The Changing Role of Employees in Japanese Corporate Governance: Participation, Adjustment and Distributional Conflict

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‘Corporate Governance in Japan: Converging to Any Specific Model?’
The Issues

• To what extent are Japanese-style employment practices changing?
• To what extent are these changes related to corporate governance (e.g. greater influence of shareholders, corporate restructuring, etc.)?
• Under what conditions are systems of CG and HRM complementary?
Data Sources

• METI Dataset
  – Survey on the Corporate System and Employment
  – October 2003
  – N=252 (12% response rate)

• RIETI Dataset
  – Survey on Labor Management and Corporate Governance in Japan
  – May 2004
  – N=131 (5% response rate)

• Company case studies
  – Interviews with investor relations, personnel and enterprise unions
I. Characteristics of J-Type HRM

• Long-term Employment
• Seniority-related Pay Schemes
• Firm-specific Training
Supported by industrial relations institutions

- **Enterprise-based Unions**
  - Cooperation
  - Homogeneous internal labor market

- **Employee Participation**
  - Labor-Management Council
  - Quality circles, etc.

- **Labor law**
  - Strong barriers to dismissal

- **Weak welfare state**
  - Internalization of welfare functions with the enterprise or enterprise group
Complementarities between HRM and CG in Japan

• Firm-specific investments
  – Main bank and stable shareholding protect investments in firm-specific skills
  – Firm-specific skills and cooperation increase productivity that benefits long-term investors

• Decision Rights
  – Information sharing
  – “Democratization” of insider control
The Challenge of a Shareholder-value Model

- **Corporate Competencies:**
  - conflict with employees over the definition of core business units and diversification strategies used to stabilize employment. Divestment raises issues of finding good buyers who honor existing employment agreements.

- **Equity-oriented performance targets:**
  - ending cross-subsidization creates conflicts over performance criteria, time horizons, and disciplining poor performance. Business independence may weaken employee solidarity and increase individual market risks and rewards.

- **Performance-oriented pay:**
  - issues of balancing individual and group incentives, defining criteria, and contingent pay risks. Managerial stock options raise issues of income inequality and short-termism.

- **Disclosure and market-oriented accounting:**
  - limits buffering risks through internal reserves and favors higher distribution of profits to shareholders, but may also increase transparency for employee representatives.
II. Current Situation of HRM in Japan

• Stability of lifetime employment norm
  – but increased corporate restructuring

• Modification of seniority-based pay
  – remains one element in more complex pay strategy, but less impact on final wage

• New forms of merit-based pay
  – but impact is uncertain
  – also a response to aging
Employment Type by Corporate Governance and Levels of Foreign Ownership

Data Source: MoF Policy Research Institute, 2003
METI 2003, Survey on the Corporate System and Employment, N=252
III. Emerging Employment Patterns

• Labour Force Surveys
  – No shift in job retention rates btw. 1980s vs. 1990s (T.Kato)
  – Average tenure of male employees increased from 12.7 years in 1991 to 13.6 in 2001 (JIL)
  – Job tenures stable across different age groups

  – Faster adjustment 91-97, then very slow
The Impact of CG on Commitment to Lifetime Employment: Probit Model

<table>
<thead>
<tr>
<th></th>
<th>Coef.</th>
<th>Std Error</th>
<th>P</th>
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</thead>
<tbody>
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<td>Employees</td>
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<tr>
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<tr>
<td>Stock Options</td>
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<td>Equity-linked Performance Measure</td>
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<td>Manufacture</td>
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<td>Utilities</td>
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<td>Transport &amp; Telecom</td>
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<tr>
<td>Retail</td>
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<td>Finance</td>
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<td>Real Estate</td>
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<td>Services</td>
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<td>Other</td>
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N = 227
LR chi2(12) = 25.22
Prob > chi2 = 0.0138
Log likelihood = -93.0808
Pseudo R2 = 0.1193
Table 3  Rates of corporate downsizing for selected countries, 1991-2001

