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Prevailing Differences in the US, German and Japanese Corporate Governance

By

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Abstract

Despite globalization and convergence in financial market regulations, financial accounting, shareholder protection or investor relations, striking differences in the governance of large, management-controlled companies remain between the largest economies among the OECD – the US, Japan and Germany. They relate to the extent of stock market listings, ownership structures, the structure and composition of boards as well as management compensation. The national variety in governance solutions is the result of system complementarities created by legal rules, such as codetermination in Germany, or structural factors, such as institutionalized inhouse careers of management in Japan. The main mechanism by which the income interests of outside equity owners are protected is performance pay in the US. In Germany, it is the direct control by dominant shareholders. In Japan, the absence of a developed market for managerial talent implies that the career interests of management align with the income interests of long-term equity investors. Governance reforms must take into account that national governance solutions are endogenous adaptations to differences in institutional environments. Discontent with governance outcomes must not address the specific national governance solutions, but the underlying institutional environment.

Keywords

Corporate Governance, Varieties of Capitalism, Convergence, Institutional Variety

1. Introduction

Corporate governance determines how stock companies, one of the core institutions of capitalist economies, are managed. Corporate governance is especially relevant in the context of managerial capitalism, which is characterized by the separation of equity ownership and management functions. Such a separation enhances the ability of companies to raise external equity, to diversify risk and to exploit the advantages of specialization in management and equity finance. However, the separation between outside equity owners and non-owner managers creates a fundamental governance problem, as both groups pursue different interests. The main task of corporate governance is to ensure that management does not lose sight of the interests of equity owners. The better corporate governance functions, the more companies will be able to benefit from the advantages offered by the separation of equity ownership and management.

In the spirit of research on the "variety of capitalism" (Hall & Soskice 2001), this paper

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revisits persistent differences in the design of national systems of corporate governance between the US, Japan and Germany. The three countries represent the three largest highly developed economies. Their larger companies compete in global markets and confront the same international investment community. However, neither global market competition nor exposure to global investors has led to a convergence of corporate governance systems. There have been adjustments, but important differences remain with regard to core elements, such as ownership structures, board composition and management remuneration. The following analysis provides clues to where such differences stem from and what implications they bear. The results highlight the importance of system complementarity in the evolution of national institutions.

The next section briefly clarifies the concept of corporate governance. Subsection 2.4., then, describes eight major governance instruments and mechanisms employed to protect the income interests of outside shareholders. Section 3 shows that, despite the existence of globalized product and financial markets, there remain distinct differences in the way large German, Japanese and the US corporations are governed. In the fourth section, after emphasizing the relevance of the observed differences, their causes and effects are analyzed. The concluding section summarizes the findings and addresses further implications.

2. Corporate governance

2.1. Narrow and broad definitions

Corporate governance has a narrow and a broad definition (Larcker & Tayan 2016, 7–8). In the narrow sense, corporate governance is about protecting the income interests of outside equity owners (= shareholders).[1] The problem is normally framed in a principal agent setting, where shareholders as principals delegate the task of operating the company to a manager as the agent. Typical governance solutions incentivize management by tying its remuneration to performance measures, which are relevant for shareholders such as profits or share price movements (Tirole 2001). In this way, the income interests of shareholders and managers become aligned, and the income interests of shareholders are protected by the self-interest of management.

In a broader understanding, corporate governance not only considers the protection of the interests of equity owners, but of all the other stakeholders typically engaged with a company and/or affected by a company's actions, i.e. employees, lenders like banks or bondholders, suppliers and customers as well as the government in its capacity as regulator and tax collector and the general public. The stakeholder perspective of corporate governance views the company as a "nexus of contracts" (Ayotte & Hansmann 2015). Each relationship has its specific governance issues and specific governance instruments and mechanisms to deal with. Together they define the system of corporate governance in the broader sense.

Even the stakeholder perspective recognizes that outside equity owners face a specific governance problem due to their position as residual income claimants (Fama & Jensen 1983a). Whereas lenders have a contractually secured rate of return and will receive their invested money back when their contract matures, equity investors have no such contractually secured income claim and no right to claim their investment back. Their income is the profit or loss at the end of each accounting period, which is the positive or negative income that remains after all the contractual income claims of other stakeholders have been settled. In this sense, outside equity owners are in a very weak position. Unlike in the case of lenders, suppliers, employees or customers, their interests cannot be protected by a contract. This is why the protection acquires special attention even under the stakeholder view of the company.

