variety of ways: through health and pension benefits, by smoothing wages rather than raising and lowering them in response to business fluctuations, and by avoiding layoffs during downturns (for white-collar employees) or rehiring them immediately after a temporary layoff (for blue-collar workers). In the industrial sector, collective bargaining was accepted as a legal and social responsibility, although usually with little enthusiasm. One indicator of how these changes affected resource allocation within corporations was the rising share of national income going to wages and salaries, which trended upwards from the end of the Second World War through the 1970s.

Buffering employees from risk and treating them as stakeholders had an economic rationale. Companies were spending heavily on corporate training, transforming employees from commodities into investments that employers were loath to part with prematurely. Because employees paid for some of this training too (as foregone wages) they too had become corporate investors. While the legal system did not recognize them as such, executives informally treated employees as stakeholders. They kept employees apprised of key developments; in unionized companies, labor leaders occasionally participated in key strategic decisions. As the finance scholar Gordon Donaldson says of this era, the typical mindset of senior management was “an introverted corporate view . . . focused on growth, diversification and opportunity for the ‘corporate family.’ . . .As career employees themselves, it was natural for management to identify with all constituents who were long-term investors in the enterprise and to view shareholders in the same light.”

Shareholder Value

After 1973, the U.S. economy began to grow more slowly than in the postwar years. Part of the problem was growing competition from the rebuilt economies of Europe and Japan. Inflation was also partly responsible for slow growth, implicating those who had pricing power: regulated industries (transportation and communications) and some labor unions. Investors were unhappy with the economic situation and the way business was responding to it. They felt that company executives had grown too complacent and weren't doing enough to squeeze value out of corporate assets. Another investor complaint was that companies had spent too much money acquiring companies in unrelated industries where they had no particular competence, the most egregious example being conglomerates like ITT and Textron, which operated in dozens of sectors.

Investors argued that cash from mature businesses would be better spent on share repurchases or dividends, since investors could earn a higher return on those funds than the companies themselves.

Investors became more vocal in the 1970s because the structure of shareholding had changed since the time of Berle and Means's study. A growing number of shares now were concentrated in the hands of giant institutional investors: chiefly pension funds, but also mutual funds, trusts, and insurance companies. Whereas institutional investors held less than 10 percent of shares in the early 1950s, by the early 1980s this had risen to almost 45 percent. Institutional investors were different from households in at least two ways. First, they owned or managed significant chunks of a corporation, not enough to give them outright control, although sometimes this could be achieved through alliances with other institutional investors. Second, because their holdings were so large, they were illiquid, meaning that institutional investors were likely to use "voice" -- pressuring corporate executives -- and not only "exit" -- selling their holdings -- when dissatisfied with a company's performance.

The 1980s saw the advent of the corporate raider: individuals like T. Boone Pickens and investment groups like KKR, who promised that by taking a company private they would make it more profitable than under its incumbent management. Hostile acquisitions, rare before the 1980s, became increasingly common, in part because institutional investors provided the margin of shares necessary to effectuate a takeover. Raiders made money by selling off parts of the company -- "stripping" a conglomerate of its assets -- and also by loading companies up with debt (including junk bonds), which conferred enormous tax advantages. The remaining company was left more focused, but also less stable and riskier.

Another way to produce value out in a company was to squeeze its workforce. This became easier during the 1980s as unions lost membership and political clout. High and persistent unemployment sapped their bargaining power and that of unorganized employees. A wave of layoffs hit blue-collar workers in the early 1980s and then was extended to white-collar workers -- including middle management -- in the early 1990s. These force reductions occurred not only at troubled companies but also at profitable firms. The latter sought to restructure themselves so that more of their resources went to shareholders and executives and less to ordinary employees. Some of the work formerly done by full-time employees was taken up by cheaper part-time workers; some of it was outsourced. "Survivor" employees carried much of the remaining workload, leaving them with longer hours and more work -- and more stress -- than before.

