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## Introduction: What Do Corporations Do?

What do business corporations do and how? Are they becoming more alike everywhere, between the Anglo-American and the Continental Europe, between the West and the East? Is that the way that should be? Or is there any virtue in there being some diversity between corporate organizations on the global scale? How do, or should, financial corporations serve non-financial business corporations?

Until the recent financial crisis, the answers to these questions were generally considered to be obvious and easy. That is, the objective of business corporations is to maximize profits. They are then to be organized and governed to maximize share value that supposedly represents the present value sum of expected future profits. Artificial barriers to this goal should be removed. The shareholders are then motivated to, and can therefore effectively, govern business corporations for the benefit of society as a whole. The reason being that share-price maximizing can act to remove any wasteful element in corporate activities, discipline the behavior of the workers, control the illegitimate attempt of management to accumulate their personal wealth at the sacrifice of others, and so on. And, we were told, the world is moving in that direction because of the mighty competitive pressure of globalized financial markets.

Whenever events occurred in the past that shook the corporate economy, however, the orthodox view of shareholder sovereignty was exposed to public scrutiny. This happened after the Great Depression and it happened again in the 1980s in the USA when the industrial competitiveness of the US economy was perceived to be threatened by Germany and Japan. The first occasion led to the introduction of the legal debate between the stakeholder-oriented view of corporate governance and the shareholder-oriented view.<sup>1</sup> The later occasion brought together for the first time

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economists to earnestly engage in discussions on the topic of corporate governance that previously had been almost exclusively a subject for lawyers. In the debate, interests in national differences in corporate governance arose and their implications were discussed. The so-called “Varieties of Capitalism” paradigm eventually emerged out of this debate as a variant of the stakeholders-oriented view.<sup>2</sup>

However, the pendulum was soon to swing back to an orthodox view with the period around 1990 marking a turning point in hindsight. The ideological and political-economy battle between the planned economy and the corporate-market economy, which had raged over most of the last century, finally came to an end with the demise of the Soviet Union, and (former) communist countries—including China—were set to explore the transition to a market economy. State enterprises, which were essentially nothing but administrative units of communist states, were to be transformed into market-oriented corporate firms, either privately-owned or state-owned. To facilitate the transition, the crucial roles of various institutional supports, such as the legal enforcement of property rights and contracts, social norms of trust, the transparency of corporate information, and the accountability of management were highlighted. Every economist seems to have agreed on that much. However, two subtly differentiated views gradually grew out of this general consensus. One view, a more institutionalist-oriented one, posited that the institutional supports may not be automatically implemented merely by an act of the legislature and that the transition path may therefore be diverse and could be even an uneasy one, depending on the historical, social, and political factors of each economy.<sup>3</sup> The other view was premised on a deeper faith in the universalistic value of markets and the market-oriented governance of corporate firms. If appropriate legal arrangements are provided and enforced after the privatization of state-owned enterprises, it was held, the corporate economy can thrive autonomously.<sup>4</sup> Faith in the market- and shareholder-oriented governance model gained momentum from the mid-1990s on, and it looked uncontested.

Indeed, from the 1990s up to 2007, share prices registered spectacular growth except for interim dents during the currency crisis in 1997 and the burst of the dot-com bubble in 2001 accompanied by the disclosure of Enron and WorldCom scandals. The growth of the world economy, including the so-called emergent market economies, made the orthodox view of business corporations more credible. Resonant with the *Zeitgeist* of the time, prominent scholars of corporate law proclaimed “the end of history for corporate law” (Hansmann and Kraakman 2001), arguing

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that the ideological or normative battle over corporate law was over. “The management-oriented model of America, the labor-oriented model of Germany, the state-oriented model of France and Japan” were all claimed to have failed and there was no longer any serious competitor to the shareholder-oriented model.

However, in less than a decade a credit crisis erupted in Wall Street and the City, in September 2008. It revealed that the spectacular growth of financial assets had been to a great extent engineered by financial intermediaries whose incentives were distorted toward endogenously generating higher risks.<sup>5</sup> Trillions of dollars worth of shareholder wealth disappeared within a matter of one month. The impact immediately spread to the real sector of the corporate economy on a global scale, as symbolized by the failure of two of the Detroit Three (once the Big Three).

What went wrong? Is it that the basic tenet of the shareholder-oriented model of the corporate economy is basically right, but that the crisis was created by the “Arrogance, Incompetence and Greed” (AIG) of the financial intermediaries so that it can be cured by regulatory reform? Or ought it be taken more seriously as a symptom of a mismatch in the ways that financial markets and intermediaries relate to non-financial business corporations? Do we therefore need an alternative model of business corporations and the corporate economy so that the single-minded shareholder-oriented model will not ideologically mislead the global corporate economy again? If so, what form would such a model take? Is it sufficient to resurrect the familiar, albeit humbled, stakeholder-society view scorned by the orthodox shareholder-oriented view for its lack of solid logic (e.g. Tirole 2001)? Does the “varieties of capitalism” view have still something to offer in spite of the globalization of markets, organizations, and information, as well as rising concern over the sustainability of the global commons (the natural environment, etc.)?