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[1] Outside equity owners are those shareholders which are not engaged in the management of the company. Inside equity owners are managers who are at the same time shareholders.

The following analysis, will mainly focus on corporate governance in the narrow sense. Nevertheless, the stakeholder perspective remains relevant, because, as the comparative analysis conducted below reveals, the way the income interests of equity owners are protected is directly influenced by how the relations with other stakeholders, in particular employees, are governed. In other words, the governance solutions for equity owners and employees are complementary.

2.2. Advantages of separation and ownership dispersion

The separation of the equity ownership in a company from the management of the company offers many advantages (Fama & Jensen 1983b, Marks 1999). If the two functions are separated, i.e. performed by different people,

(1) the amount of equity the company can raise will no longer be limited by the wealth of owner-managers,
(2) badly performing managers can more swiftly be replaced by better ones,
(3) advantages of specialization in management and risk bearing can be achieved,
(4) outside equity can be divided into shares and sold to numerous shareholders. The dispersion allows for a better risk diversification.

The listing and trading of shares on a stock market offers further advantages (Holmstrom & Tirole 1993):

(5) The trading possibility provides liquidity to shareholders as they can sell their equity position in the company.
(6) The trading of shares establishes a share price, which provides a market evaluation of the company. It includes a performance evaluation of management, which makes it easier to detect and consequently replace badly performing managers.

Separating equity ownership and management functions is not an "all-or-nothing" decision, but one of degree. The degree of separation increases as the ratio of outside equity increases and as the concentration of ownership decreases.

The extent by which the above advantages of separation and dispersion can be realized depends on the ratio of outside ownership and the degree of dispersion. The higher the outside equity ratio the less a company's capacity to raise equity is constrained by the wealth of managers, the easier it is, to realize the advantages of specialization in management and risk bearing, and the easier it becomes to replace a badly performing management team. The more dispersed shareholdings are the easier it is to exploit advantages of risk diversification. The listing of shares allows for a cheaper way of dispersing outside equity and provides at the same time advantages of liquidity.

2.3. The costs of separation and ownership dispersion

Outsiders will only acquire shares in a company, if they can be assured that their income interests are sufficiently protected. The problem is not trivial for several reasons (Marks 1999). First, the income interests of salaried managers and outside shareholders differ. Second, the differences cannot be settled by writing a contract which guarantees shareholders a certain return. This means that some kind of monitoring of management is necessary. Third, outsiders cannot observe what management does. Fourth, due to external risk factors beyond the influence of management, the residual income earned does not provide an unambiguous measure of managerial effort. The third and fourth reason imply that monitoring will be costly.

The problem of protecting outside shareholders becomes more severe, the higher the ratio of outside equity and the less concentrated the ownership of outside equity is. The less equity management holds, the less its income interests will be aligned with the income interests of outside shareholders, and the more it will be necessary to establish some kind of monitoring.

However, the more outside equity is dispersed, the more difficult it will be to secure effective monitoring. Monitoring requires information, knowledge to correctly interpret the information, influence to act upon the knowledge, and incentives to acquire knowledge and information and to exert influence. The more equity ownership becomes dispersed, the less individual shareholders will be able to exert influence and the less it will pay for them to acquire the knowledge and the information necessary to effectively monitor management. The incentive to monitor management will also decline as the tendency to free ride on the monitoring efforts of others increases with the dispersion of shares. This is because better performance – the outcome of effective monitoring – is a public good. It benefits all shareholders irrespective of their individual monitoring efforts (Eklund & Poulsen 2010, 3).

2.4. Major governance approaches and their limitations

There are eight major ways to protect the income interests of equity owners. They all come with costs and are therefore far from perfect.

(1) The first response to the governance problem is to avoid it by keeping the outside equity ratio low. This, of course, precludes the realization of the above noted benefits. It will not work for businesses which require large amounts of equity and operate in high-risk environments.

(2) Given the necessity of a high outside equity ratio, one solution to counter the monitoring problems is again to avoid them by opting for a high concentration of ownership. A majority shareholder would have the influence and the incentives to exercise control. However, the benefits of risk diversification and liquidity would not be realized. And there would be another governance problem: the majority shareholder could use his influence to appropriate profits to the detriment of minority shareholders. A practice known as “tunnelling” (Bhaumik & Gregoriou 2010).

