Can Japan Lead the World toward Public Interest Capitalism?

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"Public interest capitalism" describes an economic system where companies develop sustainable business practices, invest in long-term innovation and growth initiatives, and share profits equitably among stakeholders. The concept of public interest capitalism was born in 2008 from research by myself and my colleagues. Working under the auspices of the Tokyo Foundation and the Alliance Forum Foundation, we investigated the shortcomings of the shareholder-oriented capitalism ascendant in the US and the UK. We proposed public interest capitalism as an alternative economic system where institutions enable and encourage companies to be good: to voluntarily seek profits in ways that benefit society.

To business and economic leaders accustomed to thinking of companies as narrowly self-interested profit-maximizers, the idea of companies "choosing to be good" may seem idealistic or utopian. Such cynicism is not without cause, but there are sound reasons to believe that companies can be more than amoral economic machines. For example, in his research on professional conduct, Rakesh Khurana of the Harvard Business School describes how ethical values underpin the practice of medicine and the law. We condemn doctors or lawyers who sacrifice the welfare of their patients and clients for personal gain; why not hold corporate managers to similar standards?

Cooperation & Economic Development

Douglass North, an economic historian and Nobel laureate, notes that successful societies are characterized by far higher levels of cooperation than can be explained by theories of people as greedy profit-maximizers. In well-functioning societies, individuals do not avail themselves of every opportunity to cheat, steal, or simply grab anything free for the taking. Most of us do not sneak out of restaurants without paying, examine every contract we sign for loopholes to exploit, or stuff our pockets with packets of sugar at the local coffee shop. This inclination toward cooperative behavior, to treat others as we would be treated, functions as an economic lubricant to facilitate mutually beneficial transactions.

North's research suggests that economic development depends not on the caprice of the invisible hand, but rather on the institutions – laws, values, customs, and habits – that influence people to create new wealth through productive endeavor or, conversely, to enlarge their share of existing wealth at the expense of their compatriots. When people cooperate in the pursuit of productive activities, then society prospers. When people devote their energy to fighting over accumulated wealth through financial machinations, legal wrangling, or political battles, then society stagnates and declines.

Can Companies Be Good?

In modern societies, companies exert enormous economic influence. However cooperative people may be in their personal dealings, societies cannot prosper if companies become greedy and seek to profit at the expense of customers, employees, suppliers, and the communities where they do business. Many leading American companies, including General Electric, Apple, and Google, go to great lengths to reduce their taxes by devising elaborate financial structures and lobbying the government for preferential treatment. American companies eagerly fire employees while increasing payments to shareholders and senior executives. Perhaps these companies are not *bad* – they generally obey the law and produce valuable goods and services – but nor are they particularly *good.*

Since the 1970s, managers at American companies have become increasingly focused on boosting shareholder profits, even at the expense of other stakeholders. The primary reason is probably that senior managers have been effectively bribed with compensation packages linked to share prices. The more money senior managers make for shareholders, the more money the senior managers make for themselves. Other factors, such as the emergence of hostile takeovers and business school education emphasizing the primacy of shareholder value, have also contributed to the focus on shareholder returns.

One of the most effective techniques that managers have discovered for quickly boosting share prices is for companies to repurchase their own shares. According to University of Massachusetts economist William Lazonick, large American companies have spent more than $2 trillion on share repurchases since 1997. Since 1994, there has been a massive net outflow of funds from companies to shareholders, diverting capital away from long-term investments in human capital and new business ventures *(Chart 1)*. Had more of these funds been channeled into research and development, the US economy would be performing far better today.

Senior managers have profited handsomely from their alliance with shareholders. CEOs in particular have enjoyed a nearly eight-fold increase in compensation since the 1970s, after adjusting for inflation *(Chart 2)*. Relative to GDP, corporate profits are at record highs, while wages are at record lows. These trends have contributed to a dramatic increase in income inequality *(Chart 3)*. To make matters worse, recent research at the Bank of England finds that shareholders are increasingly and irrationally biased toward short-term profits. By enshrining share price as the preeminent management metric, American companies are sacrificing the nation's economic future while enriching a small elite at the expense of the working class.

