

# Washington University Law Review

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Volume 74

Issue 2 *Path Dependence and Comparative Corporate Governance*

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January 1996

## Those Japanese Firms with Their Disdain for Shareholders: Another Fable for the Academy

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### Recommended Citation

Steven N. Kaplan and J. Mark Ramseyer, *Those Japanese Firms with Their Disdain for Shareholders: Another Fable for the Academy*, 74 WASH. U. L. Q. 403 (1996).

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# THOSE JAPANESE FIRMS WITH THEIR DISDAIN FOR SHAREHOLDERS: ANOTHER FABLE FOR THE ACADEMY\*

STEVEN N. KAPLAN\*\*  
J. MARK RAMSEYER\*\*\*

## I. INTRODUCTION

We have not lacked in the academy for tales about the way real behavior fails to track basic economic theory: how real markets fail disastrously, how real people act irrationally, or how real firms plan short-sightedly. Until Steven N.S. Cheung studied Washington bees, the market's failure to internalize the pollination externalities to honey production was one such tale.<sup>1</sup> Until Ronald H. Coase studied coastal navigation aids, the market's failure to provide lighthouses was another.<sup>2</sup> Given the current fascination with matters Japanese, the market's apparent failure to force Japanese managers to maximize shareholder welfare is a strong third. Should anyone brazenly suggest, based on standard economic theory, that firms facing competitive product and capital markets should maximize shareholder returns or vanish, all too often the orthodox response has been "Look at Japan. You need new theory."

Orthodox observers argue that economic theory misses Japanese corporate behavior because it ignores the historically contingent constraints on entrepreneurial choice. Restated, they argue path-dependence: Economic theory purports to predict how firms will operate but predicts from an ideational and cultural vacuum. Because real firms operate within ideational and cultural constraints that reflect the idiosyncratic paths by which their societies reached the present, economic theory can not explain data from real firms. Ergo, we need new theory.

All of this, we suggest, is yet another case of bad empirics driving

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\* The authors received generous comments and suggestions from Richard Epstein, Dan Fischel, Beth Garrett, Dennis Karjala, Bill Klein, Dan Klerman, John Lott, Curtis Milhaupt, and Hugh Patrick.

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1. Steven N.S. Cheung, *The Fable of the Bees: An Economic Investigation*, 16 J.L. & ECON. 11 (1973).

2. R.H. Coase, *The Lighthouse in Economics*, 17 J.L. & ECON. 357 (1974).

needlessly complicated theory. That firms may operate within constraints that reflect idiosyncratic past choices is true. But in understanding the basic contours of the Japanese economy, it is often only trivially true—for in many ways it is largely irrelevant. Notwithstanding the usual accounts to the contrary, Japanese executives do face incentives to maximize profits. Those who fail risk losing income or even their jobs. Basic economic theory may be simple, but it also predicts basic Japanese firm behavior. The elaborate arguments about path dependence notwithstanding, on matters that implicate large amounts of money but not regulatory restrictions, competitive markets largely have no history.

We begin in Section II by discussing the modern theory of path dependence. In Section III, we trace the ties between that theory and the orthodox understanding of how Japanese firms behave. Then in Section IV, we report Steven Kaplan's recent empirical work on the actual behavior of Japanese firms. Finally, armed with the empirical results that contradict the orthodox view, in Section V we suggest how that view may have arisen.

## II. PATH DEPENDENCE

Obviously, history can matter. Individually, the choices we make today can affect the returns we earn tomorrow. The mistakes we make today can limit the choices we have tomorrow. Collectively, too, the choices and mistakes we make today can determine, sometimes decisively, the future we face tomorrow. Sometimes, as economic historian Paul A. David put it, we cannot “uncover the logic (or illogic) of the world around us except by understanding how it got that way.”<sup>3</sup>

But, just as obviously, history does not always matter. Some choices can make little difference, and some mistakes can easily be undone. At root, how completely past choices bind us is an empirical question. On the one hand, Nobel Laureate Douglass C. North posits the “peculiar *fact* that incremental changes in technology, once begun on a particular track, may lead one technological solution to win out over another . . . .”<sup>4</sup> Crucially, claims North, a solution may win out even when “this technological path may be less efficient than the abandoned alternative would have been.”<sup>5</sup> Even in competitive markets without binding regulatory restrictions, even when everyone could improve his or her lot by switching technologies,

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3. Paul A. David, *Clio and the Economics of QWERTY*, 75 AM. ECON. REV. 332, 332 (May 1985).

4. DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 93 (1990) (emphasis added).

5. *Id.*

coordination problems and information costs can prevent people from abandoning inferior technologies.