<table>
<thead>
<tr>
<th>Country</th>
<th>10% cut 2001</th>
<th>10% cut 1991</th>
<th>Average annual rate 1991-2001</th>
<th>Cumulative likelihood for each firm</th>
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</thead>
<tbody>
<tr>
<td>Australia</td>
<td>.099</td>
<td>.057</td>
<td>.093</td>
<td>.301</td>
</tr>
<tr>
<td>Canada</td>
<td>.094</td>
<td>.212</td>
<td>.096</td>
<td>.312</td>
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<tr>
<td>France</td>
<td>.083</td>
<td>.079</td>
<td>.069**</td>
<td>.306</td>
</tr>
<tr>
<td>Germany</td>
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<td>.099</td>
<td>.101</td>
<td>.402</td>
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<tr>
<td>Italy</td>
<td>.147</td>
<td>.088</td>
<td>.096</td>
<td>.413</td>
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<tr>
<td>Japan</td>
<td>.059</td>
<td>.020</td>
<td>.041**</td>
<td>.213</td>
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<tr>
<td>Korea</td>
<td>.140</td>
<td>.104</td>
<td>.153**</td>
<td>.548</td>
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<tr>
<td>Netherlands</td>
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<td>.077</td>
<td>.065*</td>
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<td>Sweden</td>
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<td>.095</td>
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<td>UK</td>
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<td>.164</td>
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<td>.473</td>
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<tr>
<td>US</td>
<td>.206</td>
<td>.092</td>
<td>.106**</td>
<td>.445</td>
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<tr>
<td>Dispersed</td>
<td>--</td>
<td>--</td>
<td>.105**</td>
<td>--</td>
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<tr>
<td>Concentrated</td>
<td>--</td>
<td>--</td>
<td>.082**</td>
<td>--</td>
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</tbody>
</table>

Notes: Refers to all listed corporations with over 2,000 employees, Thompson Worldscope Database.

Employment Adjustment

• 81% of firms express commitment to LTE, but core is shrinking...
  – Largest 1% of firms employed nearly 23,000 people in 1993, but just 17,400 people on average in 2002 (own calculations from DBJ database)

• RIETI Survey (2004)
  – 36% of survey firms implemented employment adjustment policy over the period of 2000-2003
  – Average reduction 530 employees (15% of workforce)

• „benevolent“ adjustment:
  – 54% of exits through early retirement, 29% hiring freeze
  – 5% transfer, 5% spin-offs
  – only 4% of exits through lay-offs
Impact of CG on adjustment

• Foreign ownership increases downsizing in 1990s (see Ahmadjian)
  – but also diffusion process driven by social norms
• Bank relationship decreases downsizing (see Abe, Miyajima/Arikawa)
• But…direct impact of foreign ownership seems less in 2000-2003…
• No evidence for impact on method of adjustment (e.g. likelihood of lay-off)
  – A-type firms may buffer more through temporary staff
## Probit Estimation: The Impact of HRM and CG on Downsizing, 2003

<table>
<thead>
<tr>
<th>down10</th>
<th>Coef.</th>
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<td>LTEdummy</td>
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<td>Performance Pay</td>
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<td>0.10</td>
<td>0.17</td>
<td>Performance Pay</td>
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<td>Seniority Pay</td>
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<td>0.11</td>
<td>0.49</td>
<td>Seniority Pay</td>
<td>-0.14</td>
<td>0.12</td>
<td>0.25</td>
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<tr>
<td>Job related Pay</td>
<td>-0.10</td>
<td>0.10</td>
<td>0.35</td>
<td>Job related Pay</td>
<td>-0.07</td>
<td>0.11</td>
<td>0.57</td>
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<tr>
<td>Ratio of Non-regular Employees</td>
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<td>0.00</td>
<td>0.56</td>
<td>nonregular</td>
<td>0.00</td>
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<td>0.85</td>
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<tr>
<td>Average age</td>
<td>0.20</td>
<td>0.04</td>
<td>0.00</td>
<td>Average Age</td>
<td>0.20</td>
<td>0.04</td>
<td>0.00</td>
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<tr>
<td>_cons</td>
<td>-7.61</td>
<td>1.41</td>
<td>0.00</td>
<td>Ratio of Foreign Owners</td>
<td>-0.01</td>
<td>0.01</td>
<td>0.54</td>
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<tr>
<td>Stock Options Dummy</td>
<td>0.44</td>
<td>0.28</td>
<td>0.11</td>
<td>Ration of Inhouse Executives</td>
<td>0.00</td>
<td>0.00</td>
<td>0.82</td>
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<tr>
<td>_cons</td>
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<td>1.79</td>
<td>0.00</td>
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<table>
<thead>
<tr>
<th>N</th>
<th>198</th>
<th>N</th>
<th>177</th>
</tr>
</thead>
<tbody>
<tr>
<td>LR chi2(8)</td>
<td>= 61.83</td>
<td>LR chi2(12)</td>
<td>= 64.39</td>
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<tr>
<td>Prob &gt; Chi2</td>
<td>= 0</td>
<td>Prob &gt; Chi2</td>
<td>= 0</td>
</tr>
<tr>
<td>Log likelihood</td>
<td>= -101.84</td>
<td>Log likelihood</td>
<td>= -87.3976</td>
</tr>
<tr>
<td>Pseudo R2</td>
<td>= 0.2329</td>
<td>Pseudo R2</td>
<td>= 0.2692</td>
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</table>
Limits to Benevolent Adjustment?