In this treatise, I will try to attempt a new look at “what (non-financial) business corporations do,” and their relationships with financial markets as well as societies. As a way of introducing such an agenda, let me briefly go back to the basics: namely, I will ask the ontological question of what the generic nature and *raison d'être* of corporations is, business corporations being nothing more than one species of corporation. Corporations are undoubtedly one of the most important societal devices that human beings have ever invented. Although the legal concept of corporations has arguably been said to have originated in the Roman era,<sup>6</sup> it was in medieval Europe that the incorporation was initiated for various social functions and started to flourish in a variety of domains: religion, learning, politics,

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philanthropy, trades, and crafts. Access to the corporate form was limited at this time to elites of various types. But this decentralized institutional innovation prepared “doorstep conditions” (North, Wallis, and Weingast 2009) for Europe, allowing it to get one step ahead of other regions and to make an earlier transit to the modern democratic state and corporate economy.<sup>7</sup>

Needless to say, contemporary business corporations are a highly developed form of the corporation that are both historically unparalleled and still evolving. Their special features, such as the pooling of a large sum of financial capital and the transferability of its shares through markets, the capital market control of management, limited liability, the organization of operational activities through various types of contracts, and so on need to be understood in their own light and indeed understanding has been sought through the disciplines of economics, jurisprudence, finance theory, business studies and so on. At the same time, however, business corporations share some generic features with other species of corporations that pursue different objectives than business and perform diverse social functions. This point is so obvious that it may appear not worthwhile mentioning it. But reflecting a little on the generic features of corporations may help to shed light on some aspects of business corporations that are often left behind in specialized professional inquiries. As a reference point, let me try to verbalize a minimalist conceptualization of corporations as follows: *Corporations are voluntary, permanent associations of natural persons engaged in some purposeful associative activities, having unique identity, and embodied in rule-based, self-governing organizations.*<sup>8</sup> It is expected that contemporary business corporations satisfy all these generic characteristics in unique, substantive forms and possibly more.

Among these characteristics, let us first consider the generic nature of corporations as a “permanent” entity or having perpetual life.<sup>9</sup> The great jurist of eighteenth-century England, Blackstone, began the first modern treatment of the corporations by characterizing it as “a person that never dies; in like manner as the river Thames is still the same river, though the parts which compose it are changing every instant” (Blackstone 1765–9/2005, Bk 1, ch. 18). Indeed, it is obvious that corporations can do what individuals with limited biological longevity cannot do. For one thing, the corporate ability to own property, backed up by the institution of shared ownership and share transferability, makes the permanence of business corporations secure. Its advantage is made very clear if we consider the consequence of limits on it. For example, the argument of Kuran (2005) who examined “[t]he absence of the corporation in Islamic Law” makes a

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point. Under a relatively egalitarian inheritance system of Islamic Law, the fragmentation of the estates of merchants hindered the durability of their businesses over generations. Therefore successful merchants converted their wealth into real estate and reconverted it into the corpus of a *Waqf*, the unique Islamic corporate body that emerged in the eighth to ninth centuries. The founder could appoint himself or his successor to the position of manager-trustee (*mutawalli*). Endowed real estates were leased to commercial facilities in the short term by the corporate body, and revenues from them were spent on creating and sustaining communal and religious goods such as drinking water supply, assistance to religious and commercial travelers, road maintenance, mosques and so on. But the growth of *waqf* was limited because of its individual nature, for it had to be founded by an individual and the leasing conditions were controlled by him even after his death through the enforceable, enduring founding deed. Incentives for the dynamic accumulation of corporate property were lacking, because of the incomplete separation of natural individuals and the corporate body.<sup>10</sup>

However, what an individual cannot do but corporations can is not limited to owning and using real estate and other physical property beyond his or her life. Actions, physical and cognitive, are also relevant. Corporations can organize associative activities among its members by distributing cognitive actions among members. Corporations as a corporate body can cognize and store what a mere collection of individuals cannot. Indeed it is worthwhile recalling that the first prominent types of corporations that emerged in the early medieval period and became legal models preceding later-day business corporations were those “founded *ad studendum et orandum* [for study and prayer], for the encouragement and support of religion and learning” (Blackstone 1765–9). The Roman Catholic Church was established as a legal corporate body under canon law through the Gregorian Reformation (1075–1122). A law school which had been started in Bologna around 1087 by an individual teacher named Irnerius survived after his death and was incorporated into two bodies as *universitas* by students. The universities of Paris and Oxford were also incorporated as early as the thirteenth century (In the New World as well, one of the first corporations was Harvard University, chartered in 1636).