Meeting investor demand for higher returns entailed not only resource reallocation but also a redistribution of risk. Over the past twenty years, companies have shifted more of the risk burden that they had carried during the postwar decades onto

employees' shoulders. Defined benefit pension plans, which assured employees of a guaranteed benefit, are being converted to riskier defined contribution plans. Employees have taken on more of the risks associated with health insurance, through higher co-payments and other refinements. Wages and employment today are more sensitive to business conditions, meaning pay cuts and layoffs happen more rapidly than before. The greater volatility of income is occurring at the same time as corporate earnings are higher. In other words, risk has risen and has been shifted to employees, yet most of them have not shared in the returns associated with greater risk. Moreover, the impact is magnified by the fact that public spending on health, pensions, and unemployment insurance was relatively meager in the United States to begin with.

These changes were inconsistent with the old stakeholder-governance credo and required a new philosophy to justify them. Enter the shareholder value model, promulgated by Wall Street and its allied attorneys and economists. Now, what had previously been latent and fluid in corporate law was made rigidly manifest: corporations were the property of shareholders; boards and executives had the solitary charge of maximizing share prices. To insure that boards did their job, it was recommended that they be small and independent of the company's senior management. Management's job was to concentrate every day on boosting the company's share price. But to do this, executives needed incentives to make sure that they did the shareholders' bidding.

Executive compensation was completely changed, with pay now tied to stock performance through options and similar devices. The growth of options was phenomenal: fewer than a third of CEOs received them in 1980, whereas twenty years later almost all CEOs had them. Although options sometimes were paid to middle managers or even ordinary employees, the bulk went to a firm's top executives, for whom they eventually dwarfed base salary. When hiring CEOs, corporate boards increasingly rejected insiders in favor of tough outsiders who had no sentimental loyalty to the workforce. As competition for talent heated up, executive compensation rose ever higher and the average tenure of corporate leaders declined (to about three years, on average).

It may seem obvious -- a tautology, really -- that shareholder value is good for shareholders, if not for employees and the environment. But even for shareholders, problems arose in the way the shareholder-value model incentivized executives to produce value. Executives realized that they could get rich under the new system by pumping up share prices. But with only three years available, they had to act quickly. These circumstances were ripe for abuse and in some cases they led to the corporate scandals we associate today with Enron.

One way to get rich quick was to manipulate stock option formulas. Many companies did so in ways that were inimical to shareholder interests, as when options

rewarded executives for general market movements or when they were repriced after a slide in the company's stock. Another approach was to pursue quick, dramatic restructurings through acquisitions or downsizings, the kind of tactics pioneered by corporate raiders. Restructuring was accompanied by a lot of chest-thumping about getting lean and mean, rhetoric that gave a boost to share prices. But only now, years after it all started, are we discovering that restructuring often failed to produce lasting value. Take mergers and acquisitions. An analysis by *Business Week* showed that, while there were some successful M&As during the period 1995-2001, the majority resulted in a *reduction* in share prices several years after the acquisition. As for downsizing, a recent Russell Sage Foundation study finds that downsizing in the 1980s and 1990s did increase profits--and executive pay--but that it did not boost productivity, contrary to Wall Street's claims that it did.⁶

Sometimes it takes an insider to tell the truth, a CEO who knows other CEOs and has watched corporate America from up close. James Goodnight, the CEO of software manufacturer SAS, is one such person. SAS is a privately-held company; Goodnight personally owns about two-thirds of its stock. The company is famous for treating its employees lavishly--it has an on-site health center and flexible work schedules--which gives it one of the lowest employee turnover rates in the technology industry. When asked why his company paid such high benefits to its employees and refused to lay them off during slack periods, Goodnight said, "At many companies the focus is not on the employee or the customer but on the shareholder. The outlook is not for long-term growth but for the next quarter. In today's Wall Street-driven business environments, I think it's difficult for many people to see how employee turnover or employee morale can impact a company's performance over a long period of time. . . . It all comes back to the fact that I don't need to justify SAS's benefits to thousands of shareholders. "

Goodnight's words echo those of the Russell Sage study: the shareholder-value model is fundamentally about the distribution of resources and risk. Its adoption is one reason why labor's share of national income started to plummet in the 1980s from the level where it had stood during the preceding three decades. But not everyone who works for a living has seen their incomes grow more slowly than profits. Corporate executives made out fabulously in the 1990s.

