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## Economic Institutional Forms : Made in Japan

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Economic Institutional Forms:  
Made in Japan

THOMAS B. LIFSON  
*Harvard University*

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Japan was a relative latecomer to industrialization and extensive participation in the world economy due to the self-imposed isolation of the Tokugawa Regime. Accordingly, many of the ideas and institutions deriving from the West European and North American experience of industrialization have been imported and adapted to the Japanese experience. The material success which Japan has enjoyed bears eloquent testimony to the effectiveness of the Japanese efforts at adaptation.

But in the wholesale rush to learn from the West too little attention has been paid to indigenous Japanese institutions and experiences. It is often forgotten in the West (and even in Japan) that a rich history of complex and successful business organizations existed in Japan prior to the Meiji industrialization effort. Moreover, in the last one hundred years, these traditions, values, institutions, symbols, and other elements of civilization, interacting with imported or newly-developed institutional forms, have continued to play a major role in the exceptional rate of progress Japan has made in transforming itself first into an industrial state, and now into an information society.

At last the time has come when foreigners and Japanese alike are beginning to take a close look at distinctively Japanese contributions to the world's "genetic stock" of cultural and economic factors useful in the development of complex and rich societies. This effort is only now beginning in earnest. In the US, books such as Vogel [1979], Ouchi [1981] and Athos and Pascale [1981] achieved bestseller status, by highly praising selected aspects of Japanese corporations, government, society, and culture as the keys to Japan's economic progress. In the following years a critical backlash has occurred with other authors<sup>1)</sup> being highly skeptical of Japanese practices. Meanwhile, an encouraging body of serious scholarship is

1) See Sethi, Namiki and Swanson [SETHI, NAMIKI & SWANSON 1984] for one example.

developing which recognizes the need to understand more clearly both the historical and present state of Japanese economic and business traditions, values, institutions and practices on their own terms, and as potential models or guides for other nations in their quest to develop themselves. Often, this means rethinking conventional ideas or concepts which have been based on exclusively Western experience. It is in this same spirit of wishing to foster the enrichment of humankind's store of models and concepts useful for the economy that this paper examines three aspects of Japan's contributions to the evolution institutional forms in the economic sphere: the *sōgō shōsha*, the extensive formation and use of groupings of firms, and the role of interpersonal networks as a mechanism for management within and between firms. The initial and primary example is one of world's great economic institutions which undeniably has its origins in Japan: the *sōgō shōsha*.

## 1. THE SOGO SHOSHA

Usually *sōgō shōsha* is translated into English as "general trading company," or "comprehensive trading company," or with some other even less satisfactory partial description. I believe strongly that the *sōgō shōsha* is *sui generis*: a distinctive institutional type which happens to have emerged first in the world in Japan. Thus, rather than translating it into English and other languages, I propose instead that the Japanese term be incorporated into other languages, thereby enriching their vocabularies and their conceptual bases. A *sōgō shōsha* does not have to be Japanese: Korea, Brazil, Taiwan, and even the United States have all made national efforts to create their own domestic versions of *sōgō shōsha*, largely as vehicle for fostering exports and economic development. These efforts have so far met with mixed success, and no foreign firm has yet approached the size or diversity of the six largest Japanese *sōgō shōsha* companies.<sup>2)</sup>

A *sōgō shōsha* is essentially a comprehensive intermediary, an organizer of other firms. That is, it stands among various sources of economic goods, channeling money, information, raw materials, products, services, and practically anything else from one party to another. Uniquely among the world's corporations, a *sōgō shōsha* is active from the very earliest "upstream" activities of raw material extraction or processing, through multiple stages of production, fabrication and distribution, "downstream" to the end user, in most of the basic categories of economic commodities: food, fuel, fiber, metals, chemicals, and the end products for which they are used. Although it sometimes owns a major or minor equity share in the firms with which it deals, the primary role of the *sōgō shōsha* is the coordination of firms, not overseeing their internal operations.

The breadth and scale of its role as coordinator in all the basic industries gives the *sōgō shōsha* a unique place among the world's corporations. Most giant firms

2) For the problems of the most prominent U.S. effort to copy the *sōgō shōsha*, "Sears World Trade," see Dizard [DIZARD 1984].

specialize in a range of related materials, technologies and markets. Within their chosen range they perform a wide variety of functions internally. The economists' term for this is that they are "vertically integrated."<sup>3)</sup> The *sōgō shōsha*, however, is not vertically integrated. Instead, it might be said to be a "horizontally integrated" firm: that is, one which uses its internal coordinating capacity to reach out beyond its own corporate boundaries and coordinate other firms. Moreover, because it is active in so many different industrial sectors, the *sōgō shōsha* is often in a position to spot developments in, say, the steel industry, which create opportunities (or threats) for the auto industry, the computer industry, the food industry, or any of the other spheres of activity in which it participates.

