POST-WAR INSTITUTIONAL SHOCKS: THE DIVERGENCE OF ITALIAN AND JAPANESE CORPORATE GOVERNANCE MODELS

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Abstract

After the first section, introducing some typical problems of family capitalism, the following three sections of the paper consider the ambiguity of the legal framework defining the modern corporation, the two way relation between technology and property rights and the different mechanisms by which the control of the firms can be transferred to new individuals. In the other sections we examine the different role that the American occupation has had in the two countries: in Italy it involved the definitive blessing and reinforcement of both State-owned corporations and family controlled pyramidal groups that had emerged during the fascist period, whereas in Japan it caused the end of the power of the great *zaibatsu* families. We will also consider how inter-firm share holding can promote (Japan) or inhibit (Italy) expansion of large corporations and the mechanisms that have made each model self-sustaining after the initial institutional shocks.

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1. Introduction

Italy and Japan may seem to an occasional visitor two countries that have very little to share. Still, their histories show some surprising similarities. In both countries, for a long time, a spiritual authority (the Pope in the case of Italy and the Emperor in the case of Japan) co-existed with a mundane authority (the German emperor in the case of Italy and the shogun in the case of Japan). Moreover, the histories of modern Italy and Japan start in the same years. In 1868, the Meiji restoration "restores" the spiritual authority in Japan in the name of the country's modernisation while, in Italy, only two years later, the unity and the modernisation of the country involves a fierce conflict with the (temporal) authority of the Popes. Italy and Japan have been on the same side in the two world wars and have shared the experience of military defeat. Finally, the two countries have shared the disadvantages of a "blocked" political system without competition between the leading parties.

One could continue with this list of remarkable similarities that makes the analysis of the differences between the two countries so stimulating and, paradoxically, even more striking. However, the scope of the paper is to concentrate on one aspect of their history that has made their post-war economic systems very different and, in our opinion, can be traced to the very different consequences that the defeat in the second world war has had on the economic institutions of the two countries.

In this paper we claim that the different policies of the winning powers, in particular the US, implied a substantial divergence in the systems of corporate governance of the two nations that before the war shared a system of family control in their large private firms sector. In Italy, the American (and British) policies meant the reinforcement of the ownership and governance structures that had

emerged during the fascist period. By contrast for Japan the American occupation meant the end of the power of the *zaibatsu* families that had dominated the modernisation of the Japanese economy since the Meiji restoration.

In our view the policies of the winning powers have had a lasting result: Italy's large firm sectors are, still, stuck with the contradiction of family capitalism while Japan has produced a new organisational form, the "Japanese company", that, in the years after the war has occupied a large share of world markets and, after some time, an increasing share of economic books trying to explain its success.

The purpose of our paper is to compare the patterns of development induced by these institutional shocks - an analysis that can be particularly interesting while Italy is reconsidering the characteristics of its ownership structure.

We will start by considering the problems of family capitalism through a brief account of the different management histories that have characterised Sumitomo and Fiat and introduce the general problems that come from these case studies. In the following section we will try to give some theoretical framework to these comparative issues: in particular we will try to explain why institutional shocks can produce such lasting systemic divergence in corporate governance in economies that seem to be organised according to a very similar legal framework. In the remaining sections we will try to give a comparative account of recent Italian and Japanese histories. We will argue that, even if other factors are also important, American policies (and, in the case of Italy, also British policies) had a decisive role in determining the different destiny of Italian and Japanese family capitalism. We will finally argue that inter-firm share holding can either promote (Japan) or inhibit (Italy) the expansion of large corporations and we will try to spell out other mechanisms that have made each model self-sustaining after the initial institutional shocks.

2. Contradictions of Family Capitalism and the Emergence of the Modern Corporation: The Cases of Sumitomo and Fiat

The people who have the skills to make the best use of wealth may very well not be the same people who are wealthy. This simple fact of life raised problems that were, certainly, well known by the "political merchants" that were already active in the Tokugawa period. Managerial authority was usually entrusted to men that had skills developed solely from direct experience known as *bantô* that had very little formal training before being employed as salaried managers. *Bantô* were substantially different from the new type of salaried managers that were later required by the *zaibatsu* companies, who underwent substantial formal training before being employed. However, under both systems, some common problems characterised family capitalism in Japan until its dissolution after the second world war (and, indeed, all forms of family capitalism including contemporary Italian capitalism where the counterpart of *zaibatsu* families still survives in the private sector).

According to Morikawa (1992) the retirement of *bantô* Hirose Saihei (p. 48 - 49) at Sumitomo 1894 marks the end of the age of the transition to the new management system that was going to characterise Japanese family capitalism until its forced dissolution by the American occupation forces. Hirose was an old type of salaried manager that had saved Sumitomo in the difficult years that occurred immediately after the Meiji restoration. As a result he had been given autocratic power. In seven days, in 1894, both the retired family head Sumitomo Tomochika and his young successor Tomotada died leaving the Sumitomo family without a heir. *Bantô* Hirose solved the succession crises by selecting Tokudaiji Takamaro (a younger brother of a leading figure of the Meiji government) as the husband of the sister of the late Tomotada. Takamaro took the Sumitomo surname and a new given name Tomoito and became the head of the Sumitomo house.

This episode shows the authority that the salaried managers could have under the old system. It is even more instructive that after four

years Hirose was forced to retire having being accused of abuse of power for reasons unrelated to the choice of the head of the family. His despotic power could not be accepted by the new young managers whose systematic and co-operative style had become necessary because of the growth and diversification of the company. He was accused of nepotism and of disregarding the opinion of other managers on major strategic decisions such as the establishment of a bank and entering the iron field. After Hirose's retirement Sumitomo was managed by a council of directors that could better follow the increasingly diversified business of the company.

While this story reveals some typical features of the Japanese system (perhaps, also of the Italian system), such as the peculiar relationship between political and economic power, it captures one general weakness of family capitalism: the fact that the successor may not have the skills required to manage the company; moreover, in some cases, there may be no successor able to exercise control. The way in which *bantô* Hirose solved the succession crises was, in fact, by changing the family composition according to the needs of the company - a solution that is not easily available outside Japan and, in particular, in contemporary Italy where the destiny of the company is likely to be exposed to the unpredictable tastes of the family members.

Besides succession crisis *zaibatsu* organisations were affected by other serious problems. The growth and diversification of the company implied that neither the members of the family nor an autocratic *bantò* faithful to the destiny of the family could exercise control. All *zaibatsu* had to adopt the multisubsidiary system that granted autonomy and power to the divisions of the company while the head-office retained a co-ordinating role that was also handled by professional salaried managers.

The control of the family was not only weakened by the necessity of finding outside expertise; towards the end of the *zaibatsu* era it showed the first signs of being incompatible with the necessity of

providing the additional funds required by the growth of the company. Immediately after Mitsui and Mitsubishi, in 1921 Sumitomo went through major economic changes: the head office was organised as an holding company, wholly owned by the Sumitomo family, while the various Sumitomo enterprises were transformed into joint stock companies controlled by the holding company.

In comparison with Mitsui and Mitsubishi holding companies Sumitomo share of total stock was relatively low while the ownership of the holding company was restricted until the very end to the Sumitomo family. In 1937 Sumitomo was the first of the three major *zaibatsu* to reorganise its head office into a joint stock company whose ownership was however restricted to the members of the Sumitomo family. When, in March 1945, under the pressure of the activities undertaken under the war effort Sumitomo doubled its capitalisation it offered one sixth of the new shares to the public (p. 235). The "public" offering was however limited to three Sumitomo subsidiaries: Sumitomo Bank, Sumitomo Trust and Sumitomo Life Insurance. The paths, that the other families followed were somewhat different but they were also aimed at the preservation of a closed ownership system. For instance, when the capital of the holding company of Mitsubishi was doubted in 1940, the newly issued shares were offered entirely to the public. The Iwasaki family could no longer finance the growth of the subsidiaries of the *zaibatsu* that they had founded. However, apart from the 1920 offering of Mitsubishi Mining stock, the "public offerings" were actually restricted to Mitsubishi subsidiaries, their employees and various associates of the *zaibatsu* family.

Diluting the participation of outsiders in many subsidiaries and selling the stock to people who could be trusted not to challenge the control of the company were two typical ways of preserving the family ownership systems after it had reached its "natural" limits.

How far the Japanese family system could have made violence to its natural limits is a question that cannot be easily answered. The

Italian post-war system has exploited the multi-subsidiary system to an unprecedented level creating a pyramid structure that allows an impressive multiplication of the controlling power of the capital owned by the families - a issue that we will examine in the following sections. Moreover succession crises have been overcome with the help of faithful managers that have had a role not far from that of *bantô* Hirose.

On 16 December 1945 Giovanni Agnelli, the founder of Fiat and the grandfather of the present honorary president of Fiat "Gianni" Agnelli, died at the age of 79. Ten years before his son Edward Agnelli had died in a plane accident. At the time of his grandfather's death Gianni, the eldest of Edward's sons, was 24 years old. He was clearly unprepared for taking over his job. The top Fiat manager was at that time Professor Vittorio Valletta. Like *bantô* Hirose in the case of Sumitomo his loyalty to the Agnelli's family and to the company was beyond any possible doubt. A Fiat executive remembers that during the difficult years of the war "Valletta always said we would be good Germans, we would be good Fascists, but we had to save Fiat. That was the policy." (Friedman, 1989 p. 36).

After Giovanni Agnelli's death Valletta told Gianni that there were two possibilities, that either the young Agnelli or himself become the president of the company. According to Alan Friedman's account "the young Agnelli, who did not consider himself ready for the job replied "You do it Professor". What followed was a period that is known as "The season of Valletta" or alternatively as the "Regency". The relationship between young Agnelli and Professor Valletta was indeed very similar to that of an absent sovereign. "While Gianni spent his time on fast cars and loose women, Valletta was very much in control of the Fiat empire, overseeing its reconstruction in the post-war period. Agnelli might have ruled from a distance, but Valletta governed" (Friedman, 1989 p. 44).

Valletta's regency ended in 1966. During his season Fiat had enormously prospered. When Giovanni Agnelli had died Fiat was producing 3260 automobiles a year. In 1966 Fiat was turning out

that number of cars every working day. By the year 1974 the direct involvement of Gianni Agnelli and his young brother Umberto was one of the factors that had precipitated FIAT into a serious crisis. While Umberto had consistently shown very poor skills, Gianni had with comparable consistency proven to be a better ambassador for Fiat than a manager. With Fiat in a mess, young Umberto tried to pursue a political career. This gave the opportunity to appoint Carlo De Benedetti - he was later to become the president of Olivetti - as managing director. After a short time, Umberto had to give up his hopes of a successful electoral career and he expressed his wish to go back to his FIAT job. "De Benedetti had finally to understand what everyone already knew, that for the Agnellis Fiat was more than a company to be run on strictly business grounds. It was family property, where matters such as keeping a dilettante brother happy were more important than a company clean-up. De Benedetti realised then that there was nothing more he could offer in the group"(Friedman, 1989 p.78).

Leaving the company to find its own way as an independent entrepreneur, De Benedetti predicted that the day was not far off when Fiat could not be run in such an incompetent way. The day came in 1980 when the survival itself of Fiat as an independent company was at stake. Umberto finally gave up and admitted that he was not the man to run the company. Cesare Romiti, a manager who, before working at Fiat, had shown his skills in the public sector was placed firmly in the driving seat.

The combination of the diplomatic skills of Gianni Agnelli and the managerial skills of the tough Romiti was unbeatable. Gianni Agnelli had finally found his new Valletta. Together they expanded the frontiers of the Agnelli network of power. Soon, the Agnelli group controlled one quarter of the stock exchange making free use of the clout that derived from its 569 subsidiaries and 190 associated companies. Gianni Agnelli became the single most powerful individual in Italy and, according to Alan Friedman the uncrowned king of the nation.