While there are many theories about what has caused widening income inequality in the United States, surely a contributing factor have been changes in corporate governance that boosted incomes at the top. Among the advanced societies, Canada, Britain and the U.S.--all countries with shareholder-value models of governance--saw top incomes shares increase substantially over the past twenty-five years, rising back up to levels not observed since the 1920s. The rich have become very rich indeed, with the share of the top one percent doubling in the last twenty years in the

United States. On the other hand, top income shares barely changed since 1980 in continental Europe and Japan, countries that continue to embrace some form of stakeholder governance.⁷

Taking It on the Road

In the 1990s, U.S. investors were intoxicated by what the shareholder-value model apparently had wrought. The U.S. economy and its stock market were booming, while Europe and Japan languished. Investors leapt to the conclusion that changes in corporate governance had produced the U.S. boom. They reasoned that if European and Japanese companies could be persuaded to similarly revamp their governance practices--and get lean and mean--their shareholders would reap ample rewards. Greater corporate efficiency and a rising stock market would bring an end to economic stagnation, as it had in the United States. That was the message delivered to Europe and Japan in the 1990s by a bevy of American investors, government officials, economists, and journalists.

Unfortunately, the message was wishful thinking. The causal links between governance, productivity, and growth are vague and unproven. Research by Dan Dalton and others shows that even the most basic elements of shareholder-value governance--independent boards, small boards of directors, use of stock options--are not statistically associated with better corporate performance. In the wake of Enron, this should come as little surprise. Moreover, if shareholder-value policies produce higher profits by redistributing resources rather than raising productivity, those profits--and share prices--will not keep growing in the future.

A great leap was involved in inferring that a nation's growth--or lack of it--has something to do with its dominant governance model. Japan and the United States boomed in the 1960s without the shareholder-value model. The evidence is lacking that corporate governance affects a nation's growth and productivity rates.

Yet U.S. investors preached the shareholder-value gospel abroad. Some, like the giant union pension fund CalPERS, were true believers. Others hoped that changes in governance would stimulate M&A deals and generate juicy fees for lawyers and investment bankers. Nowhere was the shareholder-value credo pushed more aggressively--and met with greater skepticism--than in Japan.

Japanese corporate governance in the postwar decades was a form of stakeholder capitalism, in which corporate boards balanced the interests of employees, business-group members, banks, customers, suppliers, and shareholders. At Japanese companies, according to sociologist Ronald Dore, "nobody gives a great deal of thought to owners. Firms are not seen as anybody's 'property'. They are organizations – bureaucracies

much like public bureaucracies that people join for careers, become members of. They are more like communities.”⁸ The community was run by its board of directors. Boards were larger than those of U.S. and British firms, some of them having thirty to forty (or more) members, and almost all directors were company managers who had made a slow ascent to the top. At large companies, enterprise unions represented all regular employees, up through the middle-management ranks. Not infrequently, board members and even company presidents were former union officers. Regular employees spent their entire career with the company, with substantial training expenditures and fringe benefits for both blue-collar and white-collar employees. In many respects this system was similar to large U.S. nonunion companies of the pre-1980s era (firms like IBM, Kodak, and Motorola) who combined welfare capitalism with a stakeholder credo.

Although there was an active market for shares in Japan, most shares were not traded. Instead a system of cross-shareholding existed, in which a company and its suppliers, banks, and customers held stock in each other’s company. Cross-holding made it nearly impossible for hostile acquisitions to occur. Also, it gave contracting parties a stake--and a nose--in each other’s business. Moreover, because reciprocal shares were rarely traded, their owners looked at long-term rather than short-term performance. So-called patient capital permitted companies to pursue projects with long payouts, such as building market share and operating a career employment system. This is not to say that Japanese companies were indifferent to shareholders. When a company did poorly--with sagging stock and reduced cash flows--its main bank might initiate a financial work-out. Company presidents would be sacked.