One would do well to be skeptical. Clearly, inefficient lock-in *can* occur. By positing appropriate transactions costs, network externalities, and scale economies, one can easily prove that lock-in is possible.<sup>6</sup> Yet that it is possible does not in a competitive market make it probable. In such a market, an entrenched inefficient technology is potentially a twenty-dollar bill lying on the sidewalk. An entrepreneur who introduces a better technology stands to make good money. Even if he or she cannot introduce it through spot-market deals, he or she may yet be able to do so with a little institutional creativity.<sup>7</sup>

Moreover, to date most scholars who argue that inefficient path-dependence is widespread in competitive markets cite only anecdotes. And most of their tales—whether claims about the Dvorak keyboard and Beta video or Thorstein Veblen's account of the 19th century British coal cars—have been proven false.<sup>8</sup> Upon examination, others have shown that the supposedly inferior technologies were not inferior at all.

At least implicitly, many contemporary students of comparative corporate governance seem to be walking the same path-dependent plank. They argue that corporations operating in different economies govern themselves in radically different ways. Those different corporate governance systems, in turn, reflect their different social contexts. And those different contexts reflect the diverse histories by which their respective economies reached the present. Even when a corporate governance regime is inefficient, path-dependent lock-in prevents firms from adopting more efficient regimes.

### III. JAPANESE CORPORATE GOVERNANCE

Consider the U.S.-Japan comparison. In a recent article, Harvard Business

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6. See, e.g., W. Brian Arthur, *Competing Technologies, Increasing Returns, and Lock-in by Historical Events*, 99 *ECON. J.* 116 (1989); Robin Cowan, *Tortoises and Hares: Choice Among Technologies of Unknown Merit*, 101 *ECON. J.* 801 (1991); Joseph Farrell & Garth Saloner, *Standardization, Compatibility, and Innovation*, *RAND J. ECON.*, Spring 1985, at 70; Michael L. Katz & Carl Shapiro, *Technology Adoption in the Presence of Network Externalities*, 94 *J. POL. ECON.* 822 (1986).

7. See S.J. Liebowitz & Stephen E. Margolis, *Path Dependence, Lock-In, and History*, 11 *J.L. ECON. & ORG.* 205, 224 (1995).

8. See S.J. Liebowitz & Stephen E. Margolis, *Network Externalities: An Uncommon Tragedy*, 8 *J. ECON. PERSPECTIVES*, Fall 1994, at 133 (video players); S.J. Liebowitz & Stephen E. Margolis, *The Fable of the Keys*, 33 *J.L. & ECON.* 1 (1990) (Dvorak keyboards); Va Nee L. Van Vleck, *Reassessing Technological Backwardness: Absolving the "Silly Little Bobtailed" Coal Car*, 55 *J. ECON. HIST.* 383 (1995) (British coal cars).

School professor Michael E. Porter nicely captured the usual stereotypes.<sup>9</sup> American institutional investors, he wrote, impose goals that “are purely financial and are focused on quarterly or annual appreciation of their investment portfolio.”<sup>10</sup> Those stock market measures, he implied, often miss a firm’s long-term prospects.

In contrast to their American counterparts, Porter continued, Japanese owners look to the “long-term.”<sup>11</sup> As a result, for senior Japanese executives “current earnings or share prices play only a modest role in promotion or compensation.”<sup>12</sup> For them, stock prices “have virtually no direct or indirect influence.”<sup>13</sup>

Porter did not invent this tale. It is a staple of the popular press and comes with a long academic pedigree. As early as the 1970s, sociologist Rodney Clark concluded that for Japanese firms, “high profitability, a large return on assets or capital employed, is unlikely to be a very important goal.”<sup>14</sup> Instead, Japanese firms pursue “aims which are given rather lower priority in the West, such as the provision of welfare to employees.”<sup>15</sup> A few years later business consultants James C. Abegglen and George Stalk, Jr., echoed the claim: “[A] Japanese manager is able to look further into the future and is freer to do what is necessary to ensure a successful future because of his greater job security.”<sup>16</sup> Ultimately, argued Abegglen and Stalk, Japanese managers “are freed from the tyranny of accountants, and from the terrible pressures throughout the U.S. organizations for steady improvement in earnings per share.”<sup>17</sup> According to sociologist Ronald Dore, “even in practical terms, Japanese managers do not have to be too worried about their share price.”<sup>18</sup> By 1992, even prominent economists Paul Milgrom and John Roberts could flatly declare that Japanese firms, impliedly in contrast to those in the United States, “are not run in the interests of their shareholders.”<sup>19</sup>

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9. Michael E. Porter, *Capital Disadvantage: America's Failing Capital Investment System*, HARV. BUS. REV., Sept.-Oct. 1992, at 65.

10. *Id.* at 70.

11. Porter, *supra* note 9, at 70.

12. *Id.* at 72.