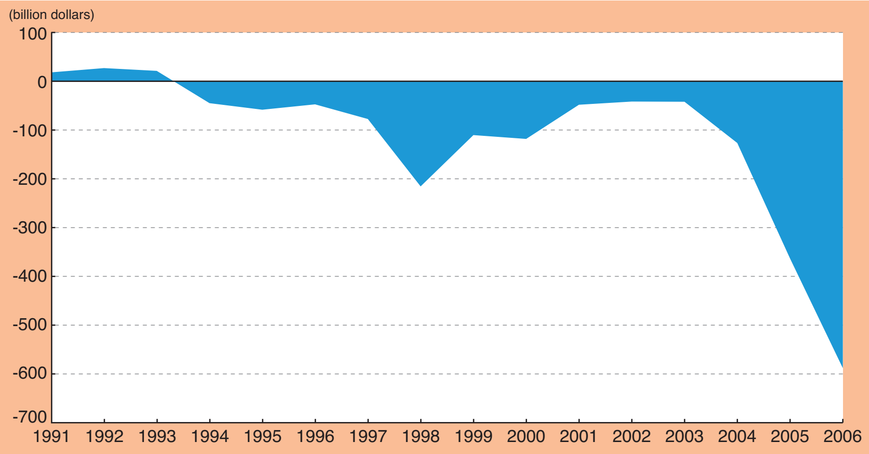
Natural Fit with Japan

In public interest capitalism, companies want to be good. Much like good people, they seek profits, take advantage of tax breaks, and shop around for low prices, but they do not squeeze every last penny out of the people with whom they do business. They try to be reasonable and fair. When they are fortunate, they give back to people who lent helping hands along the way. Good companies will contribute to economic growth and social welfare. And, in the long run, they will perform better and generate higher profits than their greedy competitors.

My mentor, James Abegglen, was a leading student of Japanese capitalism in the postwar period. He described how Japanese companies patiently reinvested their earnings, took good care of their employees, and achieved a high level of productive cooperation among suppliers, labor unions, managers, lenders and other stakeholders. The relationship between Japanese

CHART 1

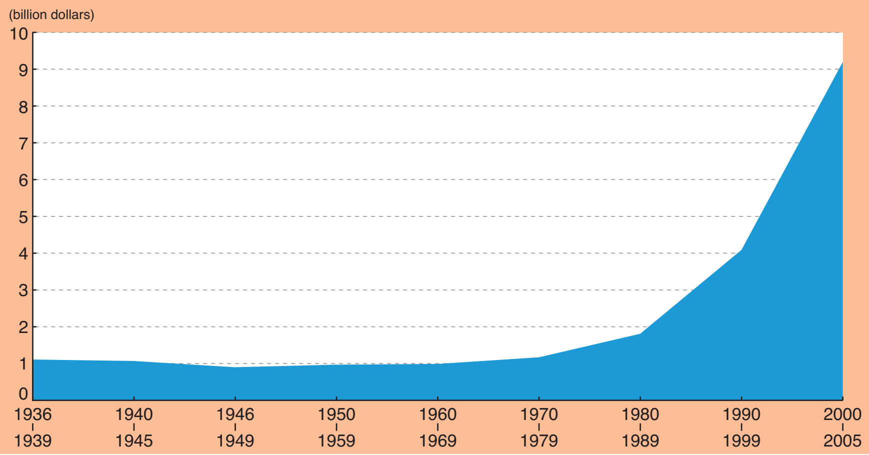
Net equity issuance



Source: Federal Reserve

CHART 2

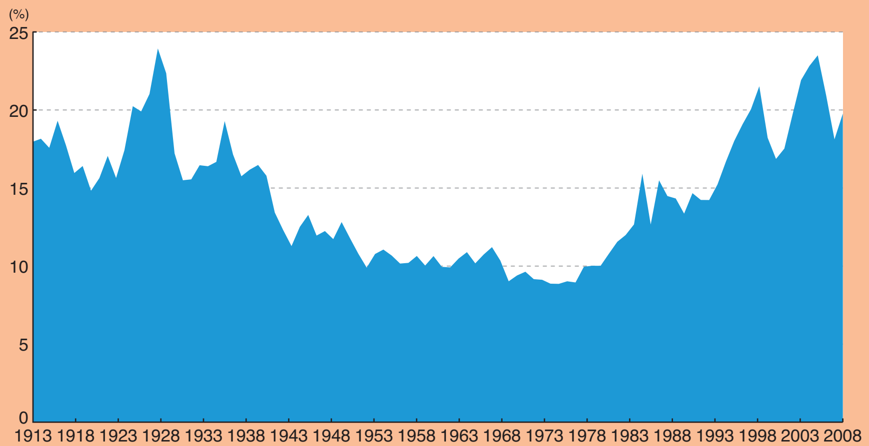
Median CEO compensation
(top 50 companies by revenue, 2,000 dollars)



Source: C. Frydman & R. E. Saks, "Executive Compensation: A New View from a Long-Term Perspective, 1936-2005", NBER Working Paper No. 14145, 8 Aug 2008.