An example may help illustrate how this happens.<sup>4)</sup> A *sōgō shōsha* operative in New Caledonia may learn of unusual activity indicating some party is exploring acquiring nickel, or the rights to develop a nickel mine. Since nickel is a key ingredient in steel manufacture this can only indicate some new development in the steel industry, perhaps a new steel complex planned by a developing country. This would not only have an impact on the *sōgō shōsha*'s existing steel manufacturing clients, it would also create a demand for steel plant construction, for financing to pay for that construction, for shipping capacity for raw materials and finished products; it might lead to new mining activities, which could create additional demand for mining equipment, and it might influence market prices for not only steel but also for products which can be a substitute for steel, such as aluminum and plastics. A *sōgō shōsha* plays an active role in each of these industries and activities. Because it has the internal capacity to gain and process knowledge about all of these related spheres, it can often act swiftly to anticipate changes and coordinate its own and its clients' responses to them.

I define a *sōgō shōsha*'s role as a "product systems manager." A product system consists of all the stages of activity which are required to create a finished product. For every product, even simple ones, many technologically separable operations have to be performed, and most often even in industries dominated by vertically integrated firms, many of these activities are performed by different companies. For example, to make steel it is necessary to mine coal and iron ore, to store and transport them, to convert them into coke and pig iron, and then to make steel, which must then be cast, rolled and further processed. Finally, steel itself becomes a raw material for diverse products such as ships, trucks, railways and many other things.

Perhaps the summit of vertical integration was achieved by Henry Ford in his

3) It is worth noting at this point that Japanese industrial firms are sometimes less vertically integrated than their Western counterparts due to their extensive use of subcontracting relationships. This phenomenon is directly related to the *sōgō shōsha*, in that both subcontracting relationships and the *sōgō shōsha*'s coordinating efforts make extensive use of external networks of interpersonal relationships, as discussed later in this paper.

4) See Yoshino and Lifson [YOSHINO & LIFSON 1986] for further details on this and other examples given in this paper.

famous Rouge Works in Detroit, where coal, iron ore, sand, and other ingredients entered, and finished Ford automobiles left. Every operation in between was owned and managed by his firm. This was believed to be the most technically efficient method for organizing industrial activity. Professor Alfred Chandler of Harvard University, in his famous book *The Visible Hand*, traces the rise of the vertically integrated firm, where the "visible hand of management replaces the invisible hand of the market" as a coordinating mechanism.<sup>5)</sup> In the U.S. and Europe, the rise of the vertically integrated firm was synonymous with the industrialization process, and there has therefore been the tendency to assume that this is simply a natural or inevitable process. Ironically, today the Rouge Works is being "dis-integrated", as the steel facilities have been sold and are being modernized with the participation of Japanese steelmakers and *sōgō shōsha*.

## 2. INTERFIRM SYSTEMS

I would contend, however, that Japan's path to industrialization has been different from the Western reliance on vertical integration. In Japan, mechanisms for coordination among firms have developed to a high degree. The *sōgō shōsha* is one such mechanism. But it is far from alone. A wide variety of institutional forms for achieving coordination among firms has been developed in Japan. Others might include *keiretsu* groups, *shitaue* subcontracting arrangements, and other kinds of business groupings. I refer to all such patterns of coordinated activity among separate firms as "interfirm systems."<sup>6)</sup> Interfirm systems are by no means unique to Japan. Cartels, formal and informal, legal and illegal, are very common throughout the world, as are close relationships between subcontractors and their customers. American history has its era of trusts, German history its *konzerns*, and other countries no doubt have their own particular forms and terminologies.

What is different about Japan is the degree to which systematic coordination among multiple firms has been developed, used and accepted. Stating the point more forcefully, I would contend that Japan has made a major contribution to the evolution of forms of effective complex economic organization through the high degree of development of interfirm coordinating mechanisms. I predict that the meaning and importance of this contribution will become far more evident in the future, as economics, organization theory and other academic disciplines lose some of the blinders attaching them so tightly to the British, American and European mainstream economic histories.

The *sōgō shōsha* and other types of interfirm systems in Japan form a middle ground, halfway between markets as a form of coordination and vertical integra-

5) Chandler [CHANDLER 1977].