The primary functions of these types of corporations were to understand or interpret the world, accumulate, theorize, and bestow knowledge for future uses and advancement, sustain culture as common knowledge and so on—although property issues were not unimportant for them either.<sup>11</sup> Some historians argue that the initial organization of European

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universities, as mentioned above, were actually influenced by the structure of *waqf*-financed colleges (*madrasas*), but the former quickly developed into higher learning institutions because of the flexibility made possible by legal personhood. One innovation made possible by this arrangement was the ability of the universities as organizations to grant degrees rather than awarding certificates from individual teachers.<sup>12</sup> Indeed, great universities became great as a result of “incorporating” scholars and students who had diverse, but complementary, cognitive competence and interests.

The primary purpose of business corporations is to make money, not to learn. But even for them, the reasons why incorporation are vital for religious and learning activities are not entirely irrelevant. As knowledge use and creation (that is, innovation) becomes a more and more important resource for the competitiveness of business corporations, this point cannot be overlooked. However, in England where the corporate economy first emerged on a substantive scale, the traditional legal view was to formally limit membership to the shareholders. But business corporations also have the dimension of the economic concept of the “firm” à la Coase (1937), that is, as the enduring producing organization that cannot be decomposed to a bundle of short-term contracts. Production and other activities taking place within the corporate firm may appear on the surface as a mere assemblage of individual physical actions, with physical externalities among them (e.g. congestion in the use of corporate physical assets, the common use of digital files, etc.). However, as expounded further in the next chapter, all physical actions of human beings are coordinated by cognitive actions, while the physical actions and assets provide extended resources for the latter.<sup>13</sup> But the orthodox economic theory of contracts is premised on the idea that cognition can take place only within the mind of individuals. Thus people may hide their intentions, information, and so on to their individual advantage, unless they are provided with the proper incentives to reveal them. This presumption indeed lies at the heart of micro economics (the economics of information) that theoretically supported the shareholder-oriented view in past decades. However, the recent development of experimental economics, cognitive neuro-science, and related areas increasingly provides evidence and theories that human cognition also takes place in more interactive ways at the group level in some contexts. Therefore, the way in which business corporations are organized as *systems of associational cognition* deserves no less attention than the financial aspects of the corporation.

However, the orthodox contract theory of the firm considers the human aspects of business corporations only in terms of authority relationships between the management and the workers. The philosophy and

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substance of corporate governance laws, following the English common law tradition, certainly embrace this approach. One of the reasons why such a view permeated in the law in the first place may have been a reflection of the timing of the first modern corporate law in England: the Joint Stock Companies Act (1844). Ahlering and Deakin (2007) argued that the passing of this act was preceded by Britain's Industrial Revolution and the master-servant regime was imported from the previous practice and transplanted into the company law. One authoritative textbook published in 1969 of the company law in the UK criticized the state of the legal theory at that time as follows:

In so far as there is any true association in the modern public company it is between them and workers rather than between the shareholders *inter se* or between them and the management. But the fact that the workers form an integral part of the company is ignored by the law. In legal theory the relationship between a company and its employees is merely the contractual relationship of master and servant and the servants no more form part of the company than do its creditors. ... This orthodox legal view is unreal in that it ignores the undoubted fact that the employees are members of the company for which they work to a greater extent than are the shareholders whom the law persists in regarding as its proprietors. (Gower 1969, 1979: 10–11)

Since then, the situation has been slightly changed in terms of formal statute. Even in the UK, the Companies Act 1985 obliges corporate directors in the execution of their functions to have regard to "the interest of employees in general, as well as the interests of its members." However, the philosophy and ideology of those who subscribe to the shareholder-oriented model does not seem to have been affected much.

Treating the workers merely as hands was deeply rooted in Industrial America as well. During the Second World War, Peter Drucker, who had emigrated from Vienna via England to the USA, was invited by Alfred Sloan to visit the offices, factories, and archives of General Motors (GM) and research how great the GM management style was. His study culminated in a classical treatise, the *Concept of the Corporation* (1946/1972). In that book, he praised the inventiveness of GM's multidivisional organization and so on, but at the same time urged GM to treat the workers as a resource rather than as a cost. He observed on the shop floors that when workers experienced and understood the whole facets of work processes (i.e. the entire assembly job), rather than being confined to a single compartmentalized job, they were better able to solve together emergent complex problems arising to meet highly delicate requirements of military procurements.

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The workers can become more productive by “standing the assembly-line technique on its head,” said Drucker (1946/1972: 156). This idea eventually led him to the notion of “knowledge workers” who can supply brains, not merely hands. But GM banned their employees and managers from reading the book, while Japanese managers studied it ardently during the 1950s and 1960s. This difference may eventually have taken a heavy toll on GM.