After white-hot growth in the 1980s, Japan’s economy plunged into prolonged stagnation. By the late 1990s, even defenders of the Japanese system had begun to waver. After all, the facts advanced by advocates of the shareholder-value model seemed convincing, even if no one could actually prove that U.S. growth and Japanese stagnation had anything to do corporate governance. Foreign investors--especially from the United States--lost nary a chance to criticize Japanese governance. These investors saw opportunities to make a killing in Japan if only its companies would reallocate internal resources to favor shareholders and shed their inhibitions about hostile acquisitions.

At the behest of American investors, the U.S. government began to pressure the Japanese to changes their governance practices. The latest initiative is the U.S.-Japan Economic Partnership for Growth, launched in 2001. It seeks to facilitate U.S. investment in Japan by having the Japanese adopt the shareholder-value model and U.S. accounting standards.

The Japanese took the message to heart, despite the hubris of the messengers. Various LDP governments in the 1990s opened Japan’s markets and promoted sectoral and financial deregulation. They changed commercial law to encourage--but not

require--American-style corporate governance: corporate boards composed of outsiders, stock options for executives, stock repurchases to boost share prices, and the like. The intent was to elevate “shareholder value” above other criteria for strategic decisions. Gradually change began to occur at the corporate level, especially in companies that had substantial foreign ownership, like Sony. In the late 1990s, Sony adopted a U.S.-style board with outsiders, shrunk employment at its domestic factories, and beefed up its investor relations efforts.

Japanese corporations conceded that giving more importance to shareholders was necessary, especially since many if not most of Japan’s actively traded shares were now held by foreigners, particularly Americans. (Troubled banks have been unwinding their cross-holdings, making more shares available for foreign purchase). Large companies put an outsider or two on their boards and beefed up their investor relations departments. They also adopted more transparent accounting procedures. But in my interviews with senior executives in Japan, I found them doubtful that stakeholder governance was responsible for Japan’s problems or that a shift to American practices would cure what ailed the Japanese economy. Instead executives placed the blame on other--more “macro”--factors such as botched fiscal policies, the Bank of Japan’s monetary stringency, and a tortoise-like resolution of Japan’s banking mess.

Until recently, these doubts were expressed quietly. But dissenting voices have grown louder since 2001 as the U.S. economy has been hit by corporate scandals and the collapse of its own financial bubble. Business leaders like Fujio Mitarai of Canon and Hiroshi Okuda of Toyota are two leading Japanese executives who refuse to accept the idea that there is one best way--the American way-- of organizing a business corporation. Instead, companies like Canon and Toyota continue to staff corporate boards largely with insiders, to pay executives modestly, to consult enterprise unions, and to avoid layoffs of “lifetime” employees. Adjustments occur instead through early retirement or reduced wage growth and hiring (except of part-timers). Unlike the United States, large corporations continue to shoulder more risk for employees and share resources more equitably with them than American companies.

The other recent development has been the recovery of the Japanese economy over the past two years. Since the beginning of 2002, Japan’s GDP grew more rapidly than America’s GDP for six of the eleven quarters covered. Although growth has been slower this year than last, a key sign of health is the recent Bank of Japan prediction that Japan will experience modest inflation in 2005, this after years of falling prices. If the recovery continues, as is expected, it will make Japanese companies more assertive in their rejection of the shareholder-value model. It’s not that Japanese executive are altruistic social democrats. Rather, their views are much like Jim Goodnight’s: that treating employees well pays off in the long term with better products, better customer service, and harder-working employees. Adopting the shareholder-value model runs the

risk of undercutting Japan's comparative advantage in global competition, which is based, in part, on its high levels of employee training, skill, and effort.