6) See Lifson [LIFSON 1985] on interfirm systems. Others pursuing similar lines of inquiry on the ties among Japanese firms include Dore [DORE 1983], Itami and Imai [ITAMI & IMAI 1984] and Imai [IMAI 1985].

tion as a form of coordination.<sup>7)</sup> That is, when a *sōgō shōsha* coordinates the flow of raw materials from mines to a blast furnace, the transaction has some of the characteristics of a market transaction, and some of the characteristics of a transaction between two related parts of the same firm. Unfortunately, it is not always the case that the best or most efficient characteristics are present. In fact, today, the *sōgō shōsha*'s role in the Japanese economy is declining, indicating that its efficiency versus other forms of coordination may also be declining, at least in the rapidly-maturing industries where *sōgō shōsha* business has been concentrated. But this does not detract from the first central point of the paper: that Japan has developed a third alternative to markets and vertical integration as a major, large-scale, long-lived and effective mechanism for coordinating economic flows of goods. As the *sōgō shōsha* declines, other forms of interfirm systems in Japan are flourishing.

At this point it is appropriate to ask the question: why have the *sōgō shōsha* and other interfirm systems developed so markedly in Japan? Is there something in Japan's history, culture or civilization which provides particularly fertile soil for this institutional form?

It is impossible to answer this question completely here, for the question of causation is inevitably complex and unclear. But it is possible to begin outlining some of the factors which may have led to the relatively extensive development of interfirm coordinating mechanisms in Japan. One basic and relatively obvious factor lies in the historical circumstances surrounding Japan's industrialization. Japan's long isolation from world commerce during the Edo Period left it with very few people or organizations capable of managing her re-entry to world trade. This then encouraged the growth of the *sōgō shōsha* as a common mechanism which many firms could share as a way of linking themselves with foreign markets.<sup>8)</sup> Similarly, the rapid pace of industrialization, with large modern installations, such as the Yawata Steel Works, superimposed on an existing economy made up of myriad small-scale producers, encouraged large firms to make extensive use of subcontractors as suppliers.<sup>9)</sup> The continuing shortages of capital and skilled manpower left large scale enterprises with few alternatives other than to "farm out" certain processes or work to other firms, or establish their own *zaibatsu* or *keiretsu* networks of subsidiaries.

While this historical type of explanation certainly has some degree of applicability, I am not completely persuaded. Other nations have faced similar circumstances, after all. Moreover, the question remains why have these forms persisted and flourished long after the initial historical circumstances have passed?

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7) The work of Oliver Williamson [WILLIAMSON 1977] has been very important in developing the theoretical basis for understanding the circumstances in which market forms and corporate forms are efficient and appropriate.

8) Nakagawa (1966) deserves much of the credit for developing the comparative framework for understanding the evolution of the *sōgō shōsha*.

9) Dore [DORE 1973] contains an excellent discussion of this topic.

### 3. NETWORKS AS AN INSTITUTIONAL FORM

Another sort of answer may lie in the realm of what social scientists call emergent social structure. An emergent social structure is a persistent pattern of behavior that develops out of the interaction of organizations, cultures, personalities, environmental factors, and other elements of what we might call here "civilization." Emergent social structures are not designed or planned, *per se*, but rather take form as the result of decisions and realities which are partially controllable by men's decisions.

Interpersonal networks are one form of emergent social structure. There are many ways to define interpersonal networks, but the one I will use here is as follows. The interpersonal network of a manager consists of the pattern of relationships with other managers which he enjoys at a given moment. Obviously, it is partially up to the personality of the manager as to with whom he develops deep relationships. But equally obviously, corporations and society as a whole impose structures (such as career paths or labor market mobility constraints) which decisively shape the patterns of relationships which a manager may develop.

To state my argument prematurely, various elements of contemporary Japanese civilization, including culture and language, typical large corporate structures and labor market characteristics, create highly favorable circumstances for the development and flourishing of interpersonal networks as an import element of managerial systems within and between firms. Such networks are not exclusively Japanese, but appear in other environments. But I believe that their level of development is comparatively high in Japan, and that Japan has contributed network-based systems as an institutional form suitable for study and use elsewhere in the world.

### 4. THE BASIC THEORY OF ADMINISTRATIVE NETWORKS

Many of the most important managerial processes of large Japanese firms, such as information-gathering and evaluation, consensus-building, decision-making, resource allocation, and certain key human resource issues are not rigidly conducted according to a highly structured bureaucratic protocol. Instead, these processes tend to be dependent on the character and use of specific relationships among key managers involved.