13. *Id.* at 71.

14. RODNEY CLARK, *THE JAPANESE COMPANY* 136 (1979) (original emphasis omitted).

15. *Id.* at 137.

16. JAMES C. ABEGLLEN & GEORGE STALK, JR., *KAISHA: THE JAPANESE CORPORATION* 188 (1985).

17. *Id.*

18. RONALD DORE, *TAKING JAPAN SERIOUSLY: A CONFUCIAN PERSPECTIVE ON LEADING ECONOMIC ISSUES* 117 (1987).

19. PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* 443 (1992).

Observers often explain these corporate governance “facts” through path-dependence.<sup>20</sup> According again to Porter, American firms find themselves caught in a coordination trap. Although all players—owners, managers, employees, and community members—would prefer to adopt a longer term perspective, no one can profitably switch alone. “[B]y focusing on long-term corporate position and creating an ownership structure and governance process that incorporate the interests of employees, suppliers, customers, and the local community, the Japanese . . . system[] better capture[s] the social benefits that private investment can create.”<sup>21</sup> Nonetheless, change takes cooperation and cooperation takes coordination. “Each group [in the United States] is behaving rationally,” Porter concludes, “given the current circumstances. All are trapped in a system that ultimately serves the interests of no one. Each is pursuing its own narrow goals within the system—but the goals operate at cross-purposes.”<sup>22</sup> The logic here involves three propositions: (1) the stock market does not accurately reflect a firm’s prospects; (2) only by overcoming serious coordination problems can a firm ignore these misleading stock-market cues; and (3) those coordination problems are historically contingent.

Plausible reasons for at least coordination problems are not impossible to imagine.<sup>23</sup> For example, suppose American corporate governance depends both on corporate control markets and on high mobility for senior executives. Perhaps no Japanese firm could unilaterally shift to the American system because takeovers are rare in Japan and an active managerial labor market does not yet exist.<sup>24</sup> Suppose Japanese governance

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20. Not all do. Some (like Mark Roe) do use path-dependency terminology, but in fact hinge their argument (much more plausibly) on political and regulatory constraints. Roe makes this regulatory argument elegantly in MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994). For a subtle analysis that places relational cooperation within legal constraints, see Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law*, 37 HARV. INT’L L.J. (forthcoming 1996).

21. Porter, *supra* note 9, at 75.

22. *Id.* at 76.

23. Insightful variations include MASAHIKO AOKI, *INFORMATION, INCENTIVES, AND BARGAINING IN THE JAPANESE ECONOMY* (1988); MICHAEL L. GERLACH, *ALLIANCE CAPITALISM: THE SOCIAL ORGANIZATION OF JAPANESE BUSINESS* 246-70 (1992); Milhaupt, *supra* note 20.

24. See generally W. CARL KESTER, *JAPANESE TAKEOVERS: THE GLOBAL CONTEST FOR CORPORATE CONTROL* (1991); J. Mark Ramseyer, *Takeovers in Japan: Opportunism, Ideology and Corporate Control*, 35 UCLA L. REV. 1 (1987). Indeed, given the importance of firm-specific skills in Japan, those who do try to shift jobs would suffer a large loss in pay. See Takao Kato & Mark Rockel, *Experiences, Credentials, and Compensation in the Japanese and U.S. Managerial Labor Markets: Evidence from New Micro Data*, 6 J. JAPANESE & INT’L ECO. 52 (1992).

depends on banks and affiliated firms actively monitoring each other.<sup>25</sup> Perhaps no American firm could unilaterally shift to the Japanese system because those alternative monitoring institutions are not in place.

And yet, this easy application of path-dependence to corporate governance misses something essential about economic performance. Wholly aside from managerial labor markets, corporate control markets, and relational monitoring schemes, firms face the basic logic of product and capital markets. Unless a firm produces good products cheaply, few will buy its goods. Unless it makes a market return on its investments, few will lend it money or buy its stock. Unless shareholders price stock in light of a firm's long-term prospects, they throw money away. According to economic theory, absent binding regulatory constraints these several factors should ultimately drive managers to maximize long-term prospects and—necessarily and simultaneously—share price. If they do, then (i) inefficient governance systems will be both rarer and more transient in market economies than most accounts of comparative corporate governance suggest; and (ii) corporate governance regimes will diverge in market economics (absent, again, binding regulatory constraints) only on points that do not much matter.