(3) Legally defined “shareholder rights” protect small, non-influential outside shareholders against management as well as against majority shareholders (Cremers & Ferrell 2014). They typically comprise equal treatment clauses regarding the issuance of new shares or share transactions in corporate takeovers, the provisions for voting rights at shareholder meetings, information rights, rights to sue management, the prohibition of insider trading and disclosure obligations about business transactions between companies and management or major shareholders. Shareholder rights are costly to implement. They may also be abused. But above all, they provide no substitute for contractual rights on income claims, and they create no incentives for effective monitoring.

(4) Companies have to apply accounting rules. The proper application of such rules has to be certified by professional accounting firms, which are typically appointed by shareholders during their annual meetings (Larcker & Tayan, chapter 10). Compliance with accounting rules will provide outside shareholders and analysts with information essential for the assessment of the performance of a company. However, there are also important limitations. All accounting rules leave room for interpretation, especially when it comes to non-realized, i.e. imputed costs, such as depreciation, or the estimation of future cashflows in the pricing of assets. Accounting figures do not deliver unambiguous management performance measures because they are influenced not only by management decisions, but also by external macro-economic, industry-level factors, and chance. They do not offer an up-to-date assessment of management performance, but rather assess the impact of past decisions. Finally, as the long history of accounting scandals shows, legal rules and the expertise as well as the reputation of accounting firms have not been able to prevent fraud. Scrupulous managers can, at least temporarily, hide information and inflict harm on shareholders and other stakeholders. Often, accounting firms happen to have been involved. To secure future contracts they are tempted to collude with management.

(5) Supervisory boards, such as boards of directors, can alleviate the typical coordination problem in the representation of interests among a large group of people (Larcker & Tayan, chapter 3). Having shareholder interests represented by a board has not only the advantage that the communication between numerous shareholders and top management can be channeled and streamlined, it also allows to bring in expertise. In addition, the board can be equipped with information and sanction rights to enhance its monitoring function. However, what is often overlooked is the fact, that while the board may solve the representation problem, it introduces a new governance problem, namely one between outside shareholders and the board. Even with their influence, expertise and information advantage, what can assure us that board members will do their best to control management? Will they have the right incentives to do so? Will they be sufficiently independent from management?

(6) The listing and trading of shares in stock markets implies that performance measurement, an essential element of monitoring, can be outsourced to the market (Holmstrom & Tirole 1993). The pricing of shares reflects the market prediction about the future profitability of the company, which includes among many other factors also the quality of management decisions. Stock prices can be distorted through misinformation or other forms of market manipulation. To prevent this from happening, listing and disclosure rules and regulatory oversight is needed. The trading infrastructure also comes at a cost, as does the work of analysts, who tend to focus on frequently traded shares in order to spread their investments in knowledge and information. Altogether, the costs associated with the use of stock markets suggests that only sufficiently large companies can afford to be listed.

(7) The stock market also functions as a "market for corporate control" (Larcker & Tayan, chapter 11). If due to bad management a company is "undervalued", potential buyers can make a profit by temporarily acquiring the majority of shares (and voting rights), install a better management and then sell shares at a value, which reflects the improvement in management. However, the use of anti-takeover measures by the incumbent management and announcements effects associated with hostile takeover bids will raise share prices in anticipation of higher future profits and reduce the benefit of the acquisition. Hostile takeovers are therefore very rare events. However, their threat alone can have a disciplining effect on incumbent management.

(8) To assure that management works in the interest of shareholders, "incentive" or "performance pay" solutions have been suggested and employed (Larcker & Tayan, chapter 8). They link the remuneration of management to the company's performance and, thereby, align the income interests of management with the income interests of shareholders. Like in the case of Adam Smith's "invisible hand", the idea is to protect the income interests of shareholders by the self-interest of management. However, due to fundamental information asymmetries a perfect alignment cannot be achieved. There is also the problem that incentives may induce unwanted side effects. For example, management may be tempted to manipulate performance measures or to take too much risk in order to maximize income.

The successful diffusion of managerial capitalism and of stock markets indicates, that although governance solutions are not perfect, they still allow, at least to some extent, for the separation ownership and management and the dispersion of equity ownership. But does this mean that the same governance solutions are applied worldwide? The globalization of product and financial markets and the circulation of knowledge about "best practices" can be expected to promote convergence of governance solutions. However, as the next section shows, even among the largest developed economies, distinct differences in the way large corporations are governed remain.