One thing that I intend to do in this book is to attend to the cognitive aspect of “what business corporations do.” That is, inside business corporations, cognitive activities, such as information collections, processing, uses and storage, are systematically distributed and interrelated between the management and the workers, as well as among the workers, while the investors, in effect, supply cognitive tools to them. Let us refer to the hither-to-rather-neglected cognitive relations between the management and the workers inside the corporate organizations as associational cognition. The reason why we need to look into this aspect of business corporations is somewhat related to the famous question raised by Coase. He wanted “to discover why a firm emerges at all in a specialized exchange economy” (1937: 335). As is well known, his answer was that the firm emerged and expanded to the extent that it was able to save on transaction costs by replacing authority relationships for markets. Within the firm the employed workers obey the entrepreneur’s discretion within the bounds of “indifference” set by contracts. He pointed out two situations under which such transaction cost saving could occur. One is where it is difficult to find relevant prices and the other is where it is troublesome to negotiate repeated market contracts. If the permanent association of the body of employees is beneficial for any reason, then the repetition of contract negotiations is certainly without merit. The difficulty of finding appropriate prices manifests itself most prominently when multilateral externalities (and economies of scale, are involved. And, the associational cognition inherently involves lots of externalities. Cognition can be shared across members and over time to organizational advantage, and sometimes to its disadvantage (e.g. too much cognitive assimilation is not always good in an organizational context; organizational inertia overriding new information may become detrimental to adapting to new environments and so on).

If we thus recognize the potential importance of associational cognition, then questions follow such as: How are cognitions (to be) distributed and related among the members of its system? How are they related to the system of tools of cognition such as computers, the Internet, robotics, machines, digital files, and so on? Whose cognitive assets are “essential” in an economically meaningful sense? Are the workers

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simply the bodily extension of the manager's brain in associational cognition? Focusing on this aspect of corporate architecture appears to be particularly important in the era of information technology. I will discuss in Chapter 2 the fact that there are actually discrete forms of architecting the corporate system of associational cognition that are not limited to the Coasian "authority relationship." And they can be subjected to selection by various factors that are not limited to efficiency. Just as there is diversity, as well as similarity, among individuals in their cognitive competence, interests, and contents, so there is among business corporations viewed as a system of associational cognition.

Besides the cognitive aspect, is there any other dimension of the corporation as generically defined previously that may suggest for us a way to revisit the nature of contemporary business corporations as a species? Contemporary jurists characterize business corporations above all by such properties as legal personality (i.e. the capacity to become the subject of contracts, property ownerships, and formal legal dispute), limited liabilities, shared ownerships and their transferability, and delegated management. These characteristics may be regarded as business-specific substantive representations of the "unique identity" and "self-organizing" dimensions of the corporation, on which I will discuss shortly.

The question of what represents the "purposeful activities" specific to the contemporary business corporation may appear obvious at a general level: that is, to be engaged in market-oriented business activities. However, if we pursue this question more specifically, it turns out to constitute the crux of the matter that we are concerned with: "what do corporations do?", that is, "exclusively for profit" as the shareholder-oriented view dictates or for something broader as the stakeholder-oriented view claims. I submit that a proper answer theoretically depends on ways in which a system of associational cognition is architected in corporate organizations. Yes, the shareholder-oriented model could be one viable model under certain conditions. But I intend to develop an argument that there can also be another model that was not even mentioned in the aforementioned, simplistic classification by Hansmann and Kraakman (2001) either as "management-oriented" (traditional American), "labor-oriented" (traditional German), or "state-oriented" (traditional French, Japanese) in their terminology. This model involves rather novel three-way relationships between the management, the workers, and the investors, whose presence may grow with the rising importance of human cognitive assets in business. This book attempts to contribute to an understanding of this new emergent phenomenon.

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The characteristics “rule-based” and “self-governing” in the generic definition of the corporation may at first sound somewhat contradictory. If the rules for corporate governance are to be specified by an outsider, say government, is the governance by corporate insiders according to those rules truly self-governing? It can be so, but then what are relationships between them? Some historically notable corporations, such as the East India Company and many of the public corporations engaged in public works during the seventeenth- and early nineteenth-century America, were chartered by the king or states. It was not until the mid nineteenth century that England finally made it possible for companies to be organized by the mere act of a registration without getting a special charter. But almost a century before that, Blackstone had already offered the following insight: “BUT, with us in England, the king’s consent is absolutely necessary to the erection of any corporation, either impliedly or expressly given. The king’s implied consent is to be found in corporations which exist by force of the common law, to which our former kings are supposed to have given their concurrence; common law being nothing else but custom, arising from the universal agreement of the whole community” (1765–9: ch. 18.I).