The Fiat experience shows that it was possible in an advanced post-world-war corporation to have a form of family control that, thanks to its pyramid structure, could influence such a large part of the Italian economy. Perhaps *Bantô* Hirose enjoyed even greater separation between ownership and control than Valletta or Romiti.

Italian family control and the post-war Japanese *keiretsu* firms (where a new ownership structure gave managers complete autonomy from physical owners) could well co-exist in an increasingly integrated market.

How could a similar corporate legal framework allow for such difference in the ownership and the organisational structure of the firms? And why did such a remarkable divergence of the Italian and Japanese corporate models come about?

3. The Diversity of Business Organisations: A Theory of the Relevance of Institutional Shocks

Among many institutions in today's capitalism nothing has contributed more to its history of colossal expansion than public corporations or joint-stock companies. Yet their ownership structures and control mechanisms vary widely both over time and across countries. As was reported in Berle and Means' classical work on corporate governance,[1] typical large corporations in America had until recently fragmented shareholders with small holdings and little voice in its management, though in the past two decades large institutional investors with strong voice in management have grown quite rapidly. Italian family empires and "coalitions," on the other hand, have developed a pyramidal ownership structure which enables a family or a tight-knit group of people at the top to exercise a monolithic control over a large number of corporations through a hierarchical chain of corporate shareholdings. *Zaibatsu* groups in pre-war Japan also had a similar pyramidal ownership structure, but their post-war successors, *keiretsu* groups, give us yet another model of ownership and control-- a set of corporations are connected through an intricate network of cross shareholdings and effectively

shield themselves from outside takeovers, thereby fortifying the *de facto* controlling powers of their managers and core employees. And undoubtedly we can find a variety of ownership structures and control mechanisms all over the world.

This leads us to pose the following questions as to the synchronic as well as diachronic diversity of the corporation's ownership and control systems. Why is such diversity possible? How could such diversity persist? How did such diversity emerge? Why should such diversity matter? These questions are of course inter-related, but we will only answer them one by one. In this section, we will take up the first question, leaving the other questions to the following sections.[2]

How is it possible that the publicly-held corporation, the most capitalistic among the supposedly universal capitalistic institutions, is capable of developing a wide variation in the systems of ownership and control?

Our answer to this question is straightforward. We claim that it is the very legal nature of "corporation" that is responsible for this diversity. But, in order to justify this straightforward answer, we have to make a detour and must explain the legal nature of corporation. What is this animal called the "corporation"?

The law speaks of a business corporation as a "legal person"-- as a subject of rights and duties, capable of owning real property, entering into contracts, and suing and being sued in its own name, separate and distinct from its constituting shareholders. For many centuries, philosophers, political scientists, sociologists, economists, and above all jurists and judges have debated heatedly as to what constitutes the "essence" of this soulless and bodiless "person."[3] It is not our purpose to review this "corporate personality controversy," one of the most famous controversies in legal theory and legal philosophy. All we would like to do here is to work out the implications of the fact that a business corporation, which is not naturally a person, is nevertheless treated legally as a person.

Our starting point is one of the most elementary facts in corporate law. If you take away a gadget from the factory of the business corporation you are a shareholder of, what will happen to you? You will be immediately arrested as a thief! Why? Because a corporate shareholder is not the legal owner of the corporate assets. Then, who owns those corporate assets? The corporation does. It is the corporation itself as a "legal person" that legally owns the corporate assets. Then, what does a corporate shareholder own? A share of the corporation. It is a fraction of the company as a "thing," separate and distinct from the underlying assets, that a corporate shareholder owns.

This observation will immediately lead us to the most crucial characterization of a business company. In contrast to a sole ownership firm or a partnership firm, an incorporated firm is composed of not one but *two* ownership relations: the shareholders own the company, and the company in turn owns the corporate assets. In fact, in this two-tier ownership structure the company is playing a *dual* role of a 'person' and a 'thing'. In regard to the corporate assets it acts legally as a person, as a subject of property right; and in regard to the shareholders it is acted on legally as a thing, as an object of property right. Naturally, of course, a corporation is neither a person nor a thing. Legally, however, it is endowed with both personality and thingness. It really is a strange animal.

Indeed, we now claim that it is this person/thing duality of the corporation that lies at the root of the diversity of its ownership structures and control mechanisms. We will consider only two variations here – one simulating the "Italian" corporate system and the other simulating the "Japanese" corporate system.

As we have already seen, a corporation as a legal person can own things and a corporation as a legal thing can be owned by persons. This at once suggests the possibility that a corporation as a person owns other corporations as things. A corporation which holds the shares of other corporations is called a "holding corporation." It was

first legalized in 1889 by the state of New Jersey in America, and quickly spread to the rest of the world.

The holding corporation has opened a way to an important organizational innovation: the pyramidal system of ownership and control. At the top is a natural person who owns a corporation as a thing. But, being also a legal person, that corporation can own another corporation as a thing, which again as a legal person can own another corporation as a thing, and so on. Such ownership hierarchy can extend *ad infinitum*. This is, however, not the whole picture. Because you do not have to own all the shares to control a publicly-held corporation. As long as minority shares are sufficiently diffused among passive investors in the stock market, only a share slightly greater than 50% is sufficient for the control. This implies that one unit of capital can in principle control almost two units of capital, if each half buys a bare majority of the shares of a corporation with a capital close to one unit. It then follows that, as more and more layers are added to the ownership hierarchy, a capitalist at the top can multiply the controlling power of his or her capital by the order close to 2^N, where N is the number of hierarchical layers beneath.[4] Moreover, as the footnote below indicates, if this hierarchical structure is combined with cross-shareholdings at each hierarchical layer, the capitalist at the top can further enhance the leverage of his or her own capital.[5]

The pyramidal system of ownership and control of Italian family empires and "coalitions" fits in with this picture quite well.

Let us turn to the analysis of another system of ownership and control. To this end, we now push the logic behind the holding corporation further and let it loop the loop. Indeed, if a corporation as a person could own other corporations as things, the same corporation as a person should be able to own *itself* as a thing. From a purely theoretical standpoint at least, nothing prevents us from imagining a corporation which becomes its own controlling shareholder by holding a majority block of its own shares under its

own name. Then, that corporation will be free from any control by real human-beings and become a kind of self-determining subject at least in the realm of law.

In reality, however, many countries prohibit corporations to repurchase their own outstanding shares. Japan, for instance, used to prohibit the share buyback, though the ban was partially lifted in 1995. And even in the countries (like America) which allow share repurchases, the repurchased shares generally lose their voting rights in the shareholders meeting.

There is an important leeway to this. Suppose that two corporations, A and B, hold a majority of each other's shares. The corporation A as a person owns the corporation B as a thing, and the corporation B as a person simultaneously owns the corporation A as a thing. Then, even though each corporation is not owning itself directly, it indirectly is through the intermediacy of the other corporation.

One might still object to the practical relevancy of this by pointing to the fact that some countries impose legal limits on the extent of cross-shareholdings between corporations. For instance, Japanese law forbids banks and other financial institutions to own more than 5 percent of the shares of any domestic corporation. Yet, even these limits can be circumvented, if twelve corporations get together and hold 5 percent of each other's shares (but its own). Then, a simple arithmetic: (12 - 1) x5 % = 55 % tells us that a majority block of each corporation's shares could be effectively sealed off. These twelve corporations would indeed become their own owners at least as a group. If the group increases its members, the necessary ratio of mutual shareholdings will be reduced further.[6]

It should be evident by now that the ownership structure of Japanese *keiretsu* groups fits in with this picture quite well.

We have thus shown that the supposedly universal law of the corporation is capable of generating (at least) two totally different systems of ownership and control – one simulating the "Italian"

system and the other simulating the "Japanese" system. The former allows a capitalist at the top of a pyramid to exercise a centralized control over the large amount of capital assets (with the minimum capital of their own), whereas the latter effectively shields a group of corporations from the control of any capitalist, thereby granting *de facto* control rights to their managers and core employees.

The diversity of systems occurring under the alleged universal law of the corporation can only explain the possibility of divergent organisational arrangements within a relatively uniform legal framework but can neither explain the actual divergence of organisational paths nor the relevance of institutional shocks.

There is little in standard economic theory that can help us to explain why institutional shocks such as the American occupation should have had such a lasting impact on the organisational arrangements of Italy and Japan.

In the Neo-Classical framework the entire issue of ownership and control rights[7] does not make sense[8]. In a world of perfect competition and zero market transaction costs agents could write a complete contract that specifies the conditions under which to participate in a coalition of agents producing a certain good. In this framework the assignment of control rights does not matter: there are no ex-post residual decisions, left by the ex-ante contract, where the power entailed by the control of the organisations could be exercised.

In the New Institutional and in the New Property Rights framework the assumption of costly and/or incomplete contracts implies that some relevant ex-post residual decisions may be left to the holders of ownership. In this framework the assignment of control rights matters and it is relevant for efficiency which individual should employ other individuals. In a second best world some agency costs are likely to be sustained by any individuals controlling the firm that has to employ other individuals. Because of the specificity of other investments every individual will have to share the fruits of his/her

investment with other agents who can make a threat to leave the coalition. Moreover, because of asymmetric information, each agent will have to sustain some (monitoring and/or bonding) costs. Thus, in comparison to the first best solution, each agent cannot get the whole fruits of its investments and tends to under invest. The "second best" solution is to assign control rights to those agents who imply the highest agency costs when they are to be employed by other agents. In a market characterised by zero transaction costs this second best solution should always be attained.

In this second best framework the re-assignments of ownership and control rights occurred under the American occupation should not matter. If the new rights implied lower agency costs they would have occurred independently of the American occupation whereas if they implied higher agency costs they would have been undone by the market after the end of the political constraints due to the occupation. In both cases institutional shocks are irrelevant and the control of the organisation would go to the high-agency-cost agents.

The relevance of institutional shocks becomes instead evident if we move beyond the New Institutional and the New Property Rights framework and acknowledge that in a transaction world where the control of firms matters it is inconsistent to assume the existence of a costless perfect market for control itself. Three distinct problems arise in such world whereby institutional changes are made to have a decisive influence on the allocation of control rights.

i) Information problems. Due to asymmetric and imperfect information on who the highest-agency-costs individuals actually are, efficiency enhancing transfers of control might not take place and efficiency - reducing ones might well take place. As the result of this market failure, institutional shocks which, either directly or indirectly, result in a forceful reallocation of control can indeed make a difference by changing the default - no transfer - option.

ii) Multiplicity of organisational equilibria. Technology (i.e. the degree of specificity and the hardness-to-be-monitored of

individuals) is not to be taken exogenously but is rather influenced by control allocation. Multiple combinations of technological and control allocation can then exist. Institutional shocks, by transferring control rights, can therefore permanently shift the economy from one equilibrium to another.

iii) Separation between ownership and control. The allocation of wealth among members of a society does not necessarily coincide with the allocation of "skills" (specificity and hardness-to-be-monitored). Therefore, control must separate itself from ownership and institutions are needed to sustain this separation; alternative institutions arranged in "property-rights systems" or, as they are now called, "corporate governance systems", can achieve separation in different ways and with different effects on the allocation of rights (as well as on the content of such rights). A diversity of corporations arise as was made clear in the previous section. As a result of that, institutional shocks can permanently move the system from one corporate governance to another, from one kind of corporation to another, and also affect the allocation of rights.

While point (i) is well known we need to consider the latter two issues in more detail.

Multiplicity of organisational equilibria. In some ways, different given systems of property rights have an effect similar to different systems of in relative prices. A change in the property right system increases the agency costs of using the non-owning factors relatively to those of the owning factors. Thus, similarly to changes in relative prices, changes in property rights have a substitution effect: the high-agency-cost resources of the non-owning individuals tend to be substituted away; for this reason non-owning factors tend to become low-agency-cost resources. Or, in other words, they tend to become less firm-specific and more difficult-to-monitor than owning factors. Thus, the effects of property rights on the technological specification of the resources that has been typically advanced by "Radical economists" can be explained by a substitution effect

similar to that determining input composition in standard microeconomic theory.