Table 1 The importance of stock market listings in comparative perspective

	the US	Germany	Japan
Listed companies per 10,000 companies	7	1	10
Listed companies per million population	12	5	30
Market capitalization in percent of GDP	2.0	0.6	1.3
Market capitalization of per listed company ('000 USD)	10,132	5,215	1,760

Sources: Own calculations based on World Federation of Exchanges (https://statistics.world-exchanges.org), OECD, National Accounts (https://data-explorer.oecd.org), World Bank Development Indicators, Population (https://databank.worldbank.org/source/world-development-indicators), Statistisches Bundesamt, Statistisches Unternehmensregister (https://www.destatis.de), Statistics Bureau of Japan, 2021 Economic Census for Business Activity (https://www.stat.go.jp/english/data/e-census/2021/index.html), United States Census Bureau, 2020 SUSB Annual Data Tables by Establishment Industry (https://www.census.gov/data/tables/2020/econ/susb/2020-susb-annual.html).

3. The US, Japan and Germany

3.1. Partial convergence

Due to their population size and average GDP per head, the US, Japan and Germany represent the largest three economies among the OECD countries. They are fully integrated in the world economy in terms of trade, investment and capital flows and are home of many multinational corporations. This implies exposure to competition in international product markets and an engagement with globally active investors in financial markets for corporate bonds and equity. One would expect that this should have led to a convergence in corporate governance. However, this has only partially happened.

Convergence has been mainly promoted by the globalization of corporate bonds and equity markets. This can be seen not only in the trading infrastructures and regulatory frameworks of these markets and the global presence of core gatekeepers, such as global accounting firms (the big four) and rating agencies (the big three). It is also visible in the evolution of accounting standards, such as IFRS, and in the leveling of shareholder rights (Martynova & Renneboog 2011; Hung et al. 2022). It seems fair to say, that the partial convergence has been mainly directed towards the application of Anglo-Saxon standards. This one-directional convergence is clearly evident among the three economies compared in this paper.

As a result of the global integration of financial markets and the convergence of accounting methods and shareholder rights, stock markets in Japan and Germany have come to fulfil monitoring functions similar to those in the US. However, with regard to other major governance instruments and mechanisms listed in section two, marked differences remain.

3.2. Differences in market capitalization and ownership dispersion

Even in highly developed economies, like the US, Japan and Germany, only a very small portion of companies gets listed – between one and ten out of ten thousand (Table 1). The main reason is that most companies are very small and, therefore, do not need much equity capital. However, among the larger companies, we see that the propensity to list on the stock market varies greatly among the three economies. Relative to the size of its population, Japan has 2.5-times as many companies listed as the US and six times as many as Germany. In terms of market capitalization relative to GDP, the US and Japan change ranks. The average amount of equity per company listed in the US is almost six times bigger than in Japan. In Germany, too, it is three times larger than in Japan. This can partly be explained by differences in capital structures, i.e. lower equity ratios of Japanese companies. The main reason, however, is that in Japan listing equity capital on the stock market is attractive even for relatively small companies.

In terms of the discussion in section 2, the numbers in Table 1 tell us, that in the US and Germany, even larger companies opt for solution 1, i.e. avoid the issue of protecting the income interests of outside shareholders accompanied with the listing of stock. The high numbers for Japan suggest that the problem of protecting the income interests of outside shareholders in the stock market is either less relevant or can more easily or cheaply be solved.

There are not only marked differences in the propensity to list equity on stock markets, there are also differences in the dispersion of listed stock. In almost 40% of the listed domestic companies in Germany, the largest shareholder owns more than 50% of the shares. In Japan and the US, a majority shareholder is present in only 10% and 8% of the listed companies, respectively.[2] The high ownership concentration in Germany suggests that the wide dispersion of shares is more costly than in Japan or the US. This may also explain the low propensity to list in the first place, because the dispersion of share is one the main advantages of listing stock.

3.3. Differences in board structures

Company laws require stock companies to have a board, which supervises top management. Board members are elected at shareholder meetings. However, the design of boards and their composition differ systematically between the three economies. Germany has a two-tier system, a management board and a supervisory board. By definition, one cannot be member of both boards, although it happens that a CEO moves to the supervisory board after retirement. The US and Japan have a one-tier system, where boards are comprised of both executive and non-executive directors. In the US, companies listed on the New York Stock Exchange (NYSE) are required to have three committees, specializing on compensation, nomination and audit issues respectively. For those listed on NASDAQ, the audit committee is an option. In Japan, companies can choose between three different board designs, the traditional Japanese system “board with statutory auditors (kansayaku)”, the US system “Company with three committees”, and a mixture of the two “Company with audit and supervisory committee”. In 2022, most companies (61%) applied the traditional system, 37% the mixed form and only 2% the US type board (Tokyo Stock Exchange 2023, 20).