A simple example will illustrate. Monitoring technological change is a key concern of many Japanese firms, anxious as they are to keep their own technologies advanced, and to anticipate changes in their suppliers' or customers' technologies which might have an impact on their own operations. Formal processes exist to regularly monitor sources of information about technological developments. But in addition to this, a great deal of informal "opportunistic" technology scanning may occur. A manager (whom we shall call Suzuki) working in one arm of a firm may come across a development which might affect another part of the firm. If

Suzuki has an established relationship with someone in the other arm of the firm (call him Kato), they may have previously spoken about the Kato's operations together. Thus, Suzuki would understand the potential impact of the development he uncovered, and he may be motivated to undertake some effort (over and above anything required of him in his current position) to communicate the development to Suzuki.

The performance of such "ad hoc" or "opportunistic" acts as just described, over and above the formal, bureaucratic, mechanistic linkage processes designed into an organization, is highly useful to an organization in helping it cope with change. Of course, such acts rest on a foundation of a generalized commitment to an organization, and an acceptance of responsibility by each (or most) of its members for its overall health and progress. But such general factors are a necessary but not sufficient explanation of the type of behavior just outlined. Because there are infinite possibilities for action, over and above that formally designed into his position, facing any manager with a generalized commitment to the firm, there must be a mechanism for prioritizing and channeling activity. The structure and dynamics of a network system provide such a mechanism. Let us return to the above example in explaining further.

The basic principle governing the process of a network is the norm of reciprocity—along with the incest taboo, the most universal rule in human culture.<sup>10)</sup> When Suzuki took the trouble to investigate and communicate his finding to Kato, he began to create an obligation which would be owed to him by Kato. If the Suzuki-Kato relationship is to continue into the future, Kato will have to acknowledge the obligation, implicitly both will put a value on it, and eventually Kato will reciprocate.

Thus, for any network process, there are actually at least four stages:

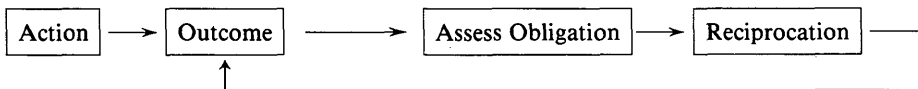


Fig. 1 Stages of a Network Transaction

The assessment of the value of obligation created is often a long term process, for there are two components of value: the effort which went into the action by Suzuki, and its value to Kato. In most cases Suzuki's effort may be rather readily known, but there may be complications. For example, Suzuki may have incurred some obligation of his own in obtaining the data, or Suzuki may have had to put aside other work to do it, which could create future problems for him. But in most cases, it is the assessment of the value to the receiver, in this case Kato, which requires the most time and judgment. If the information Suzuki supplies to Kato

10) On the universality of the norm of reciprocity, see Gouldner [GOULDNER 1960]. For an application to Japan, see Befu [BEFU 1980].



enables Kato to suggest actions by the firm which ultimately prove important, Kato may powerfully benefit in terms of his own career progress. One form of reciprocity might then involve sharing credit with Suzuki openly. Or, if credit sharing is not feasible or desirable, reciprocity may involve employing Kato's influence to obtain some kind of decision favorable to Suzuki's interests at some point in the future.

Reciprocity is an event which itself requires an outcome and assessment. Thus, there is a feedback loop from the last of the four boxes to the second. In reality, it is impossible to draw an end point within the chain of favors and reciprocity which link two individuals who enjoy a solid continuing important network relationship. And, in reality, there is no "zero balancing" within a healthy relationship. Rather, it is a situation in which each party strives to maintain either an approximate equilibrium of obligation owed between the two, or perhaps a slight positive balance in his own favor. Thus, each party is constantly thinking of ways in which to add (at minimal effort to himself) obligation of the highest ratio of value-added, in the other's "accounts payable" obligation column.