The relationships considered by much New Institutional and New Property Rights economists can be inverted on the lines suggested by the Radical economists[9]. According to the former the ownership of the firms is to be given to the factors which involve the highest agency costs, that is to the most difficult to monitor and specific factors. However, as "radical economists" have suggested, it can also be argued that owning factors will tend to save on these agency costs and, because of a standard substitution mechanism, will tend to become relatively more specific and difficult to monitor. Thus, according to the radical mechanism, owning factors tend to choose that technology under which, according to New Institutional theory, their ownership is to preferred. In this way, initial ownership conditions tend to sustain themselves via the technology that it is optimal to sustain under those conditions. This self-reinforcing mechanism is consistent with the idea that initial property rights shocks such as those due to the American occupation could in principle have had a lasting effect.

Indeed, the two mechanisms considered above are not mutually exclusive and can be joined together since causation may flow in both directions at once: while technology influences the allocation of property rights ownership influences the choice of the technology. This two way causation can generate multiple "organisational equilibria"[10] and major institutional shocks, such as the American occupation, may move the economy from one organisational equilibrium to the other.

An "organisational equilibrium" can be defined as any combination of property rights and technology which has the following characteristics. With the given property rights, the current technology is the most efficient available; conversely, with this technology, the current property rights are most efficient. In such an equilibrium, property rights and technology have a self-reinforcing character since changing one component at a time damages

efficiency, and hence reduces the total income available for distribution between the various parties.

Can competition imply that, independently of initial conditions given by the history of the economy, the market selects the most efficient organisational equilibrium?

While this is a possible outcome, we argue that effects of market selection may turn out to be rather ambiguous. Indeed, there are some circumstances in which competition may help stabilising instead of upsetting an inefficient organisational equilibrium.

The complementarity between property rights and technology, characterising an organisational equilibrium, inhibits the possibility of a gradual evolution from one equilibrium to another; the inferiority of hybrids implies that the transition from one type of equilibrium to another is likely to be abrupt and that evolution will have a punctuated character[11]. The inferiority of hybrids also implies that competition may have a negative effect wiping out the necessarily inferior hybrids before they may transform themselves into superior organisational equilibria.

In some respects the role of market selection is analogous to that of natural selection. While it favours the selection of the best members of a given species of organisations, it may inhibit the speciation of new organisational arrangements. This analogy is reinforced by the observation that in natural history the efficiency of each species depends on its frequency. Also "organisational species" share the same characteristic. Network externalities in property rights and in technologies may imply that few firms characterised by different organisational equilibria are not viable: they would be out competed by firms that, even if inferior when they exist with the same frequency, can better benefit from network externalities because of their present large number.

In other words, the successful speciation of new organisational equilibria does not only require that each firm deals successfully

with the complementarities between its own rights and technology. Because of network externalities there are also important complementarities among the organisational models adopted by different firms.

The existence of network externalities can cause a homogenisation of technology[12]. A single technological standard may be the only possible equilibrium outcome when common inputs produced under a regime involving economies to scale are used by all the firms.

Although the case of property rights has not received the same attention, network externalities can also cause the homogenisation of ownership systems. For all the firms using the same system of property rights, some pieces of legislation and the skills, that are necessary to its application and enforcement, are common inputs produced and used under a system of pronounced economies to scale. A piece of legislation can be used an infinite number of times without being destroyed. The same type of legal expertise by the same law firms can be used, enjoying the advantages of increasing returns by all the firms using the same property right system. The enforcement of contracts by courts is very likely to be more predictable and precise for the firms using the most widespread property right system. Finally, customary law requires that a custom is well established and this is more likely to happen within the framework of the property right system used by the majority of firms.

The complementarity between technology and property rights that is encompassed by the concept of organisational equilibria implies that network externalities can act indirectly on property rights via technology and also indirectly on technology via property rights. Network externalities among firms' technologies may also imply the homogenisation of property rights. Vice versa, network externalities among the ownership system may also imply the standardisation of technologies. When these complementarities between technological and property rights standards exist, the speciation of few alternative organisational models may become very difficult where the

competition of the old species of organisational equilibria is very strong.

The two way causation flowing between technology and property rights imply that institutional shocks, such as occurred during the American occupation, may have lasting consequences on economic systems. Moreover the complementarity between rights and technology at both intra-firm and inter-firm level imply that a strong competitive pressure may stabilise rather than upset inefficient "organisational species". Thus, at least in principle, we should not be surprised if the speciation of new successful species of organisation could occur as a result of a political decision in an environment relatively protected by the pressure of competitive forces while the creative activity of competitive markets could lag behind this organisational innovation.

The separation between ownership and control. If it were the case that control could be achieved only through ownership the "second best" solution invoked by the New Institutional framework would be achieved only insofar as skills, as previously defined, and wealth happened to be allocated in the same way among individuals. While such coincidence might indeed occur, especially as the result of both skills and wealth being transferred from one generation to the next in closed family groups, it will certainly not be the rule. Arrangements have then developed in all developed societies whereby ownership of financial resources is partly or fully substituted as a means to exert control and entrepreneurs can collect debt capital or raise shares and still retain control. It can indeed be argued that only thanks to such arrangements and the separation between ownership and control that they have allowed has economic development achieved the extraordinary results of this century.

To allow separation, a fundamental conflict of interest has to be somehow resolved between investors - banks or shareholders - and entrepreneurs holding control. Devices must exist which protect investors from their failure to finance the right entrepreneur and from the latter's capacity to "abuse" of his power control: abuses

might include the entrepreneur's enhancing his own non-monetary benefits which cannot be appropriated by investors, his acting in the interest of other concerns that he directly owns, or his embezzling funds. In a world of incomplete contracts these problems cannot be addressed by writing contracts where all wrongful doing is ruled out. In the same way, since investors must not prevent marginal deviation of entrepreneurs' behaviour from good practice but must prevent major diversion of funds, mechanisms making entrepreneurs' income in some way linked to the market value of the funds they manage can have only very limited effects[13]. Investors must then be granted the power to monitor control. But, whatever the monitoring devices are, since the incompleteness of information will make signals of mistakes and abuses very noisy, monitored entrepreneurs can be punished (and lose control) when no mistakes or abuses have been committed. Alternatively, they may go free when interference would have been justified.

A trade-off thus arises between certainty of control and the protection of investors. The harder it is for investors to interfere with control, the more deterred are they from financing and the more difficult it is to ensure that an efficient allocation of control comes about. On the other hand, the easier it is to interfere with control, the less effective control is as a means to enhance investments and innovation by entrepreneurs: they will no longer be guaranteed unconditional use of company's assets and reduce their irreversible investments in human capital which depend on that use. A further, "multiplicative negative effect" can be produced by high interference through behaviour of lower rank managers: the more likely it is that investors' monitoring results in hostile changes of control, the more uncertain managers will about their prospects of climbing the firm's ladder through the working of the "internal market"; that in its turn will result in them underinvesting.

The many alternative institutions which have developed to address the trade off we have now sketched can be grouped in the following six categories:

a) inside monitoring through membership of the board or other corporate organs (this may be exercised directly by the non-controlling owners, or delegated to outsiders or to financial institutions with holdings in the firms);
b) *ex post* outside monitoring by courts through shareholders' suits in order to obtain redress for breach of trust by entrepreneurs (or by the board which should monitor them);
c) market, or the threat of exit, such as the chance for non-controlling shareholders to transfer ownership and control to third parties, even without the entrepreneur's consent, if the former feel that the latter has misused or abused his or her powers;
d) monitoring through the political market, by nationalising firms and entrusting supervisory power to Parliamentary or Governmental bodies;
e) relations of trust between entrepreneur and owners that ensure the former's cooperation with the latter.
f) contractual means such as pacts among shareholders, statutory provisos and pyramidal groups - whereby the voting rights of non-controlling shareholders are spread out over a large number of firms while those of the entrepreneur are concentrated in the company at the top of the pyramid - which, while not providing any monitoring tools to investors, offers some shareholders a way to enforce control.

Two rather distinct roles can be played by inter-firm share-holdings. They correspond to the two opposite ownership structures discussed in section 3. In the case of pyramidal groups ownership links, by dispersing non-controlling shareholders voting rights, allow the controlling shareholder to expand the allocation of control well beyond his or her personal means. In Italy, where this system has been exploited furthest, for the average of existing pyramidal groups with at least one listed company and controlled by one shareholder or a set of family shareholders, entrepreneur's share capital is about 12-13 per cent of total group's capital (about 5 per cent for Fiat). Alternatively, inter-firm shareholding, when it does not amount to the control of one firm on another, as well as providing a link among firms for strategic interaction, might help to consolidate managers' control: very intense cross-shareholdings among firms, either

directly, or through "intermediate firms", can in fact allow managers with no or little shares to disperse shares and to sustain each other. This is the case of Japan, but an example of this system is also provided in the U.S. system by private pension funds of two firms investing in each other's shares.

Which of these several corporate governance devices prevail affects directly the allocation of control by making more or less binding the existing allocation of wealth. It also affects the ways in which transfers of control take place and the multiplicative effect on the incentive to invest of all managers. Let's consider the three cases when monitoring relies on exit or courts - b, c - is exercised "internally" by a financial institution - a - or is entrusted to family relations. In the first case, the market for managers is mostly an outsiders' market: internal careers are highly risky and long term commitment is discouraged, but higher chances exist for newcomers to step in. In the second case the reverse occurs: internal managers can rely on the firm's leading financial institution to preside over changes of control and make sure that the best of them get selected. More controversial is the third case: the internal market can be effective, but the prospect of managers can easily be put at risk by conflicting interests of the heirs.

The corporate governance systems prevailing at a given time in history in each countries can be interpreted as a combination of the different existing devices. In understanding why a particular mix prevails in a country at a given time one should very much rely on the self-reinforcing mechanisms that explain the multiplicity of organisational equilibria. Once a corporate governance system prevails, the successful speciation of a new device is prevented by the high risks and costs that any individual entrepreneur runs in presenting investors with a new institutional "package" and any individual investor runs in accepting it. The existence of very strong network externalities makes it extremely expensive for any group of investors or entrepreneurs to experiment with new, privately developed legal devices. The compulsory change of existing ownership structure or the reform of corporate law, stock market

regulation or bank-industry relations, whether due to endogenously developed social changes or to exogenous military rule, can then bring about deep and possibly irreversible changes in the way control allocation is transferred.

4. The Historical Roots of Japanese Corporate Governance

In Japan today, there are six large corporate groups, called *keiretsu*. They are Mitsubishi, Mitsui, Sumitomo, Fuyo (Fuji), Sanwa, and Daiichi-Kangin (DK). Though their relative weight has been declining in recent years, their core members alone still account for about 15% of total assets, total sales and total profits of the Japanese economy's non-financial sector. If we include the financial sector and add lesser members and subsidiaries, their total share would perhaps reach as high as a quarter of the entire Japanese economy.

Each *keiretsu* is clustered around a main bank, extended over the whole industry, and connected through intricate cross-shareholdings. Table 1 exhibits the matrix of shareholdings among 20 corporations which constitute the core members of the Sumitomo group (that is, the member corporations of the prestigious President Club, "Hakusui-kai") in 1995. What is remarkable about this matrix (and similar matrices for other *keiretsu* groups) is that the network of cross-shareholdings is so tight-knit that it has few vacant cells. One exception is the row for Sumitomo Life Insurance which is after all a mutual company issuing no shares, and another exception is the column for Sumitomo Light Metals which is essentially a subsidiary of Sumitomo Metals.