We are all Aristotelians or Platonists, someone once said somewhere, and most economists are the latter. We either start with data and generalize to theory or start with theory and explore for data, and most economists do the latter. Despite the massive work academics have done on Japan (in truth, perhaps because of it), Japan remains every Aristotelian's treasure trove of anti-economic anecdotes. It is a trove with an enormous array of corporate governance tales. Consistently, they confirm the Aristotelian dream: Disembodied economic theory misses real-world behavior. If standard economic theory suggests managers maximize stock price, by almost every anecdote from Japan, they never do. Reality is contextual, the anecdotes instead insist. And theory invented to explain firms in the West will never explain those in the East, for what drives firms necessarily depends on the—historically contingent—social networks and symbolic webs within which shareholders hold shares, managers manage, and ordinary people live out their ordinary lives.

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25. A point for which there is considerable evidence, both in this study, *see infra* section IV.B.2., and in excellent studies elsewhere: *E.g.*, THE JAPANESE MAIN BANK SYSTEM: ITS RELEVANCE FOR DEVELOPING AND TRANSFORMING ECONOMIES (Masahiko Aoki & Hugh Patrick eds., 1994); Takeo Hoshi, Anil Kashyap & David Scharfstein, *Corporate Structure, Liquidity, and Investment: Evidence from Japanese Industrial Groups*, 106 Q.J. ECON. 33 (1991); Stephen D. Prowse, *The Structure of Corporate Ownership in Japan*, 47 J. FIN. 1121 (1992); Paul Sheard, *The Main Bank System and Corporate Monitoring and Control in Japan*, 11 J. ECON. BEHAV. & ORG. 399 (1989).

But the anecdotes are wrong.

#### IV. THE EVIDENCE FROM JAPAN

##### A. Introduction

###### 1. The studies

To explore what drives the way Japanese firms behave, we ask three questions: (1) when do outsiders join the board of directors in a Japanese firm (section B); (2) when do senior executives lose their jobs (section C); and (3) what determines how much board members make (section D)? To answer these questions, we introduce several recent empirical studies by Steve Kaplan.<sup>26</sup> In the discussion below, we summarize the results in a more accessible form and discuss their implications—both for how we should understand Japan specifically, and for how we should understand the allegedly path-dependent character of corporate governance more generally.

The Japanese companies involved are the 119 publicly held Japanese companies that *Fortune* magazine listed among the 500 largest foreign industrials in 1980.<sup>27</sup> For these firms, Kaplan collected financial, employment, stock price, shareholding, executive, and board data for 1980-88. For comparison, we also occasionally report comparable figures from American firms in the 1980 *Fortune* listings.

Of the Japanese firms, most were part of an affiliated group, a *keiretsu*: 65% were in a bank *keiretsu* and 17% in a non-bank *keiretsu*.<sup>28</sup> Within each firm, the top ten shareholders held a mean of 40% of the stock. Only 2.5% of the firms (21.9% for corresponding American firms) were the target of a takeover or subject to a merger during 1980-88.

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26. One study was co-authored by Bernadette Minton. See Steven N. Kaplan, *Top Executive Rewards and Firm Performance: A Comparison of Japan and the United States*, 102 J. POL. ECON. 510 (1994); Steven N. Kaplan, *Top Executives, Turnover, and Firm Performance in Germany*, 10 J.L. ECON. & ORG. 142 (1994); Steven N. Kaplan & Bernadette A. Minton, *Appointments of Outsiders to Japanese Boards: Determinants and Implications for Managers*, 36 J. FIN. ECON. 225 (1994). Because Kaplan has already presented the technical econometrics in these specialty journals, we refer interested readers there for the statistical detail.

27. Andrea Ball & Edward Boyer, *The Fortune Directory of the Largest Industrial Corporations Outside the United States*, FORTUNE, Aug. 11, 1980 at 188.

28. Bank *keiretsu* are those centered around banks (e.g., the Mitsubishi group). Non-bank *keiretsu* are those centered around industrial firms (e.g., the Toyota group).

## 2. *The institutional environment*

By law, Japanese directors jointly decide corporate strategy.<sup>29</sup> For day to day operations, however, they employ officers who in turn hire subordinates. The shareholders elect these directors at their annual meeting and assign them terms of up to two years.<sup>30</sup> To remove them, shareholders with at least three percent of the stock may call a special meeting.<sup>31</sup>

The firms in Kaplan's study had a median of twenty-one directors (the American firms had a median of fifteen). Unlike American directors, most if not all of the directors of Japanese firms were company executives. Typically, they served on the board for about eight years. Each board included a president who generally functioned as the chief executive officer.<sup>32</sup> In each firm, the top executives (a median of 3 and a mean of 4.2 individuals) served as "representative directors."<sup>33</sup> As such, they had the authority to act on behalf of the firm in assorted important matters. Generally, they wielded significant power.

We call directors "outside directors" if they ever worked for another firm.<sup>34</sup> If they came to the firm from a bank, we call them "bank directors," and if they came from an outside firm other than a bank we call them "non-bank directors." Over the period studied, the firms selected one bank outside director in 7.5% of the firm-years, and a non-bank outside director in 5.9% of the firm-years. Upon appointment, outsiders served about as long as insiders.