CHART 3

Share of income received by top 1%
(including capital gains)



Source: Piketty, T. and Saez, E. (2003). "Income Inequality in the United States, 1913-1998." Quarterly Journal of Economics, 118 (1). Data updated to 2007 at http://elsa.berkeley.edu/~saez/. Figure A2.

companies and their employees, he wrote in his study of Japanese factories published in 1958, was a bond "far exceeding the specific demands of an economic organization." Cooperative relationships with suppliers and employees enabled Japanese automakers to beat their American competitors on efficiency, quality, time to market, and innovation. In recent years, Japanese cars such as the Toyota Prius and the Nissan Leaf have been among the most innovative vehicles on American roads.

The foundations of public interest capitalism are customs and values that encourage corporate stakeholders, especially managers, to consider the ethical implications of their decisions and to pursue strategies that benefit all stakeholders. Such customs and values are deeply embedded in Japanese commercial traditions. Since at least the Edo period, the Omi merchants in what is now Shiga Prefecture, near Kyoto, were known for their philosophy of *sampo-yoshi*. Literally translated as "three ways good", *sampo-yoshi* means good for the buyer, good for the seller, and good for the community. Simply adhering to the principle of *sampo-yoshi* would take Japanese companies a long way toward public interest capitalism.

A fascinating example of how cooperation facilitates economic development and improves human lives comes from the medicine merchants of Toyama, situated northwest of Tokyo on the Japan Sea. In the Edo period, these merchants developed a system where medicines were deposited at the houses of customers for use when the need arose. The merchants would visit twice a year to collect payment for the medicines that had been used. Such a system helped ensure that medicines would be on hand in time of need, but obviously depended on trust, cooperation, integrity, and a substantial measure of care on the part of both buyer and seller. If customers mistreated the inventory or refused to pay, or if merchants lost their records, offered deceptive terms, or attempted to collect in excess of their due, the system would have collapsed in short order. Instead, having endured for centuries, it continues to this day.

The Dark Side of Japanese Capitalism

Unfortunately, few Japanese companies truly follow *sampo-yoshi*. Although they have been less eager to restructure and downsize than American companies, Japanese companies are not, by and large, particularly pleasant places to work. Salarymen and salarywomen face intense social pressure to work long hours and put the company first. They must endure frequent relocations and remote assignments which often separate workers from their families for a year or more. Corporate demands take a heavy toll on family life and employee health. Japan is the only advanced nation where employees literally work themselves to death in substantial numbers. It is appalling that *karoshi,* "death by overwork," has become a tolerated side-effect of Japanese capitalism.

Events of the past year have underscored the shortcomings of Japanese capitalism. The nuclear catastrophe at Fukushima demonstrated the enormous damage that large companies can cause when they put profits ahead of the public interest. Tokyo Electric Power Co. has a history of destructive greed: in 2002, the chairman and president resigned after revelations that the company had concealed safety issues. Friendly government regulators aided and abetted Tokyo Electric's antisocial behavior, but the company's managers made unethical and short-sighted decisions to pursue profits at the expense of society.

To make matters worse, Tokyo Electric's betrayal of the public trust has called into question the safety of the entire nuclear power industry. Local governments are understandably unwilling to allow reactors to be restarted, resulting in a sudden, disruptive contraction of the nation's energy supply as reactors go offline for maintenance. As of this writing, there are only two nuclear power plants online in Japan, and there may be none by summer.

Although less tragic in their consequences, the exposure of massive fraudulent transactions totaling more than $1 billion at Olympus threw the company into turmoil and undermined confidence in Japanese corporate governance. The Olympus scandal was followed by a scandal at AIJ Investment Advisors, a fund management company that evidently lost or stole on the order of $2 billion from client pension funds.

The former president of Olympus, Michael Woodford, blames the scandal on Japan's "culture of deference and obedience." Certainly obedience has gone too far when employees work themselves to death, or help conceal safety violations or financial fraud. Employees must take responsibility for preventing unethical managers from running roughshod over other stakeholders.