Now, the three largest *keiretsu* groups, Mitsubishi, Mitsui and Sumitomo, are the descendants of the three largest *zaibatsu* of the pre-war period, and at least a part of Fuyo group can also be traced back to the fourth largest *zaibatsu*, Yasuda. In contrast to their post-war descendants, each *zaibatsu* had a pyramidal ownership structure, with the founder family residing at its top and a holding corporation functioning as its head-quarters. The family members were in general the exclusive owners of the holding corporation which in turn owned

a large proportion of each of the dozen or so core corporations, distributed over a wide range of both financial and industrial sectors of the economy. Furthermore, these core corporations often held each other's shares and had several affiliates and many subsidiaries under themselves. Table 2 exhibits the top three layers of the pyramidal ownership structure of Sumitomo *zaibatsu* in 1937, the year when its holding corporation was reorganized into a joint stock corporation. A number in parenthesis beneath each of the core corporations stands for the percentage of its shares held by Sumitomo insiders, i.e., Sumitomo family, Sumitomo holding corporation, its directors, and other Sumitomo corporations. To get a finer picture, Table 3 displays its decomposition for five selected core corporations.

Zaibatsu in pre-war Japan and *keiretsu* in post-war Japan are two organizational sub-species, which are, as we have just seen, separated by a deep structural discontinuity. In the next section, we will provide a detailed account of "institutional shocks" which destroyed the old *zaibatsu* structure and created (in one stroke) the *keiretsu* structure as a new organizational sub-species. It was certainly a revolution from above. Yet, no revolution can sustain itself for long, unless it has tapped the undercurrent of the society at large. There is always a continuity even within a discontinuous change. The purpose of this section is to trace out such continuity in the history of the Japanese economy.

There is much resemblance between the pyramidal ownership structure of pre-war Japanese *zaibatsu* and that of contemporary Italian family empires and coalitions. In theory, therefore, the *zaibatsu* family could have used this hierarchical ownership structure to exercise a monolithic control over the management of the entire group corporations. In reality, however, their control was very much circumscribed. Indeed, it may be more true to say that one of the distinctive features of Japanese *zaibatsu*, when compared with family-owned conglomerates in other parts of the world, was their strong propensity to separate management from ownership in the group as a whole as well as in each of the member corporations. At least three reasons can be given for this.

The first, and perhaps the most important, reason was a peculiarity of the traditional family (*Ie*) system in Japan.

Zaibatsu originated from a family firm. For instance, the Mitsui and the Sumitomo were two of the most powerful merchant families in Tokugawa Japan. But in the tradition of Japanese family system the whole emphasis was placed on the perpetuation of the family itself, or more appropriately the perpetuation of the family "name" (*Kamei*), rather than the continuity of blood lineage.[14] It was true that the eldest son normally succeeded his father as the family head (*Toshu*), but it would not be right to say that he inherited the family property in the usual sense of the word. What the eldest son inherited was only the nominal headship of the family. The family property belonged to the family itself, not to individual family members, and even the family head was not free to use it, as was epitomized by *Oomotokata* system of the Mitsui family.[15]

It was natural that under such a restricted property right system ownership tended to dissociate from active management. These pre-modern merchant families indeed developed a sort of governance system, in which actual power of management was delegated to experienced and loyal *banto* and the role of the family head was consigned to the formal authority to legitimize their power. *Banto* usually began their careers as living-in employees at very early ages, climbed up an internal promotion ladder, and joined the management team after 20 to 25 years service. They were treated as quasi-members of the family and very loyal to it. But, the important point was, their allegiance was pledged against the family itself, and not against any of the family members. In fact, it was a common practice in many merchant families that the family head judged improvident was, at the initiative of loyal *banto* and in the name of the family, forced to retire with a pension, and in his stead a bright son of a distant relative or more often a promising young employee, even if he had no blood relationship, was adopted as the family head.[16] The story we gave in section 2 that *banto* Hirose solved the succession crisis of the Sumitomo *zaibatsu* by literally handpicking a new family head clearly followed this tradition.

In fact, the tradition of *banto* hegemony was maintained and even strengthened after the Meiji restoration when these old merchant families had to cope with the new government's modernization programs. It is true that in the case of the Iwasaki (the family name of Mitsubishi) and the Yasuda their business activities started only after the Meiji restoration and fully under the control of their founding fathers. But, as generations altered, even their governance system began to imitate that of the older merchant families.

The second reason for the prevalence of the separation of ownership and control in pre-war *zaibatsu* groups was not peculiar to Japan, and we have already referred to it in section 2.

During World War I and immediately after the Japanese economy went through a period of rapid industrialization in steel, shipbuilding, machinery and chemical products. It was during that period that *zaibatsu* became truly *zaibatsu* and were able to build up their large industrial empires on the stronghold of their own commercial banks and trust banks which gave them easy access to money and capital. But it was this process of heavy industrialization that also planted seeds for their future difficulties.

First, the heavy industrialization required skilled workers at factories and professional managers at head offices. Since the markets for skilled workers and professional managers were very much underdeveloped, most of *zaibatsu* corporations had to hire workers fresh out of school and managers fresh out of colleges and train them internally on the job. This produced proto-type internal labor markets and internal promotion systems, for which the post-war Japanese economy is so well-known. Then, those core workers and salaried managers, who worked for the same corporation for a long period and accumulated organization-specific skills and expertise, began to identify themselves as "insiders" of the corporation and become its stakeholders.

Second, the unabated advance of heavy industrialization demanded ever larger investments on fixed capital. Towards the end of the

1930s, even *zaibatsu* could no longer finance their own capital requirement internally and began to offer part of the shares of their core corporations to the public. Indeed, as was remarked in section 2, in the early 1940s the lack of funds became so acute that most *zaibatsu* (with an exception of Yasuda) had to open up even their holding corporations to the general public, albeit very reluctantly.

These two developments promoted the move towards a separation of ownership and management from within.

The third reason was once again peculiar to Japan, this time to her sad history.[17]

Japan fought World War II, and the war-time government decided to impose a centralized control on her private sector so that her productive resources could be fully mobilized for military uses. In order to implement such a mobilization plan, the government sought to restrict the rights of shareholders by setting an upper limit (8%) on dividend ratio, requiring the governmental approval of the appointment of the president of corporations producing war supplies and freeing some of the management decisions related to military matters from the necessity of shareholders' approval. This was a separation of ownership and management from above.

The war-time government also reorganized the financial market. It divided war-related corporations into a dozen or so groups and assigned to each group a single bank as the main and responsible supplier of their loan demands. Such forced clustering of corporations around a government-designated bank is said to have marked the beginning of non-*zaibatsu* corporate groups, such as Fuyo, Sanwa and Daiichi-Kangin.

When Japan was defeated in WWII, there had already been a strong bent towards the separation of ownership and management within each of the *zaibatsu* groups and within each of the *zaibatsu* corporations. It was this undercurrent that would be tapped by the post-war Japanese economy. Yet, it is wrong to emphasize the

continuity between prewar Japan and postwar Japan too much. The corporate system in prewar Japan was not yet the "Japanese" corporate system, as we now understand it. The pre-war *zaibatsu* were still family-owned conglomerates par excellence. In spite of the strong bent towards the separation of ownership and management, the *zaibatsu* families fought hard to preserve their closed ownership. The birth of the truly "Japanese" corporate system needed sudden and large institutional shocks which would destroy the old structure of *zaibatsu* completely.

5. The American "Anti-Capitalist" Revolution in Japan

In December 1947 in a speech in the US Congress Senator William F. Knowland commented on the document drawn up by the State Department economists. The document was known as FEC (Far Eastern Commission) 230 :

"If some of the doctrine set forth in FEC 230 had been proposed by the government of the U.S.S.R. or even by the Labour government of Great Britain, I could have understood it"(Livingstone et al., 1976b, p. 113). What Senator Knowland found hard to believe, and it is for many people even harder to believe now, was that the *Americans* had been carrying out those policies.

The nature of American policy in Japan was also perceived with dismay also by the magazine Newsweek which in the December 1947 issue criticised the "revolutionary" policies of SCAP (Supreme Commander for the Allied Powers). According to the American magazine, SCAP proposed to create in Japan what it termed a "democratic economy". *Newsweek* observeds that no definition for such a term has been given in writing "but, whatever that term may mean, in this instance it is proposed to distribute the wealth of Japan to the workers, farmers, and small traders through the medium of taxes, sales of valuable properties at nominal values, financial assistance, regimentation, and regulation..." (Livingstone et al., 1976b, p. 107)

According to *Newsweek* the tough reforms introduced by SCAP were likely to cause the collapse of the Japanese economy. In particular the magazine criticised the Labour Standard Law, approved in April 1947: impoverished Japan could not afford the same labour standards enjoyed by American workers. Moreover, according to the American magazine Japanese labour contracts often went well beyond American standards:

"Many labour contracts go far beyond such agreements in this country. The agreement between the Japanese company in which a well-known American company had a controlling interest and the company union, in addition to the usual provisions for a closed shop, hours rights of dismissal, cost of living, wages etc. states that part of the profits (not stating which part) shall be paid to the union, and the election and removal of directors, inspectors, and advisers of the company may be accomplished only after consulting the union"(Livingstone et al., 1976b, p. 108).[18]

The article on Newsweek was written at a time when, because of the beginning of the confrontation with the Soviet Union, a U-turn in SCAP policies was about to take place. Indeed the U-turn was already hinted at by General MacArthur's decision to forbid a general strike in February 1947. However, in spite of the policy change that marks the last years of the American occupation, its overall revolutionary impact is very considerable especially when we compare it to the conservative approach followed in Italy during the same years.

Before the U-turn, American policies were inspired by the idea that only a "democratic" economy could favour the conditions for the development of a peaceful and democratic society. The hierarchical *zaibatsu* structure was considered to be the ultimate cause of Japanese militarism - an analysis that had no counterpart in the explanation of the causes of the rise (and, indeed, the "invention") of fascism in Italy. The American project of a "democratic" economy involved the dissolution of the *zaibatsu* and a dispersion of stock to individuals that would have prevented any undesirable

concentration of economic power. It is quite interesting that this limitation of economic power did not only involve a widespread ownership of securities but also some inside ownership especially by employees that would have made possible a control of the top management authority.

The dissolution of the *zaibatsu* companies was achieved by transferring 50 percent of the stock of the *zaibatsu* companies to the Holding Company Liquidation Commission (HCLC), a quasi-government agency. The financial and operational decisions of the companies were restricted by government in ways similar to those of state-owned firms. Thus, during postwar Japan, a huge sector of quasi-state-owned firms was created and SCAP had to pioneer a privatisation problem similar to that which is now still faced in the ex-socialist countries and Italy. Moreover, during the war years of quasi-state-owned companies, insider control prevailed in ways similar to those that can be found in their contemporary Italian and eastern counterparts.

The economic purge and the elimination of *zaibatsu* created the conditions for a managerial revolution from above: with only four exceptions, the new managers were promoted from within their companies (often with the agreement of the labour unions). In one stroke, this revolution created a promotion mechanism that was isolated not only from the succession problems typical of "family capitalism" but also from the interferences of the "outside directors" that in Anglo-American world represent the interests of large shareholders. The war, the purge and quasi-state ownership had greatly reinforced the rights of the insiders and had, in that way, created the conditions for a "pure" internal promotion system that was substantially different from the mechanisms by which control rights were transferred either under family capitalism or in the Anglo-American corporations.

The smooth and fast liquidation of the stock that had been transferred to HCLC did not involve the creation of any mechanism by which the internal promotion system could be monitored.

Following the intentions of SCAP, ownership became very dispersed and each individual share holder became too small to exercise any outside control on management. At the same time, it was impossible to rely on the inside control of the workers-share holders. Even if the 27 percent of whole disposed stock was bought by employees, it was heavily sold by them after the market collapse in August 1949. "On average, only the 50 per cent of employees who bought their companies' stocks from January 1948 to June 1949 continued to hold their stock for more than two years" (Livingstone et al, 1976b, p. 381).

According to the Americans, the classic agency problem of controlling management in a situation of dispersed individual share ownership was to be solved not only by employee ownership but also by the "classic" means of equity finance and markets for corporate control. By contrast, while job tenure and internal promotion system were retained, a drastically different system of corporate governance emerged: cross share-holding, debt *(keiretsu)* financing, and a main-bank-delegated monitoring system were going to be the key ingredients of Japan's post-war financial institutions.