### B. *Board Turnover*

#### 1. *Appointment of outsiders*

To determine what induced firms to appoint outside directors, we considered four possible performance measures:

(a) shareholder returns (dividends plus capital gains);

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29. SHOHO [Commercial Code], Law No. 48 of 1899, § 260.

30. *Id.* §§ 254, 256.

31. *Id.* §§ 237, 257.

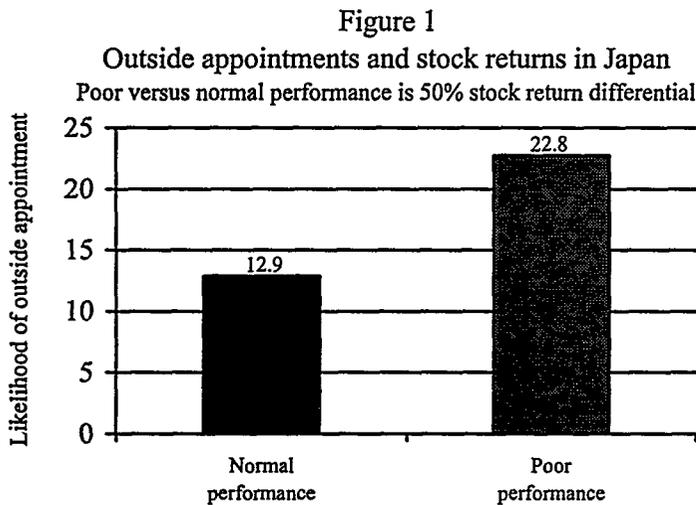
32. Sometimes, however, the chairman of the board had more power and influence.

33. *Id.* § 261.

34. Directors with prior appointments in government are excluded, on the grounds that these "amakudari posts" signify very different events. See generally J. MARK RAMSEYER & FRANCES MCCALL ROSENBLUTH, *JAPAN'S POLITICAL MARKETPLACE* ch. 6 (1993). Firms hired a former government official in 5.5% of the firm-years.

- (b) sales growth (an obviously rough proxy for change in market share);
- (c) income change (the change in pre-tax income as a fraction of total firm assets); and
- (d) whether income is negative.<sup>35</sup>

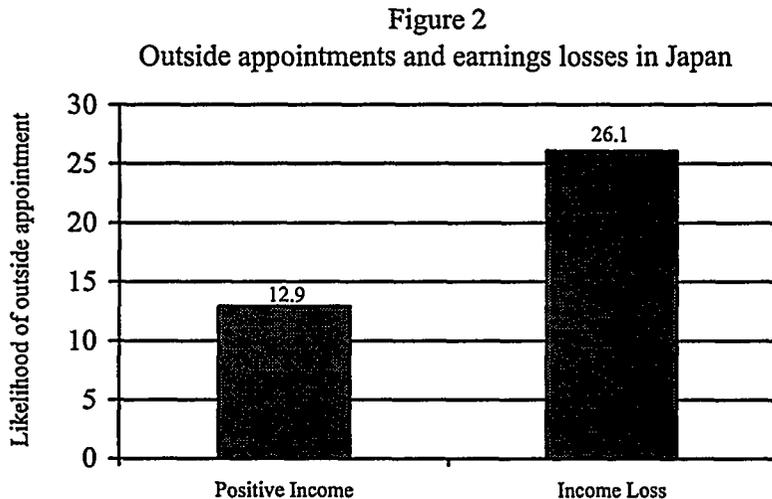
Appointments of outside directors increased significantly when returns fell (measure (a)) or income became negative (measure (d)), but were not correlated with either sales growth (measure (b)) or income change (measure (c)). Consider the implications. First and most obviously, stock price matters. When stock prices fall, firms appoint outside directors, both bank and shareholder outsiders. Figure 1 illustrates this point by showing that a 50% differential or decline in stock returns roughly doubles the likelihood that an outsider will be appointed to the board from 12.9% to 22.8%.<sup>36</sup> Indeed, outside appointments in Japan are more sensitive to stock price than in the United States.



35. The measure takes the value of zero if pre-tax income is positive, and one if pre-tax income is negative. As such, it allows one to test theories suggesting that Japanese firms encounter external monitoring if, but only if, they start to lose money.

36. We report the increased likelihood of an outside appointment when stock returns are 50% lower. The 50% differential is used here and throughout the paper for illustrative purposes. It represents approximately a two standard deviation difference in performance. In fact, the statistical analysis implies that the likelihood of an outside appointment (and, later in the paper, of executive turnover) increases monotonically with poor stock performance.