Boards fulfil both monitoring and advisory functions. In the two-tier system, the monitoring function of the supervisory board had traditionally been prioritized. In the one-tier system, the emphasis had been on the advisory function. In all three countries, governance reforms led to a convergence, although from different directions (Davis & Hopt 2013). In the German system, the introduction of a strategy committee strengthened the advisory function of the supervisory board. In the US and Japan, the increasing number of independent directors improved the monitoring function.

However, despite such partial functional convergence, major differences in board composition remain. In Germany, codetermination legislation reserves at least one third of supervisory board seats to employee representatives in corporations with more than 500 employees. In companies with more than 2000 employees, half of the supervisory board members are employee representatives (McGaughey 2015). They are elected by employees.[3] In Japan, the boards of companies, which apply the traditional and mixed structure, continue to be dominated

[2] Figures refer to the end of the year 2022. They are taken from OECD (2023, Figure 1.6). For control, not shares, but voting rights are decisive. Given that deviations from one share one vote have become the exception, the data on share ownership provide a good approximation of actual control right concentration. It is also important to note that control rights tend to be more concentrated than cashflow rights, i.e. shares, and that deviations used to be less common in Anglo-Saxon countries (Adams & Ferreira 2008; Eklund & Poulsen 2010).

[3] Only employees working in Germany are covered by codetermination. Employees working abroad are therefore not represented.

Table 2 CEO compensation in comparison, fiscal year 2022

	Ford	BMW	Honda
Car sales (million units)	4.2	2.4	3.7
Revenue (billion USD)	158.1	154.0	128.6
Employees	172,762	149,475	197,093
Return on equity (%)	−4.45	17.9	6.4
Total compensation (USD)	20,996,146	7,494,807	2,646,425
Fixed (%)	*8*	*37*	*27*
Short term (%)	*13*	*30*	*28*
Long term (%)	*72*	*33*	*45*
Others (%)	*7*	*0*	*0*

Note: Fiscal year 2022, ending before June 2023. Converted in USD using average exchange rates for the year 2022 from OECD.
Sources: Annual reports, compensation reports and SEC filings from respective company websites, https://shareholder.ford.com/Investors/Home/default.aspx, https://global.honda/en/investors/library.html, https://www.bmwgroup.com/en/investor-relations.html.

by insiders, i.e. present or former executive directors. In 2022, all listed stock companies had on average 8.3 directors, 2.9 (35%) of which were independent (Tokyo Stock Exchange 2023, 29). In the US, the majority of board members must be independent.

3.4. Differences in management remuneration

Top management renumeration packages are relatively complex, especially because of performance related pay components (Larcker & Tayan, chapter 8). Compensation varies across industries and depends on firm size. To compare, one has to control for both (Murphy 2013). There is also the problem of transparency. Disclosure varies across countries. Nevertheless, despite these challenges, systematic differences in the level and structure of management remuneration can be clearly discerned.

Table 2 contains information about the level and structure of CEO compensation at Ford, BMW and Honda for the fiscal year 2022. All three companies produce mainly passenger cars. They compete in a global market, and they are approximately of equal size in terms sales, revenues or number of employees. Nevertheless, we see a striking difference in the level of pay. Whereas the CEO of Ford earned 21 million USD in 2022, the BMW CEO had an income of 7.5 million USD and the CEO of Honda earned "just" 2.6 million USD.

The structure also differs. The most significant difference is the large share of variable pay in the Ford remuneration package. Long and short-term incentives amount to 85%. In the case of BMW and Honda, the variable share is 63 and 73% respectively. Despite the highest level of "performance pay", the Ford CEO earned almost three times as much as the BMW CEO, although his company performed worst among the three car makers.

The figures in Table 3 are consistent with previous and aggregate empirical findings (Murphy 2013). The only exception is the compensation package of the Honda CEO. Table 3 shows, that in the fiscal year of 2022 both the level of compensation and the share of variable pay were much higher than in previous years. The main reason is the introduction of stock compensation in 2018. Fixed renumeration in local currency (yen) remained more or less unchanged. It needs to be seen, if the 2022 level and structure signify a new trend in Japanese management compensation.