Cross share holding was explicitly outlawed by the Anti-Trust Law enacted in 1947. Moreover in same year the separation between banking and industrial concerns, modelled after the Glass Seagall Act in the United States, was introduced in Japan: the Securities Trade Act prohibited banks from underwriting holding and dealing in corporate securities.

The stock market collapse happened in 1949. By that time, rebuilding quickly a stable anti-communist Japan had become far more important for the Americans than the implementation of the ideal institutions of their model of a "democratic economy". Companies faced a liquidity crisis and the threat of take over mechanism that was especially effective for the ex-*zaibatsu* companies whose stock was heavily liquidated. The stock market crash, occurring within the legal framework introduced by the

Americans in 1947, was the first substantial threat to the pure internal promotion system characterising the Japanese companies.

The internal promotion system had emerged from a long experience of insider control. Insider control had, de facto, existed during the war and that, in spite of the interferences of family capitalism, had also been substantially present in the *zaibatsu* experience. Under this system not only high and lower rank managers but also many workers had accumulated much irreversible human capital investments that (through the negative multiplicative effects considered in section 3) were also under threat. The policies of the Americans had democratised the *zaibatsu* company and extended the incentive to invest in high-agency-cost human capital to many members of the company. Perhaps for the first time in their life time, managers and workers were risking to go through the uncertain consequences of a take-over from outsiders who were not bound by any form of "implicit" contract concerning their firm-specific assets.

For the Americans, upsetting the stability of the micro relation at firm level was made even more dangerous by the fact that in the same period, they were engaged in a "macro confrontation" with the central unions that they believed to be a dangerous congregation of potential enemies sympathetic to the new Soviet enemy. Thus, if the legal framework introduced in 1947 implied a very considerable danger for insiders' control, their reaction was to try to make ineffective and eventually change that legal framework. At the same time, the Americans were too concerned with the stability and the recovery of Japan to impose the full consequences of the governance system that they had set up. It is not surprising that insiders were going to be successful.

Faced with the stock exchange crises and the risk of take-overs managers tried to maintain their stock price by operations similar to "company buyout" even if that was not allowed under Japanese law. While the Americans were mildly upset by this "illegal" action, the Japanese government suggested various ways to maintain equity prices. The sale of the remaining *zaibatsu* stock by public tender

was postponed and, in the process for maintaining stock prices, shareholding by institutions such as the insurance companies was not only permitted but also encouraged. Under some conditions banks were also allowed to hold shares and the 1947 prohibition against industrial companies share holding was lifted. Cross share holding became possible and it helped to stabilise the power of top management against the risk of take over. In this way also the managerial revolution from above and its internal promotion system were protected from the threat of take-overs by unknown outsiders. Cross shareholding, that in Italy had marked the extension of the hierarchical control on managers by family capitalism, was used in Japan to guarantee its autonomy from shareholders.

Cross share holding made possible the reconstruction of a managerial version of the *zaibatsu* companies (the *keiretsu*) within which the role of the former *zaibatsu banks* became very important. Banks provided a way of solving the problems arising from the separation between ownership and control (see section 5) that, while safeguarding the interests of the individuals providing financial wealth, did not upset the internal promotion governance system and its great potential for accumulating high-agency-cost human capital.

The banking system that emerged was going to be known as the main bank system. It involved the syndication of loans and the delegation of monitoring to a single bank that, in many cases, was going to be the bank of the *keiretsu* that had emerged from the cross share holding of the companies of the former *zaibatsu* company. In other words, the main bank system allowed risk diversification without "diluting" the monitoring activity among many banks.

The historical origins of the main bank system can be traced to syndicate loans that during the war were formed to finance and monitor the risky business of the munitions companies in the late 1940s. Since its formation, the major participants - the main bank other core banks, the bankers association, government authorities and the borrowing firms - "have shown dynamic flexibility as power has shifted among them". "In each period, syndication was made

effective by the leadership with the highest bargaining power among them" (Horiuchi, 1984 p.292). Thus leadership was initially taken by the Bank of Japan and, later, in the 1950s and later the Industrial Bank of Japan (IBJ) and the bankers association. MITI had also an important influence on large heavy and chemical industry firms. More recently, by the early 1980s the initiative had passed from lenders to borrowers and many large firms have taken banks' willingness to lend for granted. As a result, as has been shown most dramatically in the bubble of the late 1980s and its aftermath, "the main bank system as a social device for corporate monitoring appears to be under severe test" (Aoki 1984 p. 137).

In spite of the difficulties of the system any reversal to an "Anglo-American" system of corporate governance seems to be very unlikely because "a quantum leap to the securities-based decentralised financial system, particularly the establishment of an active market for control, may be incompatible with other institutional features of the Japanese economy" (Aoki p. 138). A development of a market for corporate control, particularly by hostile take-over, is not compatible with the implicit contracts between workers and managers that involve job security and internal promotion in exchange for difficult-to-monitor effort and human capital specific investments.

The implicit contracts characterising the Japanese firm imply a "truncation" of the rights of share holders. Job security involves that the owners of the physical assets do not have the right to employ the assets of the firm without the managers and workers of the firm - a right that is well likely to be exercised in the case of hostile take-overs. In other words, the Japanese blend of capitalism has involved the "unbundling" and the redistribution of a right on physical assets that belongs to share holders under both family and securities based governance systems. The interaction between the rights of Japanese employees and the accumulation of their high-agency-cost human capital has produced one of the multiple self-reinforcing organisational equilibria considered in section 3. Thus, the transfer of rights from "outsiders" to "insiders", that is associated to a

securities-based decentralised financial system, may well be incompatible with the technology developed under the Japanese post-war institutions of production.

By contrast, the main bank system has been compatible with the system of employee's rights that has characterised post-war Japan. The main bank integrated "ex-ante", "interim" and "ex-post" monitoring that in a securities based market are performed by different agents. This allowed a contingent governance structure under which the bank intervened, having accumulated "inside information", only in cases of financial distress. Thus, the bank did not interfere with the internal promotion system when it was delivering good results. Moreover it did not upset the principles of the internal promotion system when intervention was necessary. The bank could act selectively rewarding and punishing employees on the basis of the "inside" information accumulated thanks to its "ex-ante" and "interim" monitoring activity. In other words, the main bank contributed actively to the exercise of rights that underlined the implicit contracts characterising Japanese firms.

The speciation of the Japanese model was due to complementary changes in rights technology and financial institutions that occurred in a period of strong institutional shocks. Any reform of the system should take into account the complementarities characterising this new species that has been so effective for the development of the country. Otherwise, the emergence of inferior hybrids may block the virtuous interaction between rights and technology that has characterised the post-war Japanese system.

6. Changes of Italian Corporate Governance Between the Two World Wars

Italy is a typical late comer, industrialising only at the end of the nineteenth century, but the process remained for decades fragile and not put on truly solid foundations until after World War II.

The country was traditionally marked by shortage of capital (absence of primitive accumulation), scarcity of raw materials and the lack of a large market (due to the historical division into small, independent states)[19]. The model of development that emerged in the closing decades of the nineteenth century was centred on heavy industries, sustained by public procurement and protected by high tariff barriers[20]. Moreover, Italy lacked a "specific industrialization ideology"[21] - be it the French myth of the firm or the ideal of building a new society as in the Soviet Union, to forge a mass consensus for the industrialization drive.

In the absence of these factors, during the first phase of industrialization beginning in 1895, the substitutes were the "mixed banks", some founded with German capital (e.g. Banca Commerciale Italiana and Credito Italiano). These financial institutions operated through a *mix* of credit relations and equity subscription. In the framework proposed by Gerschenkron, in Italy the mixed bank acted at first as a *substitute agent* to overcome the scanty primitive accumulation of capital, and later as the channel by which diffuse, fragmented savings that the holders had no intention of putting into illiquid form could be funnelled into equity that would have had a great deal of difficulty finding buyers in the stock exchange[22].

It was during the 1920s that this "bank-based corporate governance" degenerated due to a progressive erasure of the separation of interests between banks and large industrial corporations, combined with the weakness of the "rear echelons", i.e. the lack of a credible reserve of small and medium-sized businesses. In addition to sustaining growth, then, the large banks also acted as coordinators, seeing to the placement of new share issues (often enough, with the usual small circle of customers)[23]. Corporate crises were regularly dealt with and resolved by the banks themselves; if a crisis was too large to be handled by a single bank, a rescue consortium of very large dimensions would be formed[24].

The natural corollary to the prevalence of debt capital was the failure of the stock market to take off[25]. Following the turn of the century it was the mixed banks themselves that sponsored the development of the stock market, with a view to making their equity shares more liquid and more easily disposable.

With an inadequate stock market and stable, non-competitive relations between banks and industry, between 1900 and 1913 the groundwork was laid for an intensive concentration of control and the formation of "corporate pyramidal groups, based on family control". However, it was only following the enormous profits deriving from military production (in steel, shipbuilding, mechanical engineering and chemicals) that the relationship between banks and enterprises degenerated irretrievably; the main Italian banks acquired significant equity stakes in many industrial sectors and so from a "German-style" they moved toward a "Japanese-style" of banking. Public procurement orders and massive profits restored corporate finances to health and powerfully spurred further concentration, especially by mergers and buyouts. In these years, the power relations between banks and industrial corporations were inverted, and industrial pyramidal groups now made take-over bids for the leading banks, although unsuccessfully.

The stock market crash of 1929 thus hit the Italian financial system in a moment of pronounced industrial and financial concentration. The intermingling of credit and industrial capital and the underdevelopment of the stock market, but above all the creation of corporate groups based on cross-shareholding, made the crisis particularly acute, hindering adjustment and fostering the domino effect. The crisis struck huge industrial-banking colossi, and the organisation into pyramidal groups amplified the repercussions of the plunge in share prices. The leading banks found it simply impossible to liquidate their assets, which consisted primarily in equity holdings in the crisis-torn industrial groups. This paved the way for the most sweeping reallocation of ownership in the history of Italy, and above all "for the State to assume the central function within Italian capitalism" that it had refused at the turn of the

century. State ownership became a new device to ensure full separation between ownership and control and to enable a group of talented managers to acquire control over industrial and service firms.

The government decided to refinance the troubled banks by buying out their industrial holdings and transferring them to a new agency created especially for this purpose in 1933: the Institute for Industrial Reconstruction (IRI). Constituted as a holding company and as a corporation under private law, IRI took over the entire equity capital of the mixed banks, hence more than 21 per cent of all the equity capital of limited companies existing in Italy at the time[26].

Meanwhile, industrial concentration had increased notably, and in 1936 fewer than 1 per cent of all Italian limited companies accounted for half the total share capital[27].

The creation of IRI was accompanied by the fundamental Banking Law of 1936, which prohibited banks from holding equity participations in industrial companies and required maturity specialization in their credit business, assigning short-term credit business to ordinary banks and medium and long-term credit to special credit institutions. Thus the German-style mixed bank vanished from the scene. But the Italian solution, unlike the American case[28], was not intended to relaunch the stock market as a means for attaining a broader ownership base and more diffuse corporate control; the dominant logic continued to see the banks as the linchpin of industrial finance.

IRI, on May 6, 1937, was transformed into a permanent institution. The decision not to reprivatize the companies acquired was due in part to the fascist regime's desire to use public corporations as an instrument of industrial policy, but primarily it was due to difficulty in finding private buyers for so many public firms[29]. In short, unlike that found in other countries, the system of Italian public enterprise was not the result of a deliberate policy of nationalization but the by-product of a corporate salvage operation.