Also, in the first systemic treatise on corporations in the USA written in the late nineteenth century and published in the following century, Davis referred to “the creation by the state” as one of their basic attributes, but then quickly added such things as “voluntary inception-compulsory endurance,” “autonomy, self-sufficiency, self renovation”(Davis 1905/2000: 13) to qualify the characterization. Even now, there is a heated debate among scholars with regards to the question of which is the more critical determinant of corporate governance, law, politics or spontaneous evolution.<sup>14</sup> How do we understand (or reconcile) the dual aspects (the opposing views, respectively) of business corporations as expressed by these authors or in the debate?

It is telling that pre-business corporations, such as the Roman Catholic Church and municipalities, were not the immediate creation of the modern nation state. They were voluntarily created, even though some of them needed the explicit or implicit approval of the rulers. As members of *voluntary* organizations, corporate participants must basically have consented to obey its own rather than any external authority. It is considered that under Gregorian Reform in the eleventh century the Roman Catholic Church set an important precedent in this respect. The assignments of jobs in their organizations, including the election of Popes, were made on the assumed capacity of the appointed persons to carry out ecclesiastical missions. In this way, the separation of office and person was made complete

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and the Church was able to free itself of the interference of secular power (Berman 1983). The authority of the Pope's decrees was made absolute, even above any interpretative writings of the Bible by the saints (Genka 2009). The same, self-generating, self-governing nature can be seen in city communes, as well as within the Law Merchants, established as a neutral dispute-judgment organization in Champagne Fair.<sup>15</sup>

This has implications for our inquiry into the nature of business corporations. As a starting point, we may inquire what kind of general rules for governance can be agreeable to and consented to by the constituent members of the corporation. Then, we may ask whether those endogenous rules can be consistent with general rules prevailing in society. Without the first property, people would not participate in corporations voluntarily, while without the second property, corporations would not be sustainable in society. They are interrelated.<sup>16</sup>

Let us first consider the self-governing question. All the constituent members of business corporations, or equivalently the holders of constituent assets, human, financial, and physical, can potentially benefit from participating in corporate associative activities in one way or another. However, their interests in the division of economic benefits from their associative activities are, at the same time, partly in opposition. Thus, concomitant with an evolving architectural convention, there ought to be basic agreeable rules about how the interests of the holders of contributing corporate assets are to be mediated and regulated in terms of their respective rights and duties. What could the nature of such rules be? In my view, this is the essence of the corporate governance problem, broadly conceived. I will discuss in the second half of the next chapter that the general characteristics of such rules are to be co-determined with a conventional mode of organizational architecture and that it may be characterized as a latent "agreement" among the contributing asset holders with their respective bargaining power being conditional on their positions in the architecture. By an agreement, I imply a solution that would satisfy such fundamental requirements as competitive sustainability of associative activities, consistency with a shared sense of fairness/justice, and a cognitive economy independent of irrelevant information. As informed readers easily recognize, these requirements are fundamentally equivalent to the basic axioms of a Nash bargaining solution (Nash 1953)<sup>17</sup>.

Beyond an agreement on the basic principle, however, the governance rules may need to be further specified and formalized to become effective and workable by generating secure expectations among the people. This can partly be the role of formal statutes. However, I contend that

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legislative rules need to be consistent with the basic principle as conceptualized above. If not, they would not be enforceable and would have a detrimental effect on the competitive working of the associative activities of business corporations by distorting the incentives of constituent members. One of the most influential theories of corporate governance at the present time, the legal origin theory, identifies a difference in the legal origin of corporate laws as the most important variable that can explain variations in corporate performance across different economies.<sup>18</sup> However, it is debatable whether a desirable as well as a workable pattern of legal provisions can be uniquely identified and made durable over time.<sup>19</sup> I will argue in this book that different modes of corporate associational cognition call for different forms of governance in order to satisfy the fundamental requirement of self-governance as mentioned above.

I plan to deal with the second, consistency issue as follows. While pursuing their own business objectives under self-governing relationships among their members, corporations in general are overtly or implicitly exerting significant social and public impacts. Thus, for business corporations to become an institutionalized element of a social order, stable expectations need to be both generated and sustained in society in terms of the patterns of corporate behavior. In other words, corporate governance must be such as to generate corporate behavior that is largely consistent and coherent with societal institutional arrangements. Even if business corporations are not literally created by the state—either through a state charter, state ownership, or otherwise—are they still “state-created” in some other sense? More broadly, do they have to secure some kind of “a franchise from society” (Hannah 1976)? In spite of their self-governing nature in the sense discussed above, I answer these questions in the affirmative in a particular sense. I consider that the governance rules prevailing in the corporate field where business corporations cluster and compete must be in a “stable state” in the broader spectrum of *societal rules* that include enforceable statutory laws but are not limited to them.