- exhaustion of transfer system
  - case of NTT (Sako and Jackson)
  - consolidated accounting
- social closure of the firm to young recruits
- restructuring and scope of internal labor market
- CG as a distributional constraint?
  - few firms have reduced wages, but no wage growth
  - DBJ Data of listed firms:
    - increasing labor share of value-added (1992-2001)
    - lower VA shares to banks, state and shareholders
    - foreign ownership associated with rising dividends
Pay Systems

- LTE positively correlated with seniority, but no correlation with merit pay
- Seniority is not disappearing, but just one element in more complex pay strategy
- Different meanings of merit…
  - Variable pay based on individual performance
  - Variable pay based on company performance
  - Job-related elements
  - Low correlation between “merit” and particular practices
## Elements of Pay Schemes and LTE

<table>
<thead>
<tr>
<th></th>
<th>Seniority Based</th>
<th>Job/Rank Based</th>
<th>Individual PRP</th>
<th>PRP % employees</th>
<th>PRP % Managers</th>
<th>Firm PRP</th>
</tr>
</thead>
<tbody>
<tr>
<td>No LTE Firms</td>
<td>1.4</td>
<td>2.8</td>
<td>3.7</td>
<td>0.27</td>
<td>0.41</td>
<td>3.2</td>
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<td>LTE High LTE</td>
<td>2.0</td>
<td>3.2</td>
<td>4.1</td>
<td>0.37</td>
<td>0.59</td>
<td>3.5</td>
</tr>
<tr>
<td>All Firms</td>
<td>1.6</td>
<td>2.9</td>
<td>3.7</td>
<td>0.32</td>
<td>0.48</td>
<td>3.3</td>
</tr>
</tbody>
</table>

Notes: Numbers indicate the average importance of each pay element on a 5-point Likert Scale. 1=Not important 2=A little important 3= Important 4=Very Important 5=Extremely Important. No LTE indicators LTE score of 1-2, whereas high is LTE = 4 or 5.

Sources: RIETI Survey, 2004, N=136
Determinants of Pay Systems

• **Dependent variable**
  – Factor analysis of different pay elements
  – PRP Factor / Seniority Factor / Job Factor

• **Independent variables**
  – Foreign ownership
  – Stock options (dummy)
  – % of in-house executives
  – Strategy (e.g. diversification)
  – Corporate Structure
  – Equity-related Performance measures
  – Controls: industry, size, average age of employees
Main results

• Performance-related pay
  – No impact of governance factors!
  – Different result than in Germany
    • Japan already has some link to firm performance

• Seniority
  – Foreign ownership (- )
  – In-house executives (+ )

• Job/Rank
  – No impact
Determinates of Employment Types

- 4 Types ranging from J ↔ A
  - In-house executives ( - )
  - Stock options (+)
  - Equity based performance index ( + )
  - No significant result for foreign ownership

- Degree of external pressure may be less important than style of insider control!
IV. Employee Participation

• Still high union presence in large firms, but changing role

• Changing boundaries of the firm
  – Heterogeneity of employee interests
  – Problematic access to strategic decision makers
  – Shift toward co-management (e.g. supporting spin-offs)

• Boundary of the union
  – NTT example
  – Sako Chapter
Unions and CG Reform

• Political role limited
  – No strong opposition
  – Amended spin-off legislation

• Supportive role in companies
  – ‘Transparency coalition’
  – If market pressure high, participation increases degree of reform (Miyajima chapter)
V. Complementarities?

• Not simple causal model
  – CG → Employment
  – Employment → CG

• Compatibility vs. Complementarity
  – Japanese style-employment compatible with a range of CG
  – Complementarities implies a narrower concept
    • \( f(CG_a + E_b + industry_c) = performance_d \)
  – Methodological challenge

• Cross-national evidence (Jackson RIETI DP 2004)
  – Countries with strong market-oriented CG do not have strong relational employment (CG constraint)
  – But very large scope for variation at intermediate levels
  – Different impact of legal vs. market variables
Stability and Contribution to Governance

• Stable hybrid?
  – Will reducing seniority-related wage components weaken incentives for long-term employment?
  – Distributional struggle
  – Market for corporate control

• Accountability
  – Shareholder activism for labor via ESOPs?
  – Internal governance function
Conclusions

• Continued stakeholder orientation depends very much on the character of internal governance

• Importance of social norms
  – Legal change has been slow