For the Italian economy, the crisis of the 1930s thus represents a truly structural divide, with an outright transformation of the model of corporate governance taking place between 1930 and 1936. With the direct, massive intervention of the State, Italy moved from an ownership pattern based on the corporate family group and mixed banks (similar in some ways to the German model) to one centred on the corporate group but subdivided into state owned and private groups controlled by families. A characteristic feature of the Anglo-American model of corporate control was introduced, namely separation of banking and industry. The bank as controller, mandated to oversee the rehabilitation and restructuring of firms in crisis, disappeared. The resulting vacuum was partly filled by the state holding company, which was repeatedly required to take over companies in financial distress. Due to the lack of other institutions that could have taken over the role played before by the mixed banks, the state provided relevant resources and direct ownership over an important section of the Italian economy.

7. Continuity and Change in the Italian Corporate Governance in the Postwar Period

The Italian model of corporate governance after the restructuring of 1933-36 was based on two major actors: family-controlled pyramidal groups and State-owned pyramidal groups. The end of the war and the liberation of the nation from fascism by the Allied forces and by Italian partisan units made up of communists, liberals and Catholics, the end of the monarchy and the institution of a republic, the drafting of the democratic Constitution and the formation of a coalition government involving all the forces that had taken part in the partisan Resistance did little to alter the institutional structure of Italian capitalism. Most of the negative aspects of the Italian corporate governance were perceived by the Economic Committee of the Constitutional Assembly, but no reforms were implemented.[30]

From 1943 till December 1947 the Anglo-American armies were a powerful actor in the Italian political scene. The British Prime

Minister, Churchill, since 1943 was preoccupied to defend and re-establish the "traditional ownership relationships in Italy". Churchill had been an admirer of Mussolini in the 1920s and still during the last years of the war believed that the key issue in Italy was to avoid a communist take-over[31]. In 1944 a civil war broke out in Greece between the communists and the monarchists and British troops were sent to fight against the "reds"; this reinforced the conservative approach within the Allies. Churchill was not interested at all in purging Italy from the fascist presence in the State, in economic life and in society at large, and considered the monarchy as the preferred institutional solution for the future Italian State. A military defeat of the fascist regime was enough. For several months the British government vetoed the first American recovery plans in support of the Italian industries[32].

The American point of view was quite different. The Americans refused to recognise the King as the only legitimate representative of the new Italy and rapidly established some relationships with the Partisan forces organized in the National Liberation Committee (CLN); and unilaterally, from September 1944, decided to distribute food and financial aid. In general however the Allied occupation forces tried to speed up the process of reconstruction, with the explicit goal of preventing social disorder and any possible left-wing insurrection. At the end of 1944 the CLN signed an agreement with the American general H.M. Wilson in Rome receiving some assistance in the struggle against the nazi-fascists in Northern Italy but accepting to dismantle their military organization as soon as the war was over and to be considered not as a real government but just as a military group[33]. For almost two years Italy was divided into two separate States: a monarchy in the South, under the Allied protection, and a residual fascist regime in the North, under German control. The bureaucracy of the Southern government was completely derived from the previous fascist regime. Even after the re-unification of the country the state apparatus was almost totally based on the fascist structure. The promised purging plans were never put into practice and a general amnesty (June 1946) for fascist crimes was passed by the new government[34]. For a few months in

1945 and 1946 there was some discussion of possible workers participation in firms' control but these proposals were never realized.

The invasion by the Anglo-American forces certainly enhanced a liberal rule in Italy. On the other hand, following the armed defence of the factories against the German invaders in several firms in North Italy, a first experience of workers participatory councils, fiercely opposed by the entrepreneurs, took place. The necessity of accelerating the process of reconstruction and the emergence of a new conflict - the cold war with the Soviet Union - induced, however, the Allies to support a quick return to the traditional system. Two other factors moved in the same direction: the view of the leading party emerging from the resistance, the Communist Party, that existing institutions should at first be retained in order to allow rapid Reconstruction; the positions - and the preferential links with the Americans - held by a small group of managers who had emerged in the State-owned companies and were now leading them[35].

As a result of these several factors State-owned companies were not dismantled, the family corporate groups were not reformed and no major reform was devised. After a very short phase of coalition government which included the Communist Party, in 1947 also due to the promises of American financial help through the "Marshall Plan", the Christian Democratic leader Alcide De Gasperi formed the first government excluding the left-wing parties (socialists and communists). Italy clearly went under the American influence: signed the Bretton Woods agreements (1947), received financial transfers under the European Recovery Program [36] (1948), and joined the NATO military alliance (1949). From May 1947 till February 1962 Italy was ruled by a series of government firmly centred on the Christian Democrats and liberal parties. During this "liberal" phase however little was done in terms of traditionally liberal reforms: no antitrust laws; no reform of the commercial code; no steps toward a more developed financial market.

In the absence of financial institutions exercising interim and *ex post* monitoring through equity or debt relations with firms, all of the large firms, organized as hierarchical groups, were kept under family control or under State control. The return to democracy with the rise of a new governing class formed largely in the opposition to fascism and the decisive option for European integration and for free trade permitted, however, the full unfolding of the development potential inherent in the model of corporate governance installed between 1933 and 1936.

But one can go further than that. It can be argued that in the first 10 to 15 years after the end of the war some features of the governance framework, in the contingent economic and cultural context, suited very rapid development. State control gave a new generation of managers, broadly untainted by involvement with the previous fascist regime (and in some case, known opponents of it), the chance to acquire control of large, emerging enterprises: a sense of mission linked to the post-war reconstruction climate helped to make up for the monitoring failures of the model, while many of the relevant strategic choices were clear-cut (providing the country with an adequate and stable supply of energy, developing and modernizing the steel industry to suit the needs of the engineering sector, building a highway system, etc.). At the same time, low wages due to an excess supply of labour allowed rapid growth in small and large family-controlled firms to be fuelled by abnormally high self-financing.

In the immediate aftermath of the war there was intense debate over the function of IRI, which at the end of 1945 controlled 216 companies with more than 135,000 employees. Some groups (liberals and Communists, though for different reasons), maintained that these public enterprises should be eliminated as a holdover from the fascist regime; according to others, the persistent backwardness of the economy made the privatisation of an enormous group like IRI simply impracticable. The representatives of the US government had also questioned the wisdom of retaining a public group created under fascism. In July 1944 Donato Menichella, one of the

designers of IRI back in 1933, had addressed a report to Captain Andrew Kamark, the representative for IRI of the Finance Sub-Commission of the Allied Control Commission. Menichella had argued that the public ownership of banks and industries did not reflect the fascist regime's bent for planning but had stemmed from the rescue of the banks, whose purpose was primarily to protect savers and depositors and safeguard the stability of the banking system as a whole[37]. The impossibility of finding capable hands to run IRI's banks and industrial firms through private ownership, Menichella maintained, had compelled the government to transform IRI into a permanent structure[38].

Over and above this historical judgement, the position that won the day, in the late forties, was that public enterprises were good tools for speeding up reconstruction[39]. State-owned enterprises were finally considered as a powerful tool to ensure a proper separation between ownership and control, probably one of the few tools available in a fast developing country without a real financial market. The structure of corporate governance in the state-owned industrial sector became one in which management exercises the power of control (i.e., of strategic design). The arrangement differed from the theory in that during this initial phase the oversight exercised by the political power structure was not stringent.

State-ownership enabled, in Italy, a separation between ownership and control that in the private sector was limited. A new generation of public managers was entitled of control of state enterprises. In the post war period, this entrepreneurial fluidity in the state-owned sector contrasted with the immobility in the private large firms. In the state-owned pyramidal groups the "residual right of control" seems to have been tightly in the hands of management. It was management, not the political tutors, that made the choice to focus the accumulation effort on rebuilding a modern industrial apparatus in steel, shipbuilding and engineering, and on major infrastructure (highways, the telephone network, etc.).[40] This institutional solution was all the more necessary in that in the absence of other models of corporate governance the only alternative source of finance for such

a project would have been bank credit; and the leading banks (Banca Commerciale and Credito Italiano) were closely connected to the interests of just a few large Italian and foreign industrial groups[41].

What explains the satisfactorory performance of the state-owned groups in these early years of the new Democracy? Three elements were in place from 1945 till the end of the 1950s: public managers were assigned to pursue relatively simple targets: reconstruct the economy and foster growth, build the basic transport and energy infrastructure and set the engineering sector on the solid ground of home steel production; public management shared common experiences and a mission often built through opposition to fascism; the ruling center-right parties were strongly competing with left-wing parties to prove that capitalism was capable of bringing about fast development[42].

All of these three conditions disappeared at the end of the 1950s. The market for political control failed: from 1945 to 1993 the government was uninterruptedly controlled by a series of alliances among an unchanging group of parties. The communist party was segregated to an often sterile opposition and failed to function as watchdog over the public enterprises; indeed there was often collusion between majority and opposition in this regard (for instance, most of the measures on behalf of the public enterprises, including subsidies, were approved unanimously in Parliament[43]).

An attempt to introduce some monitoring device in the management of the State-owned system was made in 1956 in the creation of the Ministry for State Shareholding to exercise political oversight of the IRI and the ENI groups. At the same time strategic target objectives were adopted to contest monopoly, to promote new industrial relations, to sustain employment and to foster the economic development of the South. By adding new goals to the original one any monitoring activity by the Ministry for State Shareholding became extremely difficult. So-called "social objectives" would always be called for as an excuse for bad results by public managers.

The development in the governance of large private corporations paralleled that of State-owned companies. After the war changes took place neither in the corporate law nor in the allocation of ownership of private corporations. The issue of reforming the corporate governance structure of the Italian industry was indeed at the centre of the economic and political debate in the first two years after the war, in particular in the Constitutional Assembly, but no reform was enacted. Available data on major Italian private corporations show that the pyramidal groups structure was indeed already used in 1947 but that it did not often allow for a great degree of separation between ownership and control (Table 4). Together with some likely expansion of such leverage and with the use of contractual tools (such as proxy votes entrusted to directors, multiple-votes share, ecc.) the financing of the rapid post-war growth of large private corporations was then provided by extraordinarily high profits and self-financing. That was in turn allowed by a rise of real wages much lower than productivity due to very uneven labour relations, weak unions, and high unemployment (in European-wide comparison).

This abnormal state of affairs came slowly to an end from the end of the 1950s, in the same years when State-owned companies were undergoing major changes. Tensions arose after 1958 in the labour market, wages rose very quickly and by 1962-63 the share of self-financing had drastically dropped; after a brief period of truce, tensions quickly resumed which kept profits relatively low till the early 1980s. A growing need arose then for external capital and that, in turn, underlined the failures of Italian corporate governance. It was not enough for relevant reforms to be enacted: some partial changes took place only in 1974 after long controversies. Pressure grew then for a much more intense use of pyramidal groups; new contractual means were introduced such as shareholders voting agreements; and a growing role came to be played by Mediobanca, a merchant bank founded in 1946[44], which, by devising financial plans and holding strategic shares in private companies allowed in many occasions founding families to mantain their control over them. It could be argued that Mediobanca has indeed come to play a

role very similar to that of Japan main banks, though it has mostly specialised in ex post monitoring, i.e. in devising rescue and restructuring plans once incumbent entrepreneurs had failed to deliver good economic results.

How intensely pyramidal groups have been used as a means to separate ownership and control comes out clearly from Table 4, where data for three major corporations, Fiat, Pirelli and Falck, in 1993 are reported. Recent research on the current ownership structure of Italian industry shows that in 1993 the average degree of leverage in Italy was about 8 for private non-banking holders of control[45].

The very relevant increase in groups' leverage has been achieved by lengthening the group structure and by diluting the capital held by the family or by companies in the high ranks of the group. This dilution has undoubtedly led to a relevant weakening of the group structure: in other words, family control is no longer unchecked, especially in those companies of the group which, by being closer to the core business, are clearly preferred by external shareholders. Let's consider table 4 where a comparison is presented for Fiat, Falck and Pirelli of the major shareholders of the "key companies" of the groups in 1947 and 1993. In 1947 only the Pirelli family had already no majority of votes in the key company Pirelli Spa: control was then exerted through the support of a set of well-established households, mostly from the same town (Milan) and cultural roots. In 1993 the founding families still control an extraordinarily high share of all those key companies, partly thanks to group branches above those companies (as in Fiat); but they are certainly not enough to exert stable control, nor is financial support any more provided by wealthy rentier-households.