Although Suzuki and Kato may occasionally keep the depth of their relationship secret, or may sometimes choose to conceal its use in certain instances, a dyadic relationship does not exist in isolation. It must be understood in the context of the other relationships Kato and Suzuki maintain. Context impinges on the dyad in several important ways:

1. Kato and Suzuki may need to rely on others, especially mutual associates, to help them measure obligation owed and discharged;
2. Mutual associates are an implicit enforcement mechanism to ensure that obligations are fully discharged. If Kato refuses to satisfy Suzuki, and others side with Suzuki, then Kato's reputation, and ability to call on others for their help, will suffer. In a system where formal sanctions are few, and job responsibilities and authority are kept to a low level of specificity, this can be a fatal disability; and
3. Third parties can provide a supply currency for obligation balancing.
  - a. By making Suzuki's meritorious deeds known to others, Kato can add to his prestige and credibility easily. This is more than an abstract consideration, for it improves Suzuki's ability to form new relationships and to call on others' help readily.
  - b. Kato may go a step further, and actually introduce and recommend Suzuki to a third party, say, Ikeda, when Suzuki is in need of a resource over which Ikeda has discretionary control. In so doing, Kato stands as a guarantor of Suzuki's ability to use Ikeda's resources well, and of Suzuki's ability to discharge any obligation which might be incurred toward Ikeda.
  - c. Or, alternatively, Kato may have a store of obligation owed to him by Ikeda, and may realize that Suzuki, to whom Kato owes obligations, could use Ikeda's resources. In this case, Kato may act as a "broker"

or reticulator, simultaneously collecting obligation from Ikeda and discharging it to Suzuki.

So far, nothing that has been described is necessarily peculiar to Japan. Indeed, I believe that the mechanism so far described is quite a universal one, which operates in business systems where membership is important, and the sanction of ostracism is a real possibility. Examples would include most ethnic business communities, such as Indian and Chinese traders in Southeast Asia, Lebanese in Africa, and various groups in America. There are a number of important commodities whose trade is largely handled by systems with a large component of network-based obligation exchange: wholesale diamonds, certain metals, West Texas oil, and some aspects of investment banking. There may even be certain elements of this system present in university faculties.

But the system does apply to Japan in a specially powerful way, for I believe that networks are more extensively used as a basic mechanism in the economy of Japan on a larger scale, and with more regularity than practically anywhere else. The oft-noted clan-like elements of large Japanese firms, with their emphasis on members, and many other elements of the employment and corporate systems have evolved so that they structurally support the use of networks. Finally, certain aspects of Japanese culture, especially concepts of obligation, can be drawn upon to facilitate the process of network functioning.

In a Japanese corporation, for managerial staff, membership is a key concept, far more so than merely an employment relationship. Not only does this produce a generalized commitment to the firm, its overall welfare, and to learning as much as possible about all its key aspects, it makes the sanction of ostracism or exclusion from obligation exchange all the more powerful. A manager who does not handle his network of relationships with care will have few alternatives in employment markets outside the firm and little chance of rising within it.

Concepts of authority, and the formal structures allocating it create a large volitional element in the efforts of most Japanese managerial workers. It is absolutely necessary to capture the active support of others in order to be an effective manager or leader in a Japanese business situation.

The human resource systems of large bureaucracies in Japan have evolved to provide extensive support and encouragement to the development of networks. The career-long employment commitment not only makes exclusion a devastating sanction, it also provides a stable context within which it is possible to take a long time to develop a consistent set of network relationships. Seniority-based promotion during the first half of a career reduces the incentives to grab credit for oneself prematurely. By stretching out the time horizon of formal reward, it allows a more leisurely pace of reciprocation, and the gradual emergence of a broadly-shared consensus about individuals' capabilities and credibility. With this pace, the likelihood of being able to successfully behave unethically around reciprocation issues is reduced.

During the first half of a managerial career, the dominant work context is that

of a *ka* or section. Within the *ka*, most members' job responsibilities are formally undefined, that is, left to the discretion of the *kachō* or his delegate. This creates the necessity for the *kachō* to monitor the work performance of junior members closely. The most efficient way to do this is to check with a network of those associating with the junior member in his work. Thus, from a very early stage, a new recruit into a company begins to see that the credibility he is generating through his work with others has direct consequences for his job responsibilities. If he impresses and works with others well, the *kachō* is likely to delegate more and more significant responsibilities to him over time. These increasing responsibilities will have a largely positive effect on his ability to be of use to others in his network. A self-reinforcing cycle is begun.

The daily work of a young section member provides many object lessons in obligation and its discharge. Because he is usually dependent on *senpai* for help in learning new duties or in performing existing ones, it is inevitable that the younger section member incurs obligation. The *senpai* for their part have a direct personal interest in encouraging the younger member to understand the depth of his obligation and the importance of its discharge. They seek to delegate as much of their "old work" (tasks which they have already mastered) to free up their time and energies for "new work" (broader, more important tasks, which they seek to be delegated by more senior managers). This is how one rises in a Japanese bureaucracy.