Second, an earnings loss matters. If a Japanese firm loses money, Figure 2 shows that the chance that the firm will appoint an outside director in either that year or the next year doubles—from 12.9% to 26.1%. Interestingly, the coefficients for a loss are significant for bank directors but not for non-bank outside directors. A loss, of course, bears directly on whether a firm can meet obligations to its bank.



Third, sales growth has no significant impact on outside appointments. Changes in sales—a proxy for a firm's market share—do not affect the possibility that a firm will appoint outsiders.

Holding performance constant, firms are also more likely to appoint bank directors after they have borrowed the most (relative to their size), and when they have obtained those borrowings from a single lender. They are more likely to appoint non-bank (shareholder) directors when their shareholdings are concentrated and when they are part of a *keiretsu*. More simply, bankers join the board when a bank has a large loan to protect, and non-bank outsiders join when a few shareholders have large investments to protect.

## 2. *Appointments of outsiders and internal change*

Some readers may question whether adding an outsider to a board matters. After all, an outsider is only one person on a board of approximately twenty people. Perhaps, however, in representing a bank or a large shareholder, the outsider wields a great deal of power. Kaplan tested this by considering what

happened to important incumbent directors (i.e., senior managers) in years that an outsider was appointed to the board. The results show that the appointment of an outside director strongly indicates that major changes are about to occur. Consider four measures of internal change:

- (i) the turnover of the president;
- (ii) the non-standard turnover of the president (the old president leaves and does not become chairman, something that happens about 30% of the time that a president loses his<sup>37</sup> job);
- (iii) the percentage turnover of the representative directors; and
- (iv) the percentage turnover of all of the directors.

As Table 1 shows, once a firm appoints an outsider to its board, the probability of each type of internal change increases substantially.

Table 1: Likelihood of Major Internal Changes,  
Given Outside Board Appointments

|                                    | Years w/o<br>outside appt | Years w/<br>outside appt |
|------------------------------------|---------------------------|--------------------------|
| Presidential turnover              | 15.1%                     | 24.9%                    |
| Non-standard presidential turnover | 3.9                       | 11.1                     |
| Representative director turnover   | 14.4                      | 24.5                     |
| All director turnover              | 12.1                      | 16.3                     |

These increases do not just capture the fact that firms appoint outside directors when they perform poorly (after all, bad performance itself increases executive turnover).<sup>38</sup> Even holding firm performance constant, outside appointments correlate with increased senior personnel turnover.

The point is basic: a firm's banks and shareholders care about the firm's performance. They do not lend money and buy stock just to cement relationships. Rather, banks and shareholders appear to demand performance and intervene if they do not obtain it. Upon intervening, they take seats on the board and fire senior managers.

### C. Executive Turnover

Now ask whether the turnover of senior executives is directly sensitive (independent of the outside board appointments) to any of the same performance measures: (a) stock returns, (b) sales growth, (c) income

37. All Japanese executives in these studies were male.

38. See Part IV. C, *infra*.

change, and (d) whether income is negative. Turn first to presidents and then to representative directors.

### 1. *Presidents*

Japanese presidents have a median age of sixty-six (fifty-nine for American CEOs). They have worked in their firms for a median of thirty-nine years (twenty-eight years for American CEOs), and serve as president for an average of 6.7 years (9.7 years for American CEOs). When a president leaves his job, 68.5% of the time he becomes chairman of the board. As in Section B, if a president becomes chairman, we call it “standard turnover”; if he does not, we call it “non-standard.”<sup>39</sup> We will consider each separately.

Standard presidential turnover is not significantly related to any of the four performance variables. When presidents step down to become chairman, they tend to do so because they have served the typical four to eight years, not because their firm experienced poor performance during their tenure.

Non-standard presidential turnover, by contrast, is significantly related to share price (measure (a)), income change (measure (c)), and whether income is negative (measure (d))—but not to sales (measure (b)).<sup>40</sup> Suppose a firm’s stock price underperforms the market by fifty percent. The odds that its president will lose his job and not become chairman increase from 3.5% to 8.5%. Or suppose that the firm has a loss. The odds jump by about 9% from 3.5% to 12.5%. For presidential tenure as for outside appointments, stock price and profits matter.<sup>41</sup>

### 2. *Representative directors*

The turnover of representative directors is significantly related to all four performance measures. Again, suppose a firm’s stock price underperforms the market by fifty percent. The statistical analysis implies that the turnover of its representative directors will increase from 14.3% to 18.9%. Or suppose the firm reports a loss. Turnover jumps from 14.3% to 25.3%.<sup>42</sup>

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39. Turnovers caused by death, illness, or takeover are treated as missing observations.

40. In the United States presidential turnover is significantly related to all four measures.

41. When all four performance measures are regressed together against turnover, only the coefficient on whether income is negative was statistically significant.