A new ownership structure has then arisen in these companies made up of founding families, banks and insurance companies and industrial firms. The latter do indeed play a role in Pirelli and Falck through cross-shareholdings, which are reminiscent of the Japanese case. In Fiat the supporting role is played only by banks and

insurance companies, both through the holding of shares and through the threat of acting as "white knights" in case of takeovers. In such a company a tripolar equilibrium has probably arisen by which control is exerted through some agreement or compromise between the founding family, the top manager and the leading financial institution (namely Mediobanca). A similar arrangement has arisen in A.F.L. Falk in 1996. The instability of such arrangements might well explain the resilience of founding families to expand their corporations, as the technological and competitive challenge would require. It might also explain the strong pressure that is arising today to finally devise a reform of Italian corporate governance.

The same factors which brought large corporations to a crisis since the early 1960s constituted also the premise for the unleashing of small-scale, local entrepreneurial energies.

In many areas of Central Northern and Southern Italy so called "potential industrial districts" were already alive as early as the 1950s (see Brusco and Paba, 1997): technological knowledge and human capital had been accumulated and were ready to migrate from large firms to new more flexible small scale activities. Informal financing channels (family savings, etc.) and the provision of large State subsidies had been sustaining the survival and growth of small firms. Furthermore in Central and Northern Italy, locally based civic culture was well alive and ready to fuel micro-industry development. However, only at the beginning of the 1960s, when a "social shock" came from the crisis of the governance of large corporations, did "potential districts" quickly develop into fully-fledged districts: because of the "institutional shock" large companies tried to push skilled workers to set up their own firms that, because of their small size, could be isolated from the social conflicts impairing productivity in the large corporations.

With good luck for the Italian economy this was happening when the world was facing the consequences of the " shocks" related to the advent of information technology and programmable machines.

These "technological" shocks made small firms based on "flexible specialisation" very competitive in world markets. The fast growth of the Italian small firm sector created the conditions under which many individuals could enjoy the rights related to ownership of their firms, had the incentives to develop the specific skills that were necessary for their development and, having developed these skills, became often the most efficient possible owners. The institutional shock of the 1960s had an important role in bringing about the virtuous circle characterising this self-reinforcing organisational equilibrium. While new technological changes were making it possible to have large sectors of the economy based on small firms (linked however by various forms of untraditional cooperation), Italy was one of the few countries to exploit this opportunity to such a great extent. While (or, perhaps, because!) the organisation of governance in the large firms was stuck in a form of family capitalism characterised by social immobility and class conflicts, the governance system characterising small firms became a "model" to be studied and imitated in other parts of the world.

8. Conclusion

The crucial years after World War II created a bifurcation between the Japanese and the Italian experience.

Family control over pyramidal groups was reduced and eliminated in Japan, and cross-share holding adopted as a tool to reciprocally isolate the management. External supervision by the main bank was aimed at guaranteeing against possible abuses by the managers themselves.

In Italy, no "managerial revolution" took place. Families strengthened their control over pyramidal groups. State ownership was largely used and financial crises were often resolved with public funds or nationalisation.

Comparing the two post-war experiences is very stimulating.

For Japan, the Italian corporate sector can be instructive in understanding the impact of the *zaibatsu* forced dissolution and the importance of those institutional shocks that have characterised its history. While many factors like the war helped to separate managerial control from *zaibatsu* the Italian experience shows that these factors could have not been sufficient to move to a new organisational equilibrium of the corporate sector.

For Italy the comparison can be even more instructive. FIAT managers like Valletta (and, perhaps Romiti) had less power than *banto* Hirose at the time when he was engaged in the solution of the dynastic crises of the Sumitomo family (section 2). From this point of view Italian large private firms look like a stronger version of Japanese *zaibatsu*. The post-war Japanese experience then suggests a second institutional alternative, other than the US one, that could have been pursued by the Allied Powers and political forces in Italy after the war.

More generally, comparing the Japanese and the Italian models shows that within the same legal framework characterising corporate capitalism it is possible to have very different "organisational equilibria" which in turn depend on the "institutional shocks" characterising the histories of the two countries. The very same institutions such as "inter-firm" share holding and main banking (if one wants to classify "Mediobanca" as the only "Italian main bank" serving the corporate sector) assumed a very different meaning in the two countries.[46] In Japan they were the means by which "managerial capitalism" could organise itself and managers could achieve their autonomy. By contrast in Italy the same institutions contributed to the stability of "family capitalism" beyond the limits of the capitals of the family and helped the local *zaibatsus* to strengthen their control.

Perhaps the study of the Italian and Japanese models has also other important "general" implications. Post-war Italy and Japan may be

interpreted as two extreme cases defining a continuum within which other corporate governance models are likely to fall. In this way their analysis may help the progress of comparative study of history which allows us to understand the many forms under which the same legal genus of capitalism may manifest itself.

Notes

1. Berle and Means (1933).

2. The following discussion draws heavily from Iwai (1997). The discussion of the "Italian" pyramidal ownership structure is, however, new.

3. See Iwai (1997).

4. For the sake of simplicity we are assuming that all the corporations except at the bottom layer function only as holding corporations. If they also engage in real economic activities, using part of their capitals as productive assets, this "multiplier" has to be adjusted downwards.

5. Let M be the number of corporations each holding corporation controls and let s be the ratio of the shares mutually held by corporations controlled by the same holding corporation (or by the top shareholder). If we assume the size of every corporation equal and ignore mutual shareholdings between corporations controlled by different holding corporations, then the upper bound of M can be calculated as $1 = \{1/2 - (M-1)s\}M$, or $M = 1/2+1/4s+\sqrt{(1/4 - 3/4s + 1/16s^2)}$, as long as $(M-1)s < 1/2$. (For the sake of simplicity we assume M to be continuous.) The upper bound of the control-\-ownership "leverage" of the top shareholder can then be calculated as M^N. Note that when $s = 0$, or there is no cross shareholding, M becomes equal to 2.

6. If we use the same notation as in the above footnote, the lower bound of the number of corporations, M, which can insulate a group from outside takeover by cross shareholdings, is given by a formula: $(M-1)s = 1/2$, or $M = 1+1/2s$.

7. Let us for now use the two as synonymous.

8. The neo-classical model is also characterised by a very restrictive vision of individual preferences. In this framework preferences for work (Pagano, 1985) and preferences related to self-definition (Pagano, 1995) and identity are not considered satisfactorily. By contrast, they play a very important role in determining the success of the organisations and, more in general, the outcome of the complex historical events that are the object of this paper.

9. See Pagano (1993).

10. The formal properties of organisational equilibria are examined in Pagano (1993) and in Pagano and Rowthorn (1994) and (1995).

11. See section 7 of Pagano and Rowthorn (1995).

12. See Agliardi (1991) and Arthur (1989).

13. See Hart (1995).

14. See, for instance, Nakane (1970).

15. In 1710 after the death of the founding father of Mitsui merchant house, Mitsui Takatoshi, the heads of the nine families who inherited his properties and businesses formed an organization called "Oomotokata" (meaning approximately "the foundation"). The nine families pooled all their properties at Oomotokata as "Motodekin" (the principal), "lent" it to their own business operations as working capital, and paid back "interests" to twice a year. They also returned all the earned profits to Oomotokata every three years, but received "dividends" for their family expenses in proportion to their original shares. The heads of the nine families had equal voice in the decision-making processes at Oomotokata. The most important feature of this system was an agreement among nine families, stated in the family constitution, that they would

forever keep Motodekin at the vault of Oomotokata and never claim their shares of Motodekin as their own properties. The number of the core Mitsui families had once increased to 11 and the shares among these 11 families changed in 1722 and 1900, but, true to the original agreement, the system of Oomotokata persisted until 1946 when the SCAP ordered the dissolution of Mitsui *zaibatsu*. An ownership agreement similar to Oomotokata was also adopted by many merchant families during Tokugawa period and after the Meiji restoration by *zaibatsu* families as well, including the Sumitomo, the Iwasaki (Mitsubishi) and the Yasuda. According to Jumei Yasuda (1970, 1982), an authority on Mitsui *zaibatsu*, the system of Oomotokata should be characterized as "total ownership (Gesamteigentum)" of ancient German village communities, rather than as "joint ownership (Miteigentum)" of Roman law. It is because the controlling right of the property belongs to the collectivity of the families and the right of each family is restricted to that of receiving returns from the property.

16. The family constitution of the Konoike, one of the largest merchant families during the Tokugawa period, stated as follows: "If the family head happened to be improvident, ... though really sorry for the stigma he has to carry with him but solely for the sake of the perpetual prosperity of our offsprings, he should be put into a forced retirement after a frank consultation, and a new heir had to be adopted." From Miyamoto (1964).

17. See Okazaki (1993) for comprehensive discussions on this.

18. Iwata (1992) points out that during this period this practice was not uncommon. "It was not rare to ask for the union's consent to nominees for company president."..... "Indeed, some union leaders were later promoted to the presidency or other executive posts in their companies" Iwata, (1992), p. 183.

19. In the words of a great Italian thinker of this century, Antonio Gramsci : "the Italian economy was very weak (and) there was no large and powerful economic bourgeoisie; instead there was a great number of intellectuals and petty bourgeois, etc. The problem was not so much to free already developed economic forces from antiquated legal and political fetters as to bring into being the general conditions for these economic forces to arise and develop along the same lines as in other countries" (Gramsci 1975a p. 57).

20. As Gerschenkron noted, and as has been confirmed by more recent studies (Federico and Toniolo, 1991), protectionism was misdirected, favouring wheat production and basic industries with strong lobbying powers but poor long-term prospects.

21. See Gerschenkron (1962) p. 11.

22. This thesis has not been dismantled even by subsequent studies emphasising the limits of the "German-type bank" experience. See Confalonieri (1974).

23. On the eve of World War I, both Banca Commerciale Italiana and Credito Italiano had significant equity stakes in a number of major nascent enterprises.

24. See Zamagni (1990).

25. Until the reform of 1913 the primary source of law governing Italian stock exchanges was the French commercial code promulgated by Napoleon in 1807. The stock exchange, conceived of as the centre for directing savings into industrial and commercial activities, was a Napoleonic concept, introduced when Italy was in the French sphere of influence in the first decade of the nineteenth century. Bourses were founded in a number of Italian cities between 1802 and 1808, but this forcible innovation, not borne of any commercial necessity, was greeted with indifference if not outright hostility. The Italian

exchanges were not structured as free associations of participants, on the English model, but were imposed from above, on the state-controlled pattern of the "Bourse du Roi". See Aleotti (1990) p. 29.

26. 100 per cent of Italy's defence-related steel industry and coal mining, 90 per cent of its shipbuilding, 80 per cent of maritime shipping, 80 per cent of locomotive manufacture, 40 per cent of the non-military steel industry, 30 per cent of electricity generation, 20 per cent of the output of rayon and 13 per cent of the output of cotton. In addition, IRI owned a number of mechanical engineering firms, controlled the three largest commercial banks and the telephone service in central and northern Italy, and possessed very extensive real estate holdings. See Castronovo (1995).

27. See Aleotti (1990).

28. This was quite different from the path followed in the United States, where financial rehabilitation and the separation between banking and industry were founded upon the recovery of the stock market, with the formation of the SEC, the regulation of mutual funds and deposit protection legislation.

29. See Cianci (1977).

30. See Barca (1994), chapter VIII.

31. See Ginsborg (1990).

32. See Ellwood (1985).

33. Sandro Pertini, future Italian President of the Republic, denounced this agreement as "the total surrender of the Italian Resistance movement to the English interests": see Ginsborg (1990).