Ambition is the driving force behind the dynamics of network construction and use. Members of an entering class of recruits are acutely aware of the fact that only a few of them will rise to senior levels of responsibility by the time of retirement. This provides a general motivation to perform well and be valuable in the eyes of others. While formal differentials in promotion will not appear until approximately the midpoint in a career (usually at the time when the first members of a class are promoted to *kachō*), some evidence suggests that in many companies less formally obvious distinctions begin quite early in career paths.<sup>11)</sup> A relatively small group within a cohort may be selected for a "generalist" rotation pattern, moving them relatively swiftly through a larger number of units of the firm. Those on the generalist track are widely perceived, over time if they are successful in their postings, as the emerging "stars" of the cohort. This is partly because their emerging broad range of contacts within the firm enables their reputation to grow. It may also well be due to the fact that, having been chosen for an elite track, they are given more opportunities to exercise higher level responsibilities. These generalist stars not only provide a demonstration effect of a broad network's power, they offer an education in the importance of network selectivity.

Any manager, even a young one, is faced with the necessity of selectivity in the formation and maintenance of a network. His time is, after all, finite, so that by choosing to maintain one relationship, the time available for others is diminished.

11) Pucik [Pucik 1981].

Thus priorities must be drawn, even if subconsciously. Over the long term, the most valuable network will be comprised of managers who are placed in important positions throughout the firm, and whose ability to draw on others, through their own store of obligation, is highest. Thus, from a coldly calculating point of view, it makes sense to invest one's time in establishing relationships with those young managers who are likely to rise the highest, and to perform the most activity of a value-adding nature. If Suzuki is such a manager, and Kato has previously established a relationship with him, then Kato has the good fortune to have potential access to Suzuki's large and valuable network of resources. Suzuki's obligation takes on a higher value to him than it previously had.

Suzuki, meanwhile, finds himself at the center of a virtuous circle. As his network expands, he is in a position to pay back obligation faster, through his ability to call on more diverse resources than most. Moreover, the value which others, such as Kato, place on Suzuki's obligation to them is rising. I call this valence applied to a manager's obligation his credibility. As more people are attracted by the reputation of a high credibility manager, they become interested in bringing information and other resources to him, in the hope of establishing or reinforcing a network relationship. The fortunate Suzuki thus has even more resources at his disposal.

Suzuki's credibility in this case is very analogous to the price of a commodity in short supply. In fact, the entire reciprocity system of obligation accounting bears close comparison with a market system. I would contend that over time, through the credibility mechanism quasi-market prices are established for the obligation of managers, and that these prices closely reflect the real executive worth of individuals. As one rises up the hierarchy of any organization, but especially so in a Japanese firm, the executive positions are more and more concerned with coordination planning, relationship maintenance and other skills which tend to draw heavily on a network such as the one described. Of course the same sorts of market imperfections apply to this system as to any other markets.

## 5. THE STRUCTURE OF PARALLEL HIERARCHIES

Networks also develop between firms. When two hierarchically-organized Japanese firms interact regularly, a pattern of interpersonal relationships or networks predictably develops between them. I call this pattern the structure of parallel hierarchies. Figure 2 is a vastly simplified schematic illustration of an ideal-type structure of parallel hierarchies. The most notable feature is that relationships exist between individuals in each company and their counterparts in the other firm at many important levels in the hierarchy. There can well be more than one party and relationship at each level. In this ideal-type the relationships are exactly parallel at each level. In practice, there are relationships that go down or up across the two firms, there are missing levels of contact, or only a few levels existing. There are also, of course, many instances of multiple relations at approx-

imately the same level, between individuals in different segments of the two firms.

The *nenkō joretsu* system of hiring and promotion is the single most important factor in producing this pattern of relationships. Young managers in 'A' who make contact with their counterparts in 'B' can expect to be promoted at approximately the same speed, especially if their firms are about the same size and enjoy similar success. The very low rate of job leaving by managers in large firms also works to ensure that a relationship formed early can, if it is maintained, be used when both parties are more senior.<sup>12)</sup>

Each level of the corporate hierarchy performs a somewhat different role in creating and managing the overall relationship. Generally speaking, the lower levels are responsible for the nitty-gritty planning and implementation of well-defined projects, while the upper levels handle broader goal-setting, philosophical, abstract, and symbolic aspects of relationship-management. For instance, if raw-material supplier 'A' has to pass-on market price increases for its product to 'B', a variety of levels would be involved in handling the matter. Lower levels might be the first used, to informally communicate the earliest information 'A' has about market trends to 'B', warning that trends are unfavorable, and asking 'B's