Table 3 Evolution of CEO compensation at Honda

	2014	2016	2018	2020	2022
Total compensation (million USD)	1.3	1.4	1.6	1.5	2.6
Total compensation (million yen)	139	150	173	164	348
Fixed (million yen)	96	102	94	91	94
Fixed (%)	*69*	*68*	*54*	*56*	*27*
Short term, Bonus (%)	*31*	*32*	*26*	*16*	*28*
Long term, Stock (%)	–	–	*20*	*28*	*45*

Note: Fiscal year ending March the following year. Converted in USD using average exchange rates for the year 2022 from OECD.
Sources: SEC Filings (Form 20-F) respective years, https://global.honda/en/investors/library/form20_f.html

4. Discussion

4.1. Differences raise questions

The three largest, highly developed capitalist economies differ markedly in the extent to which companies exploit the advantages of separating equity ownership and management functions. As the numbers of listed companies per population show, Japan uses stock markets most extensively, Germany uses them least. Even when listed, German companies make much less use of the ability to disperse shareholdings.

Despite the convergence in the balancing of advisory and monitory functions of boards, fundamental differences also remain in terms of board structure and board composition. The same can said about the level and structure of management compensation. US top managers receive huge pay packages, whereas their Japanese counterparts seem sufficiently motivated by one tenth of the amount. The huge differences in compensation levels imply that there is no global market for managerial talent. The differences in the structure of pay reveal important differences in the way top management is incentivized.

The apparent differences raise two fundamental questions: how can they be explained? What implications do they bear?

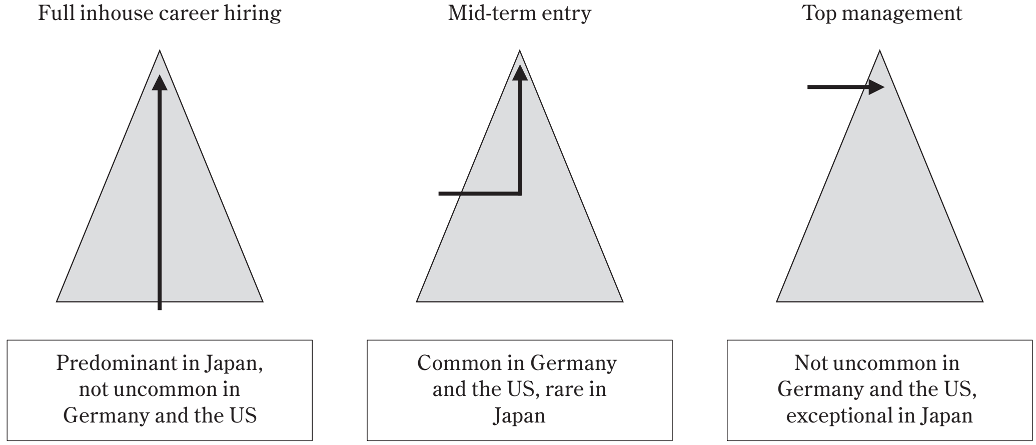
4.2. Causes – system complementarity

Institutional diversity is the result of system complementarity (Amable 2000). Some parts of a system, often those, which cannot easily be adjusted, influence the design of other parts. System complementarity provides an important clue to institutional diversity.

- Germany -

In Germany, an obvious explanatory variable for national corporate governance features is the legally prescribed codetermination. It directly influences board composition. It also justifies the two-tier board structure. The requirement for employee representation in supervisory boards applies to all incorporated companies with 500 or more employees. It does not matter whether they are listed or not. To counter and contain the influence of employee representatives in supervisory boards affords a strong and unified shareholder side (Roe 1999). In this way, codetermination tends to prevent German companies from taking advantage of the liquidity and the dispersion of shares offered by stock markets. As a consequence, the benefits of stock market listings are reduced. Codetermination therefore not only determines board composition, but also

Figure 1 Patterns of management careers and their prevalence in Japan, the US and Germany



Source: Author.

share ownership concentration and the low propensity for listing a company on the stock market.