34. The judiciary was not touched by the purge, so that the total majority of the purging trials held in the early months after the war came out with "not guilty" sentences. Still in 1960, 62 of the 64 local government officers (Prefetti), and all of the 135 Police chiefs (Questori) had been appointed under the fascist regime: Ginsborg (1990) p. 120.

35. Barca (1997).

36. Between 1948 and 1952 Italy received transfers of a total value of US$ 1,470 million, equivalent to 11% of the total ERP aid to Western Europe. See Romeo (1991) p. 174.

37. He offered a severe judgment of Italian financiers as a group: "Italy has never had a class of financiers who loved banking for banking's sake; that is, who were disposed to invest their money in bank shares and to operate banks with the sole aim of earning the largest possible dividends from those shares. Only industrial groups have manifested any interest, at various times, in acquiring stakes in the leading banks": Menichella (1944) pp. 127-128.

38. This position belongs to a long-standing line of thought according to which Italian capitalism had always been fragile, bereft of legitimacy in the country and lacking a farsighted bourgeoisie. See Gramsci (1975b) p. 56.

39. See Bottiglieri (1984).

40. In particular, at the turn of the decade, Oscar Sinigaglia, head of the steel division, drafted and implemented a plan for the construction of three full-cycle steel plants comparable in size and technology to the most up-to-date foreign facilities. Until then the Italian steel industry had been modest and antiquated, mainly reprocessing scrap metal. Sinigaglia argued that without a modern steel industry Italy would never have a true

engineering or motor vehicle industry. See La Bella (1983) p. 53.

41. See Colitti (1979) p. 117 ff.

42. See Barca and Trento (1996).

43. See Maraffi (1990).

44. The 1936 reform had produced a banking system in which commercial banks were prohibited from medium and long-term lending. In 1944 and 1945 Raffaele Mattioli, chairman of Banca Commerciale Italiana, sponsored the formation of a new industrial credit institute mandated to offer five-year credit to firms. Originally, the plan called for close links between the new institute and Banca Commerciale, virtually replicating the "universal bank", with Banca Commerciale specializing in ordinary credit and the new institution financing longer-term industrial investment projects. Eventually, in 1946, this project led to the creation of a new medium-term credit institution, Mediobanca, whose equity capital was mostly subscribed by three IRI banks: Banca Commerciale, Credito Italiano and Banco di Roma. Originally intended in part to sustain the development of small firms, over the years Mediobanca was transformed into a true investment bank for Italy's leading private enterprises.

45. See Barca (1995) and Barca, Bianchi, Brioschi *et al.*, (1994).

46. This similarity should, however, be cautioned. For detailed analysis, see De Cecco Ferri (1996).

TABLES

Table 1. **Cross-Shareholdings among Core 20 Corporations of Sumitomo Group 1993**

HOLDER %\ ISSUER	S. Bnk	S. Trst Bnk	S. Life	S. Mar Insr	S. Corp	S. Coal Ming	S. Cons	S. Fore	S. Che	S. Bake	Jap Glas	S. Cem	S. Met	S. Met Minng	S. Ligh Metals	S. Elect	S. Heav Ind	NEC	S. Real Estte	S. Stor	TOTAL
S. Bank	----	2.8	6.1	1.8	1.7	0.0	0.0	0.1	1.1	0.2	1.1	0.2	1.3	0.4	----	0.9	0.2	1.1	0.1	0.2	19.3
S. Trust Bank	3.3	----	4.2	1.5	2.5	0.0	0.0	0.2	1.2	0.5	1.4	0.5	2.3	1.2	0.0	1.7	0.4	2.8	----	1.5	25.3
S. Life	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
S. Marine Insr	4.4	6.3	4.6	----	2.3	0.1	0.1	0.1	1.2	0.3	1.2	0.3	1.0	1.0	----	0.9	0.6	1.8	0.1	0.8	27.1
S. Corporation	4.8	5.8	5.1	2.9	----	0.1	0.0	0.3	1.6	0.3	1.0	0.4	2.7	1.7	----	1.0	0.8	3.7	0.1	0.4	32.8
S. Coal Ming	4.8	4.0	2.5	2.4	3.4	----	0.8	----	2.5	----	0.4	1.0	4.9	2.1	----	----	1.7	4.2	----	0.2	34.8
S. Construct	4.4	2.9	5.8	1.4	----	3.1	----	0.6	1.1	----	0.6	2.3	----	3.3	----	1.0	----	----	0.4	0.2	27.0
S. Forestry	4.3	7.0	7.2	----	2.6	0.1	0.4	----	----	0.4	----	0.3	----	7.3	----	----	0.2	1.4	----	----	31.1
S. Chemical	4.7	5.3	8.9	1.4	1.3	0.0	0.1	0.1	----	0.1	0.4	0.3	----	0.2	----	0.3	0.2	0.5	0.0	0.2	23.9
S. Bakelite	4.8	7.1	5.9	1.3	2.1	----	0.3	0.4	21.6	----	0.3	0.5	0.9	----	----	0.3	----	1.3	0.4	0.1	48.2
Japan Glass	5.0	6.8	5.5	2.3	1.6	----	0.1	0.1	1.2	0.5	----	0.8	----	0.3	----	----	0.6	----	0.5	0.2	25.6
S. Cement	4.6	5.4	8.5	1.0	2.3	1.9	0.6	0.4	1.1	0.4	0.8	----	1.0	1.1	----	0.3	2.2	0.8	0.2	----	32.8
S. Metals	4.0	6.2	5.5	----	1.6	0.1	0.0	----	----	0.1	0.1	0.1	----	0.5	----	0.3	0.2	0.6	0.0	0.1	19.2
S. Metal Ming	4.6	10.0	4.8	1.5	2.5	0.1	0.2	0.3	----	----	0.3	0.7	0.8	----	----	1.0	0.3	2.4	0.1	0.1	29.6
S. Light Metals	4.7	5.8	4.0	1.4	4.0	----	----	----	1.3	----	----	0.4	23.3	0.9	----	0.8	0.6	0.8	----	0.2	48.2
S. Electric	3.8	5.4	7.0	----	0.8	0.0	0.0	----	----	----	----	0.1	----	0.8	----	----	0.1	2.4	----	0.1	20.6
S. Heavy Ind.	4.6	6.4	7.8	2.5	3.0	0.1	0.1	0.1	----	----	0.5	1.3	----	0.7	----	0.7	----	----	----	0.3	27.9
NEC	5.0	4.8	6.8	2.6	2.2	0.0	0.0	0.1	0.4	0.1	0.2	0.1	0.7	1.0	----	2.2	0.1	----	0.0	0.2	26.4
S. Real Estate	3.4	5.1	2.3	1.6	0.5	0.0	0.2	----	0.4	0.2	0.7	0.1	0.5	0.3	----	0.5	----	0.7	----	0.5	17.2
S. Storage	4.7	6.7	8.4	5.4	2.4	----	0.3	----	1.5	0.1	0.8	----	2.2	----	----	0.9	0.9	3.9	0.3	----	38.5

Sources: Toyo Keizai, *Kigyo Keiretsu Soran '95 (Survey on Corporate Groups, '95)*, (Toyo Keizai Shinpo Sha, 1995).
Note: '0.0' means a very small percentage, and '----' means no holding or N.A.

Table 2. **The Ownership Pyramid of Sumitomo *zaibatsu*, 1937**

Sumitomo Family

S. Holding Co.

S. Bnk	S. Trs Bnk	S. Lif Ins	S. Chm Eng	S. Mtl Eng	S. Min	S. Alm Ref	S. Elc Lin	S. Mcn Eng	N E C	S. Bld	Osk. Nrt Prt	S. Str	Other Affiliated Co.s
(55)	(39)	(100)	(38)	(49)	(99)	(35)	(46)	(50)	(20)	(50)	(63)	(100)	

Subsidiaries Subsidiaries Subsidiaries Subsidiaries

[Source: Sakudo Y. (1979), *Sumitomo Zaibatsu Shi (History of Sumitomo Zaibatsu)*, Tokyo, Kyoiku Sha.]

Table 3. Composition of Insider Ownership for 5 Key Corporations of Sumitomo *Zaibatsu*, 1937

% Owner \ Ownee	Sumitomo Family	Sumitomo Hoding Co.	Directors of Holding Co.	Group Co.s	Total of Insiders
Sumitomo Bank	20	35	--	--	55
Sumitomo Trust Bank	2	--	--	37	39
Sumitomo Life Insurance	70	26	4	--	100
Sumitomo Chemical Engineering	10	23	--	5	38
Sumitomo Metal Engineering	12	27	--	9	49

[Source: Sakudo, Y. (1979), *Sumitomo Zaibatsu Shi (History of Sumitomo Zaibatsu)*, Kyoiku sha.]

Table 4. Main shareholders of "key companies" of three major Italian groups: 1947 e 1993[1]

Fiat Group		Pirelli Group		Falck Group	
Shareholders	Shares	Shareholders	Shares	Shareholders	Shares
FIAT SPA (1947)		**PIRELLI SPA (1947)**		**A.F.L. FALCK (1947)**	
Agnelli family	*70,2*	*Pirelli family*	*12,9*	*Falck family*	*73,1*
persons (37)	*10,5*	*persons (75)*	*23,2*	*persons (40)*	*11,8*
Vatican	*0,4*	*banks (4)*	*2,6*	*Vatican*	*0,7*
banks (10)	*2,8*	*non-banking firms (11)*	*2,9*	*non-banking firms(3):*	*14,4*
non-banking firms	*2,5*	*"others"*	*58,4*	*"others"*	*0,0*
"others" (2207)	*13,6*				
FIAT SPA (1993)		**PIRELLI & C. (1993)**		**A.F.L. FALCK (1993)**	
Agnelli family	*24,8*	*Pirelli family* [5]	*8,7*	*Falck family* [6]	*32,3*
via IFI* [2]	18,1	*banks*	*16,4*	*banks*	*4,8*
via IFIL* [3]	1,9	Mediobanca*	10,0	IMI	4,8
via Fimepar [4]	4,8	Banque Indosuez	6,4	*non-banking firms*	*28,3*
banks	*11,0*	*non-banking firms*	*32,9*	Italmobiliare * (Pesenti)	11,8
Istituto San Paolo	3,4	GIM* (Orlando)	6,7	Siderca Techint * (Rocca)	5,9
Mediobanca*	3,2	SMI* (Orlando)	3,6	Ilva* (IRI)	4,9
Deutsche Bank*	2,4	Gemina*	5,3	Finarvedi * (Arvedi)	4,7
Banco di Roma	2,0	SAI* (Ligresti)	5,0	Sofinda* (Danieli)	2,9
non-banking firms	*4,8*	CAMFIN* (Tronchetti Provera)	5,0	Pirelli & C.*	2,0
Assicurazioni Generali*	2,4	CIR* (De Benedetti)	4,4	Ras *	1,0
Alcatel *	2,0	SOPAF* (Vender)	2,9	*"others"*	*34,6*
"others"	*59,4*	*"others"*	*42,0*		
* Belonging to shareholders' voting and block agreements		* Belonging to shareholders' voting and block agreements		* Belonging to shareholders' voting and block agreements	

Source: F. Barca, F. Bertucci, G. Capello, P. Casavola (1997), *La trasformazione proprietaria di Fiat, Pirelli e Falck dal 1947 a oggi, in F. Barca* (a cura di), *Storia del capitalismo italiano, dal 1945 a oggi*, Roma, Donzelli.
(1) As a percentage of total voting capital , ordinary and preferred.. Number of shareholders - when known - in brackets.

Table 5

The control-ownership leverage in three major Italian Groups (1)

Years	Fiat	Pirelli	Falck
1947	1,9	8,9	2,5
1993	17,9	52,6	4,4

Source: F. Barca, F. Bertucci, G. Capello, P. Casavola (1997), *La trasformazione proprietaria di Fiat, Pirelli e Falck dal 1947, in F. Barca* (cura di), *Storia del capitalismo italiano, dal 1945 a oggi*, Roma, Donzelli.

(1) Ratio between group's net share capital and share capital held by founding family.

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