Societal rules, or institutions, are not imposed on business corporations simply as external constraints. While business corporations attempt to behave in a coherent manner with existing market demands and societal rules, they are also active players in the formation of societal rules through their market and other behaviors. What is needed then is a framework for conceptualizing and analyzing such two-way interplays between business corporations and other social actors, including individuals, governments, non-business corporations, interest groups, non-governmental organizations (NGOs), and so on. These social actors mutually interact with some

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intentions. They aim to achieve some goals—economic, political, or social by their own actions, but in doing so they have to form expectations as to how the others will act and react to their own actions (which in turn is based on others' expectations about their own expectations and so on). In that sense, social interactions are all games, regardless of whether payoffs are exclusively self-regarding, material-oriented, hedonistic, or otherwise.<sup>20</sup> I call those games recursively played in society the *societal games*, although there are different kinds of domains of play. Indeed, viewing the societal order as stable patterns of game playing, and seeing it as generated through the recursive play of games, has been expounded by many authors—prior to the birth of, as well as outside the realm of, formal game theory as founded by von Neumann and Morgenstern (1944). Besides Huizinga, who said “play creates order, is order” in a book entitled *Homo Ludens (Man, as the One Who Plays)*, many great authors, including Plato, Hume, Adam Smith, Hayek, Braudel, and possibly many more, employed analogies of the game as a means of understanding the nature of society.<sup>21</sup>

I follow this tradition, but try to go beyond a mere analogy by differentiating the discrete domains of societal games that embed corporate organizations—commons, economic, social, and polity—by discerning mutually distinct game forms and examining the interrelationships between those games and organization games played internally within business corporations by their members including workers. However, I may add in advance that, in doing so, I am not to be bound by the severe notion of substantive rationality and that of exclusively material-oriented, self-regarding payoffs (i.e. what individuals seek to achieve). I recognize that individuals are limited in their cognitive competence, and for this reason, they need societal rules, as well as corporate organizations, as extended cognitive resources. I will formulate primitive models of societal games in the mentioned domains and examine how different societal rules can evolve in each of those domains together with, and corresponding to, discrete modes of corporate architecture and governance. One great advantage of the application of game theory is its ability to analyze mutual relationships between embedding societal rules and corporate self-governing rules as stable, fit outcomes of play, that is as (multiple) equilibrium phenomena, of the societal and organizational games as linked. Those societal rules include the structure of public governance (that is, the political state), social norms and social status, legal rules and so on.

I have just referred to “equilibrium” in order to capture stable and mutually reinforcing aspects of the societal order and its impacts on the architectural and governance structure of business corporations. However, nothing in the societal order is static in a strict sense. Business corporations

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adapt their associative activities in response to evolving market and societal environments, while evolving corporate behavior impacts on the latter. But under what conditions can these mutually reinforcing processes generate a stable co-evolving path? Can it be understood as the aggregate outcome of rational choices by individual persons, natural and corporate, who are strong enough to possess their own unshakable tastes/objectives, beliefs, values, cognitive capacities, and so on, formed prior to the processes of societal interactions? The recent contributions of epistemic game theory and other disciplines suggest that in order for a stable societal order to evolve, something more may be needed, say, common backgrounds in information and inference, as well as various social cognitive categories such as social symbols carrying some meanings, public propositions such as laws and regulations acting as focal points for cognition, culture as common priors, and so on. In other words, in order to understand the basic nature of institutional evolution, the ironclad methodological individualism needs to be laid to rest. Arrow, one of the greatest economists of our time, stated in his Ely Lecture at the American Economic Association that: “I do conclude that social variables, not attached to particular individuals, are essential in studying the economy or any other social system and that, in particular, knowledge and technical information have an irremovably social component, of increasing importance over time” (Arrow 1994: 8). Chapter 4 of this book presents a coherent framework for understanding how the rules of societal games can be formed and evolve, what the role of business corporations in this process can be, how the above mentioned social categories can be generated and become cognitive environments to which cognitively-limited individual agents including corporations can offload their cognitive burdens.

Finally, toward the end of the book I provide data which depicts the corporate landscape of Japan that emerged out of the so-called “Lost Decade” triggered by the 1992 burst of the financial bubble. I regard the naming of the “Lost Decade” as a more meaningful reference to the societal cognitive crisis rather than just to the economic consequences of macro-policy and banking failures: that is, the state in which traditional rules could not be taken for granted any more. But no consensus has yet emerged as regards what the new rules could be. Yet, behind the crisis, the Japanese corporate landscape had undergone a tremendous change and it can no longer be characterized by a single stereotype of the “Japanese model.” Beside with the traditional corporate structure, it now includes architectural hybrids featuring both increasingly indispensable human cognitive assets and market monitoring, on one hand, and those absorbing a more mobile, often

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disadvantaged, workforce combined with traditional bank financing, on the other. I interpret the causes, nature, and political implications of the evolving diversity, using the framework developed by that point. I suggest then that this diversifying phenomenon is not necessarily an isolated event limited to Japan, but there is a suggestion of similar phenomena evolving globally, albeit each one in a path-dependent, unique manner.