42. When all four performance measures are regressed together against representative director turnover, only the coefficients on stock return and sales growth were statistically significant.

Once more, readers may ask whether those increases in turnover are meaningful. After all, even in very bad years the majority of representative directors keep their jobs. Perhaps the best way to consider this is to compare what happens to representative directors in Japan with what happens to executive directors in the United States. Figures 3 and 4 indicate that the effects are qualitatively identical. Turnover in the United States increases with poor performance by roughly the same amount as in Japan. In other words, poor stock and earnings performance has roughly the same impact (or lack of impact) on top executives in Japan as on top executives in the United States.

Figure 3

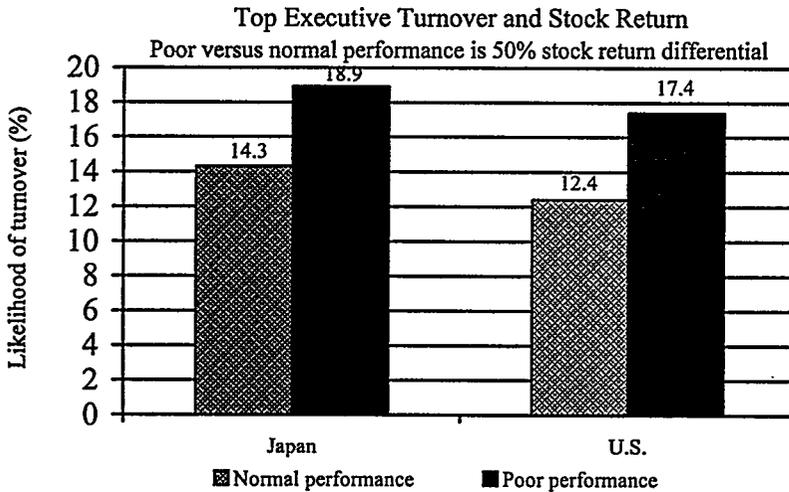
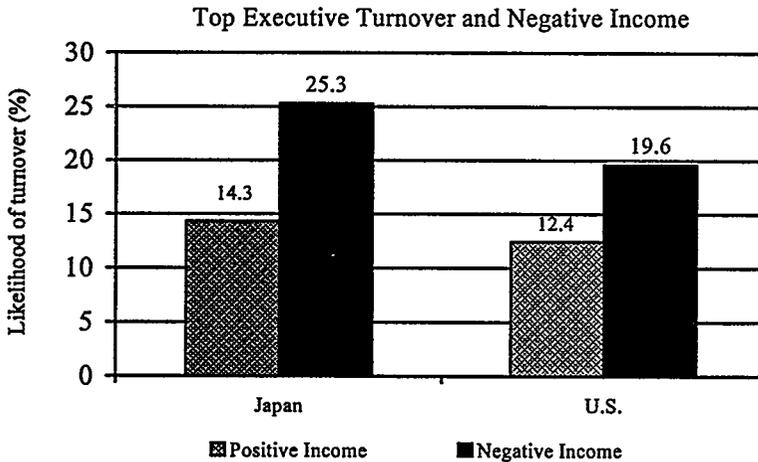


Figure 4

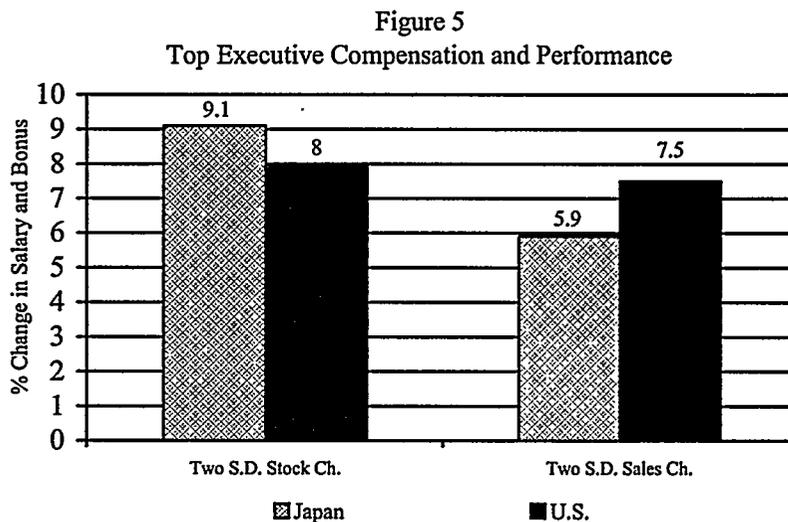


#### D. Senior Management Compensation

Consider now the determinants of executive compensation. More particularly, ask whether—as orthodox observers claim—compensation practices in Japan give senior personnel an incentive to govern the firm in ways that emphasize market share over profitability and stock price. Consistent with the earlier discussion, the answer is a flat no. We again used the four performance measures and traced their effect on the cash compensation of Japanese directors, generally, the senior-most executives.