As a result of codetermination, the main governance mechanism in German companies is direct control by a dominant shareholder or shareholder group, who will also decide the shareholder representatives in supervisory boards. This explains why incentive pay is less important and why management cannot extract as much rent from the company as in the US. The presence of employee representatives on supervisory boards could also have a moderating effect on the level pay, especially the gap between executive remuneration and the level of wages and salaries within the company. It further reduces the influence of management as it provides the supervisory board with an information channel independent from the management board (Fauver & Fuersta 2006).

- Japan -

Japanese corporate governance features are not determined by law, but by structural characteristics. The core structural factor can be seen in the prevalence of inhouse careers for top management (Waldenberger 2016). Inhouse careers are common in all economies. However, they usually are the outcome of a choice both by the employer – to fill a top management position with someone from within the company instead of hiring someone from outside – and by the employee – to continue her career in the same company instead of another employer. In Japan, inhouse careers have become institutionalized in the course of the successful postwar economic development. Whereas Japan's employment system has changed in many ways – more non-regular employment, more mid-term hires – companies continue to fill executive positions inhouse.

The different management career patterns and their prevalence in the US, Japan and Germany are schematically depicted in Figure 1. The relevance of institutionalized inhouse careers in Japan can be seen at the career entry and exit points. The entry points consist of the recruitment of university graduates. Students are not recruited for particular jobs, but for a lifelong career. This is why it pays for both sides to invest much time in finding the right match. At the exit, the prevalence of inhouse careers is visible in the careers of those who made it to the top. Japanese executive directors typically have had a lifelong career in their company.

Institutionalized inhouse careers are not an option, but the outcome of a self-enforcing evolutionary process. Their existence both presupposes and implies the underdevelopment of an external market for managerial talent: when people pursue an inhouse career, an outside market cannot develop, and as long as the outside market is underdeveloped, people cannot build a career by changing companies. Once established, inhouse careers provide an almost costless governance mechanism. Knowing that the only prospect for a successful career is within their present company, management will do everything to make the company succeed.[4] Japanese managers are de-facto owners. They have not invested shares, but their lifetime career in their companies. The long-term career interests align the personal goals of management with those outside shareholders, who pursue a long-term investment strategy. The lower governance costs resulting from institutionalized inhouse careers enhance the separation of equity ownership from management. This explains the relatively high number of listed companies in Japan and why the lack of independent directors on Japanese boards does not constitute a severe governance issue.

Inhouse careers also provide the clue for Japan's comparatively low level of executive pay (Waldenberger 2013). In a market, top management compensation follows the logic of the "superstar model". Compensation is determined by competition for the best managers available. Since top management decisions affect the productivity of all corporate assets, the marginal productivity of a CEO is higher in larger companies. This explains why the largest companies pay the highest remuneration and (hopefully) attract the best manager to do the job. In the Japanese context, management compensation follows the tournament model. Managers compete inhouse for promotion. It can be shown that the level of compensation is then not determined by the asset size of the company as in the "superstar model", but by the employment size. The tournament model imposes an upper bound on the pay gap between levels of management.

Given the strong incentives inherent in institutionalized inhouse careers, Japanese management remuneration should not require large performance components. This was indeed the case until recently. It remains an open question, whether the recent trend towards higher performance pay is just a fad, or a response to pressures from international institutional investors who do not understand the logic of the Japanese system, or a sign that the prevalence of inhouse careers can no longer be counted on.

- the US -

The US system developed undisturbed from codetermination. It is also embedded in a well-developed managerial labor market. Given the absence of strong shareholders, power resides with the top management team. This had already been noted in the early 1930's, in a study by Berle and Means (1932), which concluded that shareholders had surrendered their influence to all-powerful managers. The absence of dominant shareholders has been explained by strict regulations on insider trading, which precluded advantages from privileged access to insider information created by concentrated ownership (Roe 1994). The relatively strong position of the US managers in comparison with their German and Japanese counterparts was confirmed in a study by Crossland & Hambrick (2007), who looked at share price reactions to CEO relevant events.

In the absence of a controlling shareholder and institutionalized inhouse careers, the main instrument to protect the income interests of outside shareholders in the US is incentive pay. The reliance on incentive pay reflects the limitations of other major governance instruments, such as independent boards or the market for corporate control.

[4] More precisely, middle management will do so and exert control on senior management in this respect. Eguchi considers this internal control mechanism as the core of Japanese corporate governance (Eguchi & Waldenberger 2017).