Evolving corporate diversity is thus not so much exactly a diversity due to national characteristics as the “varieties of capitalism” literature suggests, but a ubiquitous phenomenon across economies, exhibiting to differing degrees. In that sense it can be considered as a product of the global integration of economies. The global corporate landscape will never become flat, but it will exhibit varied modes of architectural structure that are built into it. In order to derive the potential gains from the global process of a “convergence to diversities”, however, the global financial markets need to co-evolve as an infrastructure that will accommodate this evolutionary path of diversifying corporate architecture rather than exercise sovereign control over non-financial business corporations of all types. The 2008 credit crisis revealed that relationships between financial intermediaries and non-financial business corporations are still uneasy. The painful process of corporate recovery from the recession is to become the process of a search for a mutual fit between the two.

## Notes

1. The shareholder-oriented view was prominently presented by Berle and Means (1932) out of concerns arising from their findings of the widespread share ownerships and the consequential separation of management and ownership in the USA. In his earlier writing Berle maintained that corporate powers were held in trust not only for the corporation per se but also for individual members of it (Berle 1931). Dodd (1932) challenged this view by arguing that the directors of a corporation must (if they had not already) become trustees, not merely for shareholders but also for other constituents of corporation, such as employees, customers, and particularly the entire community. Later, Berle conceded to Dodd, and admitted that modern directors act *de facto* and *de jure* as administrators of a community system, although he remained rather cautious about admitting this as the “right disposition” (Berle 1959: xii).
2. For a systematic exposition of the “varieties of capitalism” position, see Hall and Soskice (2001) and Amable (2003). Around this period, I also wrote about

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Japanese and German corporate organizations and governance in a comparative perspective (e.g. Aoki 1984, 1988, 1990). However, as is to be clarified in this book, my theory and approach are to be distinguished from those in the so-called “Varieties of Capitalism” literature.

3. See, for example, Aoki (1994c) in which a mixture of bank-oriented governance and securities market-oriented governance was proposed as an option for evolutionary selection on the transition path.
4. Boycko *et al* (1996). Also see Shleifer and Vishny (1997).
5. Financial engineering—designing various financial derivatives to hedge risks—relies on mathematical tools, such as the Black–Scholes formula as an extension of Ito’s Lemma, that can be applied to calculus of stochastic processes (say, securities prices) involving a random Brownian movement of variables. However, in the practical performance-evaluation of financial engineers the tail risks (extreme events with small probability) are not properly accounted for. If events occur in the lower tail, the loss is largely born by client investors who are less well-informed, while financial engineers are generously rewarded when events occur in the high tail. However a large proportion of the revenue increase in the latter case is not a real gain, but should be set aside as a reserve for future risks (i.e. as costs). Such misalignment of incentives has induced financial engineers and fund managers to gamble on excessive tail risks, which was bound to result in a great crash.
6. The term “corporation” (*universitas*; also *corpus* or *collegium*) was derived from Roman law. Romans formed associations of families as *societatis* and *corpora*. The former were engaged in various types of colonial management such as tax farming, while the latter was a kind of guild. Although they had the notion of collective ownership, it has been pointed out that the Roman jurists, “with their intense hostility to definitions and theories,” rarely used or analyzed the phrase “legal person” (Berman 1983: 85–8). North, Wallis, and Weingast (2009: 159–60) also point out that the Romans lacked a clear notion of “legal person” and a corporate body had to be represented by and act through individuals (2009: 160).
7. Also see Davis (1905/2000), Berman (1983), Rosenberg and Birdzell, Jr. (1986), Micklethwait and Wooldridge (2003), Greif (2008). Although more constrained in design and application, however, various institutional devices sharing certain aspects of corporations evolved elsewhere even before the development of capitalist economies, and those organizational experiences left path-dependent impacts on the nature of their transition to corporate market economies. For example, one may cite *Waqf* under the Ottoman Empire, referred to below, and various quasi-corporate organizations, such as *Han* governments, merchant houses, cultural schools, and so on in Edo Japan (e.g. Sugeno 1931; Murakami 1984, 1985; Ikegami 1995; Kasaya 1988). These Japanese organizations were formally dynastically controlled, but equipped with a professional administrative/management apparatus. Incompetent rulers/heads were forced to retire

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early by the bureaucrats and the lack of any proper successors in kinship was dealt with by the practice of the adoption of, or arranged marriage with, able men. Although it is beyond the scope of this book, I consider historical comparative studies of the evolution of corporations and quasi-corporations in various cultural regions will have a significant contribution to our understanding of diverse evolutionary paths of the institutional arrangements of business corporations.