Companies Must Take Responsibility for Public Interest

To create public interest capitalism, we must dispose of a particularly bad idea that gained currency in the 1970s and 1980s. This idea, articulated by eminent economist Milton Friedman, is that "there is one and only one social responsibility of business – to … increase its profits." According to this idea, companies are responsible for making money, while government is responsible for the public interest. It is the responsibility of government, acting through regulation, to prevent companies from injuring the public. Since companies have only to make as much money as possible, the duty of managers is simply to maximize profits for shareholders. Managers need not – indeed, should not – think about how their companies can contribute to society; they should think only about how to increase shareholder returns, even if profits come at the expense of employees, society, and the company's future growth. This idea legitimates greed and encourages companies to be bad.

Prosperity requires productive cooperation among people and companies, which depends in turn on trust, integrity, patience and a measure of generosity. Well-designed regulations can help facilitate cooperation. For example, outlawing hostile takeovers would prevent unscrupulous investors from acquiring companies and forcing them to renege on their commitments to employees and other stakeholders. Regulations that allow companies to reward long-term shareholders with larger dividends and more voting rights would decrease the influence of greedy speculators. Such reforms should be implemented; however, regulations alone cannot make companies choose to be good. Only companies themselves can make that choice. Public interest capitalism depends first and foremost on companies making the decision to be more than profit-maximizing machines.

If the idea of companies choosing to be good seems radical or idealistic, it is only because we have become so accustomed to Milton Friedman's worldview. We have developed informal institutions – values, habits and rules of thumb – consistent with this worldview, and these institutions influence the structure of our economies. Yet just two generations ago, our institutions were different. Even in the US, leading management thinkers, business associations, and senior executives emphasized the importance of high ethical standards and of balancing the interests of corporate stakeholders. It is time to bring back the ethical dimension of management.

What to Do Differently on Monday Morning

Before becoming a management researcher and technology entrepreneur, I worked as a management consultant. Part of my job was to translate big strategic ideas into concrete actions. We had to help our clients decide what do differently on Monday morning. So, in conclusion, I will put on my management consultant suit and describe what companies should do next Monday morning to lead the transition to public interest capitalism.

To serve the public interest, first we have to define it. In our research on public interest capitalism, we proposed three dimensions of the public interest: sustainability, equity, and innovation. Sustainability means that companies do not profit at the expense of future generations. Equity means that profits are shared equitably among stakeholders – but not equally, because some stakeholders contribute more than others. Innovation means that companies find new and better ways to meet the needs of their stakeholders.

Decision-making in companies is guided by objectives, metrics, and reports. Currently, these objectives, metrics, and reports are designed primarily to serve the interests of shareholders and, to a lesser extent, bondholders. Sustainability, equity, and innovation are not incorporated at all, except in narrow financial terms. Employees, usually the most valuable assets in advanced economies, appear in financial statements only as costs. The first step to implementing public interest capitalism is to complement financial accounting and reporting with new objectives, metrics and reports that reflect the public interest.

So, if you are a corporate manager, here is what to do next Monday morning. Create a Public Interest Capitalism Committee including senior and mid-level managers. Commit to preparing your company's first annual Public Interest Capitalism Report by the end of this year. Structure the report to include the following sections:

1. Purpose
- What are the social needs that our company seeks to meet?
- What are our unique capabilities that enable us to meet these needs?

2. Sustainability
- What are the resources – natural, social, technological, organizational, and financial – that enable our company to meet the needs of our stakeholders?
- How sustainable are these resources?
- How can we make these resources more sustainable?

3. Equity
- Who are the stakeholders that support the company?
- How much value is the company creating for each stakeholder group in return for their contributions?
- How is value creation for each stakeholder group changing over time?
- Is value creation skewed in favor of one group at the expense of other groups?

4. Innovation
- How much does the company invest in innovation?
- What is the composition of our innovation portfolio, i.e., the mix of incremental improvements, transformational initiatives, and adventurous exploration?
- What value are our innovation initiatives creating for our stakeholders?

In the first year, the report will be very simple and there will be many questions and arguments within the company. This is part of the creative process, and it will help the company learn. Exchanging ideas with colleagues at other companies will accelerate the learning process. Over time, these richer metrics, objectives and reports will help companies see beyond short-term profits and prosper together with society. JS

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