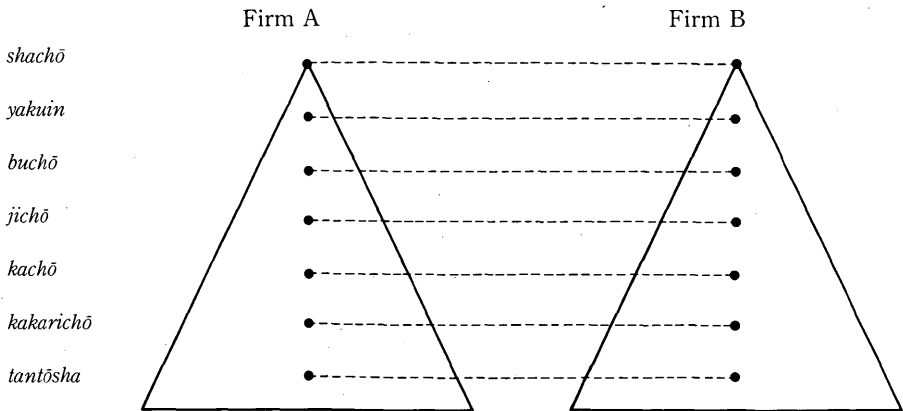


Fig. 2 Schematic of Parallel Hierarchies

- 12) Obviously, in Japan's vast and important medium and small business sector, promotion speed and job turnover can differ greatly from the big business pattern. This complicates the pattern of parallel hierarchies, but does not mean that they do not exist. Typically, there are fewer linkages between a small firm and a big one, and the managers in the small firms who enjoy personal contacts with counterparts in a large firm have much higher-sounding positions, and may be much older. There is also much "passing-down" of relationships by managers in a big firm. Thus, a large firm *kachō* who has been dealing with a *yakuin* or *shachō* at a small firm will introduce his successor to his counterpart when he is promoted, and subsequently maintain only a very limited relationship with the counterpart.

understanding indulgence and cooperation in coping with the trend.

Such warnings would naturally be transmitted up 'B's hierarchy, but often via internal network channels. Senior managers might discuss ways to minimize consumption of 'B's product, ways to develop other more competitive suppliers, or ways of putting pressure on 'B' to absorb most or all of the cost increase itself. Each of these responses would have a different impact on 'B'. All would affect 'B's welfare. Thus is created a need for the two organizations to bargain with one another.

The bargaining process makes use of the parallel hierarchies to explore in a non-threatening fashion, the impact of various possible ways of reacting to the price increase. For proposals which 'B' might regard as threatening in some way, lower-level relationships between managers who know and trust each other could be used. The top levels rarely become involved in this stage. A lower level manager, such as a *kachō* or a *tantōsha*, where there is a reservoir of operating experience, but as yet relatively low levels of formal responsibility, might be chosen. A *tantōsha* in 'B' could check the impact of 'A's proposal by referring it up the hierarchy of his firm, using both formal and network channels. At this stage no formal offer or response has been made, so there is a relative freedom to be frank within the firm. If various individuals and units of 'B' find the proposal mostly unacceptable, but with one or two elements which 'B' could accept with modifications, this complex message could be conveyed back to 'A' at the *kachō* or *tantōsha* level. The next stage of discussions could take place at various levels, depending on the content, importance, or conflict potential of the issues.

Two things are important to note about the process so far. One is that although there is potential for conflict, there is as yet no overt or formal bargaining. The incentives for ultimatums, theatrics or other counterproductive strategies are minimized, though there is ample room for posturing. The continuity of the relationship is reinforced and protected at the symbolic level throughout the process, by avoiding direct confrontation of differences at formal or senior levels. The second thing to note is that the use of horizontal relationships between the firms leads directly to the use of vertical relationships within each firm. It is often the case that 'A's positions or actions will have a differential impact on different managers and subunits of 'B's organization. In other words, there is an internal political dimension to the process of utilizing the structure of parallel hierarchies. Internal vertical networks of managers are functionally related to their external ties.