4.3. Implications – functional equivalence and comparative advantage

The survival of different institutional designs competing in a globalized economy suggests that they are either functionally equivalent and, therefore, have no effect on competitive outcomes, or that they result in comparative advantages, which then influence the division of labor between national economies. Both aspects seem relevant. Despite their reliance on different governance instruments, Germany, the US and Japan have over decades successfully competed in world automotive markets. But this is just one industry. There are good reasons to belief that the different governance schemes affect business strategies and comparative advantage, but it is hardly possible to isolate effects from other institutional differences.

In Germany, codetermination slows down corporate restructuring, especially in terms of layoffs and rehiring. Higher restructuring costs increase the downward risk of investments. Companies will react to this by reducing the need for (radical) restructuring, which means pursuing less risky strategies. The ownership concentration resulting from codetermination adds to this, because it reduces the propensity of companies to diversify risk. In Japan, inhouse careers increase the risk aversion of management as corporate strategies put not only shareholder income at risk, but also the careers of middle management (Waldenberger 2016). The higher degree of risk aversion caused by codetermination and inhouse careers should be especially apparent in corporate R&D strategies. They should be more conservative and more incremental. However, cross-country comparisons are inconclusive in this respect (Waldenberger 2003).

Slow restructuring requires patient shareholders (Waldenberger 2003). Uninformed outside shareholders will not be able to assess whether slow restructuring is necessitated by legal or structural factors or whether it is because management is not doing its best to serve shareholder interests. If restructuring is prolonged, they will sell shares, which will depress share prices and increase the cost of raising new equity. In Germany, the existence of well-informed majority shareholders resolves the communication problem between management and outside equity owners. In Japan, patience was secured by dispersed, but stable shareholdings. These stable shareholdings have since the end of the 1990s been dissolved (Tokyo Stock Exchange 2023, 148–159; Miyajima 2023). This has created a dilemma for Japanese companies. To counter the impatience of uninformed shareholders they not only increased equity ratios, but also hoarded large amounts of cash (Waldenberger 2016). Both measures will buy them time during restructuring, the time that shareholders may no longer grant them.

5. Conclusion

The corporate governance structures of larger corporations in the US, Japan and Germany show distinctive national characteristics with regard to the use of stock markets, ownership concentration, the structure and composition of supervisory boards and the level and structure of top management remuneration packages. The differences indicate that in the three systems the income interests of outside shareholders are protected in different ways. In Germany, the main solution to the governance problem is the concentration of ownership. In Japan, the institutionalization of inhouse careers aligns the interests of management and outside shareholders. In the US, corporations achieve such an alignment through incentive pay.

Over last three decades there have been frequent requests for reforms of corporate governance, caused by corporate scandals, financial crises or dissatisfaction with economic performance. To support and guide reforms, the OECD and non-OECD countries among the G20 responded to these demands by drafting the *G20/OECD Principles of Corporate Governance* in 2015, which have since then be regularly revised – most recently in 2023 (OECD 2023). The above analysis has shown that companies choose governance solutions in response to constraints defined by regulations and structural conditions. In Germany, the avoidance of stock market listings and the high concentration of shareholdings reflects corporate responses to codetermination. In Japan, relative high number of listed companies, the insider dominated boards and the hoarding of cash reflect the logic of inhouse careers. In the US, the reliance of high-powered incentive compensation is the only way to deal with powerful managers. Dissatisfaction with governance outcomes and corporate performance must be answered by tackling the exogenous factors, that influence governance choices. Otherwise, reforms will be either ineffective or even counterproductive, because reforms that lack an understanding of the logic of the system run the risk of creating unnecessary additional constraints, which may force corporations to choose second or third best governance solutions.

Taking a wider perspective, the institutional variety visible in the area of corporate governance reflects different answers to the question "What is a corporation?" and "To whom does a company belong?" (Yoshimori 1995). Managerial capitalism in the US puts shareholder value first. It is possible, because of the absence of codetermination and because of developed markets for managerial talent. In Germany and Japan, these constraints respectively introduce an explicit stakeholder orientation, because employee interests have a voice on supervisory boards and because the protection of inhouse careers constitutes a necessary condition for corporate success. Shareholder and stakeholder orientation are not the outcome of abstract socio-philosophical reflections, but are respectively rooted in institutions to which corporate governance solutions have been adjusted. To what extent these underlying institutions are the result of historical coincidences or the outcome of cultural values or explicit societal choices is another important question, which can, however, not be answered here.

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