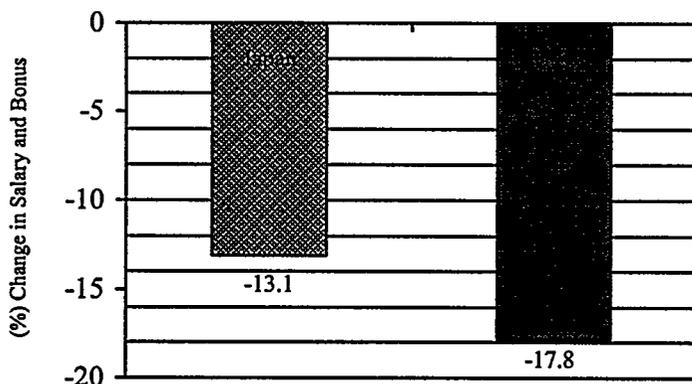
The compensation of Japanese directors is significantly related to all four performance variables. The performance measure that explains the most variation in the data<sup>43</sup> is whether the firm made a profit. The measure that explains the least is sales growth. For example, a fifty percent increase in stock returns leads to director pay increases totaling more than 9% (over the following two years). A director of a firm that reports a loss can expect to see his pay cut by 13%.

Again, what happens in Japan is not aberrational. In fact, it closely resembles the experience in the United States. Figures 5 and 6 illustrate this comparison by comparing the effect of stock returns, sales growth, and earnings losses on the cash compensation of Japanese directors and American CEOs.



43. *I.e.*, the measure yielding the highest  $R^2$  in the regressions.

Figure 6  
Top Executive Compensation After Earnings Loss



#### V. THE (MISTAKEN) SOURCE OF THE ORTHODOX VIEW

How could the orthodox view arise, despite its strong rejection in the data? We conjecture that timing—ironically enough, academic “path dependence”—played a perverse trick on students of Japanese firms.

Most orthodox observers based their conclusions about Japanese firms on what those firms did during the 1960s, 70s, and 80s. Those were decades of tremendous growth and success. It seems plausible, if not likely, that the value maximizing strategy for most Japanese firms during the period was to grow as fast as possible. Many of their investments probably had large payoffs in the longer-term. Because the advisability of rapid growth for many American firms ended with the 1960s,<sup>44</sup> the successful, well-known Japanese firms would have seemed quite different from the well-known American firms.

The advantage of Kaplan’s large-scale studies is that they consider not only successful firms but also unsuccessful Japanese firms in the 1980s. It is those *unsuccessful* firms that exhibit the behavior we associate with American firms. Executives of those firms are more likely to lose their jobs and are paid less.

Unconvinced readers need only consider the behavior of Japanese firms in the 1990s. Although we have only anecdotal accounts of their behavior, the anecdotes are very different from the old ones, but completely consistent

44. See Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831 (1993).

with the data above. With the depressed economic conditions in Japan in the 1990s, Japanese firms have cut back on investment and have reduced employment, albeit through retirement and reduced hiring rather than through firings.<sup>45</sup> Most recently, even Sony, one of the best-known companies in Japan, fired its top entertainment executive Mickey Schulhof for poor earnings performance.<sup>46</sup>

## VI. CONCLUSION

Observers have long argued that Japanese managers ignore stock prices and immediate profits. From that factual premise, they urge a variety of complex theoretical permutations. Some propose theories that place markets and firms within their idiosyncratic social and cultural contexts. Others urge theories that account for the particular paths by which those markets and firms reached the present.

The truth is simpler—for when large amounts of money are at stake competitive markets know no history. To explore the purported path dependence of corporate governance, we reported the results of several large-scale econometric studies of Japanese and American firms. According to the data, Japanese firms do indeed give their managers incentives to maximize share price: Those that do live well, while those that do not earn less and may even find themselves without their jobs and the status that those jobs confer. We do not ignore the scores of dissertations, articles, and books on Japan to the contrary. We merely observe that they are wrong. Once again, needlessly complicated theory has been chasing demonstrably untrue facts.

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45. See, e.g., Joshua Ogawa, *NTT Job Cuts Hit as More Politics Than Economics: 'Restructuring' Plan Reduces Odds of Breakup*, NIKKEI WKLY., Nov. 13, 1995, at 1 (reporting that Nippon Telephone & Telegraph's plan to eliminate 45,000 jobs over the next five years will actually result in no layoffs).

46. See James Bates & Claudia Eller, *Sony Ousts Head of U.S. Operations*, L.A. TIMES, Dec. 6, 1995, at A1.