One of the key managerial abilities in Japan is skill at developing and managing external corporate relations, such as those with suppliers or customers. Therefore, managers in 'A' whose career paths may bring them in contact with external firms (as all generalist career paths do), are interested in building personal relationships with peers at 'B' and other counterpart firms. They are particularly concerned to identify outside contacts who are currently or potentially able to draw on extensive sources of information, influence and other resources, within their home companies. This kind of access to resources usually requires an extensive internal net-

work of personal contacts. Thus, for a manager in 'A', a primary criterion for judging the desirability of forming a relationship with a particular manager in 'B' is that manager's own personal network within 'B'. To the extent a manager in 'A' enjoys relationships with well-connected managers in 'B', he is able to obtain information and influence there. The same logic also applies to managers in 'B' in developing their relationships within 'A', of course.

If 'A' and 'B' are important firms to each other, then numerous managers at each level in each firm will be competing with one another to form relationships with the most capable members in the counterpart firm at their own level. They compete on the basis of being able to promise access to their own current and potential future resources, many of which will come to them via their own personal networks within their home firm. To the extent that members of 'A' and 'B' have reliable information about each other, a sorting-out process will take place. High potential and fast-rising managers in each will, in effect, "bid" for each other, offering their own resources in exchange for potential access to the resources of others. There is only a finite number of relationships which each manager can maintain, so it is a serious business to decide where to allocate one's time and other resources in the building and maintenance of outside contacts.

The real basis of a long term relationship between two managers is that each can promise to use his own resources to help identify, plan, and implement joint activities between 'A' and 'B' which will benefit both firms. To the extent that they succeed, each will be rewarded by his own firm. To the extent each is rewarded internally, his utility to his counterpart is also increased. Internal and external networks thus reinforce one another.

There are efficiency implications to the pattern of interfirm governance just described. Oliver Williamson has pointed to transactions costs as the key variable in distinguishing between the market and the vertical integration mode of coordination. The same factor bears application to the interfirm systems model. It is clear that a large overall investment in time is necessary to form relationships at each level of the hierarchy in 'A' and 'B'. Numerous managers must invest considerable time in meeting and talking with their counterparts. The costs are largely fixed costs. That is, once the investment in establishing the parallel hierarchies has been made, the incremental costs of negotiating any particular project are relatively low in comparison.

By contrast, American styles of negotiating interfirm relationships tend to emphasize low fixed costs, and high variable costs. When negotiations take place, they are often at a senior level (where time costs are highest), and lawyers and the courts frequently become involved in contract writing and dispute resolution. Thus the incremental transactions costs of adjusting a relationship are high for Americans, whereas the initial fixed costs are relatively low. For Japanese firms, the balance between fixed and incremental costs is reversed.

For situations in which the inputs are of uncertain cost, and the outcome is also uncertain, the division of rewards and costs requires what is known as a "contingent

claims contract." This is the most expensive type of transaction to govern. Yet, it is the type which is more frequently encountered when the pace of technological and market change is highest. The existence of both intra- and interfirm network mechanisms which govern complex contingent transactions may be as yet an unexamined explanation of Japanese economic performance.

These economic efficiency considerations suggest that rationality may be a factor underlying the Japanese tendency to use long term business relations as a corporate policy. Although total transactions costs are difficult to measure, the relative division of transactions costs between fixed costs and variable costs may itself influence corporate choices in issues of vertical integration, and outside contracting.

I would suggest that the high fixed cost mode is most efficient when highly complex interdependence is required, such as when carrying on joint technical development, or any other activity in which the stakes and uncertainties are high, and the relative resource abundance is low. These are circumstances with which Japanese businesses have long contended as they modernized and expanded their productive activities. It is particularly intriguing, therefore, that two of the largest and most successful businesses in the U.S., IBM and General Motors, have each recently launched experiments in creating their own sorts of interfirm systems. IBM, with its purchases of substantial (though not complete) ownership of chipmaker, Intel, and PBX-maker, Rolm, may be creating its own *Keiretsu* of sorts. Meanwhile, GM is undertaking a variety of activities: reducing the number of suppliers it buys from; intensifying relations with the survivors; and establishing the "Buick City" operation in Flint, Michigan, to take advantage of the *kanban* system of inventory management.

## CONCLUSIONS

I have taken a fairly bold position quite self-consciously in arguing that Japan has been the site of development for important institutional forms, which are only beginning to be recognized at home and abroad for what they are: excellent models of ways to deal with economic complexity. I am painfully aware that my argument lacks concrete empirical evidence here. To supply such evidence will require much more space and much more research. Yet, I believe that this conference is an important venue at which to make such bold efforts. I am convinced that there is at least some truth to what I have put forward, and am eager to enlist the help of colleagues who are willing to share their criticisms, experiences and insights to help refine these still crude notions.

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