8. The eighteenth-century jurist, Blackstone gave the following classical characterizations which he said applied to “every corporation”: (1) perpetual succession; (2) the ability to sue and be sued by its corporate name; (3) to purchase lands, and hold them; (4) to have a common seal; and (5) to make by-laws or private statutes (Blackstone 1765–9/2005, Bk 1, ch. 18, II). The first systemic treatise of corporation in the USA by Davis conceptualized the corporation as “a group of natural persons embodied in a certain class of the many forms of organization within or through which certain classes of social functions are exercised” (1905/2000: 13). Then, as its delimitations, he referred to the following attributes: (1) associative activity; (2) creation by the state; (3) voluntary inception–compulsory endurance; (4) autonomy, self-sufficiency, self renovation; (5) compulsory unity; (6) having its motives in private interest; (7) functioning in the public domain and in a manner appropriate for associative activity. Greif (2008) also gives a similar definition of corporations, supposedly consistent with their historical meanings, as “intentionally created, voluntary, interest-based, and self-governed permanent associations”. (2008: 8) My definition does not explicitly refer to the “motivational” or “incentive-based” aspect. But for a while let it be implicit in the “voluntary” nature of association.
9. Needless to say, even corporations may cease to exist by their own choice or by law. But its life is not defined by the identity of its members.
10. Under the Ottoman rule, the number of *waqf*-owned commercial facilities amounted to 5,400 in the central market and port districts of Istanbul. By the middle of the nineteenth century most of them had become de facto owned by the lessees and in the twentieth century were transferred to them at a low price (Hayashi 2000).
11. Incorporating the property rights over real estate and prohibiting private ownership of them was a contested issue even for the Gregorian Reformation, and its establishment had to overcome fierce resistance from local priests (Berman 1983). For universities as well, issues of property ownership, even of prisons, became sources of enduring disputes with neighboring communities, sometimes involving severe physical confrontation leading to the deaths of students and residents (e.g. Davis 1905/2000, ch. 7).
12. Makdisi (1981) referred to by Kuran (2005: n.50).
13. This is a growing view of cognitive science; see Clark (1997, 2008).
14. See the debate discussed in chapter 3.
15. See Milgrom, North, and Weingast (1990) for the Law Merchant.

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16. North, Wallis, and Weingast (2009) classify two types of organizations: “An *adherent organization* is characterized by self-enforcing, incentive compatible agreements among its members. . . . *Contractual organizations*, in contrast, utilize both third-party enforcement of contracts and incentive compatible agreements among members.” (p.16) Clearly business corporations are considered to belong to the second category. In contrast, I premise that the deep structure of internal “agreements” defines the fundamental self-governing nature of business corporations, while the third-party enforcement by the state complements them. They co-evolve as discussed in Chapter 3.
17. Binmore (1994, 1998, 2005) provides a comprehensive, general theory of the deep structure of social order based on a Nash bargaining solution. Aoki (1984) is an early treatment of business corporations from a similar perspective.
18. See La Porta *et al* (1998, 1999, 2008).
19. For critical examinations of the legal-origin theory and empirical methodology, see Ahlering and Deakin (2007), Armour *et al.* (2009).
20. A numerical measure thought to underlie observed behavior is referred to as “a decision utility” by Kahneman (1994). That is, the action chosen is inferred to have the highest numerical decision utility not limited to hedonistic experience associated with the consumption of a good or an event but reflecting other motives, say social, altruism, public concern, and so on.
21. Plato believed that playing games according to the rules is essential for educating children to follow societal rules. “I say that in states generally no one has observed that the plays of childhood has a great deal to do with the permanence or want of permanence in legislation. For when plays are ordered with a view to children having the same plays, and amusing themselves after the same manner, and finding delight in the same playthings, the more solemn institutions of the state are allowed to remain undisturbed” (2000, Book VII, 797: 154). Contrast this view with an analogy by McMillan (2002: 22) of the evolutionary development of the rules of folk football to the institutional evolution of market institutions (to be discussed later in Chapter 4(A)(iii)). The famous analogy of “the great chessboard of human society” by Adam Smith is found in (1759: 234). See Hayek (1988, Appendix E: 154) for a reference to “insufficiently appreciated” work by Huizinga. Braudel, the great historian of the French *École des Annales*, discusses the possibility of fruitful interactions between the historic observation of social reality and a model based on “social mathematics”, particularly “the language of conditional facts, neither determined nor contingent but behaving under certain constraints, tied to the rules of a game, to the ‘strategic’ axis in the game of Von Neumann and Morgenstern” (Braudel 1969/1980: 42). He argued that through such interactions, the model can attempt “at an explanation of the structure, and instrument of control and comparison, able to verify the solidity and the very life of a given structure” (1969/1980: 44–5). But the models are of varying duration as the structures are subjected to swift or slow deterioration under the effect of contradictory pressures.