The Japanese also don't want the levels of inequality that have surfaced in the United States in the last twenty years. Japan remains an almost-homogeneous society, where the upper middle-class and the working-class still live and commute in relatively close proximity. True, there has been some growth of income inequality since the 1980s, and with it phenomena like middle-class flight to private schools. But Japan remains egalitarian as compared to the United States. Ranked by income inequality, its standing has changed little among the OECD countries since the 1980s, putting it between the welfare states of Northern Europe and the Anglo-Saxon nations, such as the United States, the United Kingdom, and Canada.

Back at the Ranch

America's corporate scandals--and recent academic research--have revealed various defects in the shareholder-value model. True believers claim that the defects stem from just a few bad corporate apples, yet the truth is that the barrel contains a great deal of rot. Enron is now four years behind us yet Eliot Spitzer's investigations show no signs of slowing down. The reforms adopted in the wake of Enron have been extensive---the Sarbanes-Oxley law, new rules at the major stock exchanges, and additional requirements from the SEC. There has also been voluntary reform by corporations, especially on stock options, which are now less likely to be offered and, if they are, more likely to be expensed for tax purposes.

Yet despite all this, many of the assumptions behind the shareholder-value model remain in place: that outsiders are better than insiders as CEOs and board members; that executives need substantial compensation to motivate them; and that shareholders are the only group whose interests executives should serve. Hence for most employees, it remains a mean season. Risk continues to be shifted to the workforce or, as in the case of pension plan terminations, to the U.S. taxpayer. Downsizing and outsourcing continue, causing resources to be reallocated from labor to capital. On the other hand, executive compensation remains at stratospheric levels.

Part of the problem has to do with boards of directors. Even when directors are nominally independent (as most in the United States are), they are unwilling to question the need for huge salaries and options grants. These directors are themselves current or former business executives. They conform to and reinforce each other's ideas about corporate governance, a phenomenon that psychologists label "groupthink." They also are themselves beneficiaries of the executive compensation approach that emerged in the 1980s. Another part of the problem are institutional investors, who tend to be

equally rigid in their thinking about corporate governance. Many were passionate advocates of the shareholder-value model in the 1980s and 1990s. Those major investors find it difficult now to admit that the model's virtues were oversold and caused problems for shareholders as well as other stakeholders. However, many of them--including CalPERS-- are in favor of a recent proposal from the Securities and Exchange Commission that might revolutionize U.S. corporate governance.

Last year, the SEC proposed a rule permitting long-term shareholders to nominate candidates for a company's board of directors. So-called proxy access is opposed by much of the business community yet supported by several large pension and mutual funds. These funds hold their shares for long periods and therefore would meet the participation thresholds in the SEC proposal. (The proposal says that only shareholders holding five percent of shares for at least two years may nominate directors, and only if there is evidence of opposition to nominees proposed by management.) If adopted, the rule would be a major change from the present situation in which boards are not obligated to act on shareholder resolutions and shareholders have no right to nominate board candidates. The presence of shareholder-nominated directors would promote greater independence and accountability in the boardrooms of poorly governed companies.

With President Bush in his second term, the SEC is under intense pressure from business to shelve the proposal. (In fact, CalPERS's support for the proposal has incensed the business community and is one reason why California Governor Arnold Schwarzenegger has proposed terminating CalPERS in favor of a defined-contribution pension plan for state workers.) Yet the SEC proposal is a modest step in the right direction, one that would help to counteract conformity and cronyism on corporate boards. By giving shareholders a real opportunity to be represented on boards, it would repair defects in the crude shareholder-value model. Combined with other recent changes--the de-emphasis of stock options and quarterly results, the explosive growth of socially responsible investing-- it would push U.S. corporate governance towards a more balanced approach, one that recognizes that shareholders are not the only group with a financial stake in corporate decisions. Ironically, this would come at the same time as Japanese corporations are being pressured to move in the opposite direction.

We are only just now beginning to appreciate the myriad links between decisions made in the rarified atmosphere of corporate headquarters and major social outcomes such as equality, risk bearing, and environmental quality. Japan right now is engaged in a debate over the corporation's societal role and responsibilities. The United States is ripe for a similar, wide-ranging debate; if not now, then surely in 2008.

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