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"In my view it is the labor market, particularly the practice of permanent employment, that is the most important persisting institutional difference between the U.S. and Japan. This difference has much to do with shaping many of the more obvious differences between both economies."

Gary Saxonhouse[1]

"The single greatest challenge facing managers in the developed countries of the world is to raise the productivity of knowledge and service workers. This challenge, which will dominate the management agenda for the next several decades, will ultimately determine the competitive performance of companies."

Peter Drucker[2]

There has been a plethora of recent articles in the popular business press in both Japan and the U.S. about the "end of the Japanese-style human resource management system," in particular, the end of the practices of *lifetime employment and seniority-based wages and promotion among large Japanese firms*.[3] While changes *are* being made at many companies, it is a far cry to proclaim the end of the current system, since this "system" itself has been far more an evolving process than a long term stable phenomenon. Moreover, there is a fairly large amount of evidence that while changes are taking place, they are generally limited to seniority-based pay and promotion practices, while the practice of lifetime employment remains intact in most large companies. In addition, even in terms of seniority-based wages (*nenko*), only a minority of large firms (approximately 10%) have actually substituted performance-based pay and promotion systems, and even among these firms, some retain guarantees as to wage levels which are contrary to a pure performance-based system.

The evidence for the above statements lies in the results of a number of recently published surveys carried out by the Japanese Ministry of Labor (hereafter JMOL), the Federation of Japan Employers or *Nikkeiren* (hereafter FJE), the Japan Productivity Center (hereafter JPC), and the Japan Employment Information Center (hereafter JEIC) over the past two to three years. Using such surveys, it is possible to obtain a broad-based (rather than journalistically skewed toward the exceptional) picture of what large Japanese companies are doing within Japan in regards to their employment policies, in particular the practices of lifetime employment and seniority-based wages and promotion. This paper will make use of such survey results in answering the *first* issue to be addressed here: namely, are Japanese employment practices undergoing fundamental changes and if so how much?

A second issue is the set of *reasons* behind these changes in employment practices. While popular press reports commonly point to two factors in particular, i.e. (a) a long recession over the past four years in the Japanese economy, and (b) an excess of older white collar employees whose productivity needs to be improved (Schlender, 1994, and Hori, 1993), this categorization of the problem leaves out a range of other reasons. These include changes in (1) Japanese companies' international competitive positions, (2) the structure of the Japanese economy, and (3) employee attitudes toward work.

A third issue is the strategic implications of these changes (and non-changes) in employment practices, both for Japanese firms themselves and for Western companies competing with Japanese firms. Again, contrary to a certain recent popular view that Japanese firms are simply becoming more and more like Western firms in both their human resource policies and overall firm strategies (and as a result for example emphasizing profits over market share), this paper will show why large companies will be forced to continue to place a strong emphasis on both growth and market share as corporate strategies, and put even greater emphasis on product, marketing and service innovations. Moreover, in order to deal with high labor costs in Japan and to create these innovations, large firms will continue to shift lower value-added manufacturing overseas at a rapid pace while simultaneously increasing performance-based pay and promotion systems within Japan to foster greater white collar productivity and innovation. All of these changes will result in an *evolution*ary rather than *revolution*ary change in both large firm human resource policies and corporate strategies, with various implications for Western companies who compete or cooperate with large Japanese firms.

RECENT CHANGES IN THE EMPLOYMENT SYSTEMS OF LARGE JAPANESE FIRMS

According to a recent publication of the Japanese Ministry of Labor, "lifetime employment" can be defined as the "practice of companies to hire their core employees primarily from among new graduates and other young persons, to plan their continual training and development, to continue their employment within the company group over a long period of time [usually until 55 or 60], and not to discharge or layoff such employees except in very unusual circumstances."[4] First it is important to note that this definition refers to "core employees." That is, the system does not and never has applied to <u>all</u> employees (that is, it leaves out temporary workers, subcontractors, seasonal workers, part-timers and dispatched employees).[5] Second, although this JMOL definition doesn't refer to the issue, lifetime employment is really only limited to larger companies. Third, this definition refers to core employees' long term training and employment within the enterprise group or *keiretsu*. It does not state that they never leave the particular companies they entered, either to go to another company within the *keiretsu* or to leave on their own to pursue a career at another company. For example, according to a JMOL survey carried out in 1993 among manufacturing companies with over 1000 employees, the following percentages of university graduate white collar male workers remained with their initial company of employment at the following ages: Age 30 - 78.9%; Age 40 - 70 %; Age 50 - 66.2%; Age 60 - 33.6%.[6] As a result, one can conclude that "lifetime employment" in large companies for white collar male employees actually means that on average roughly two thirds of employees stay with the same company until the age of 50, while by the age of 60 this figure declines to only 33.6% as many employees retire and move to subsidiary firms.

JMOL surveys of companies also point to recent changes in this system of lifetime employment. One such change is that there has been a gradual trend since 1969 for the percentage of the total labor force under lifetime employment to decrease, accompanied by a gradual increase in the service sector as a percentage of Japan's economy and an increasing use of part-timers in all companies. At the same time, between 1973-1993, there was an *increasing* use of lifetime employment among male workers in the 45-49 years old age category in large companies with over 1000 employees.[7] As a result, in the twenty years between 1973-1993, the practice of lifetime employment had already begun to decline as a percentage of the total labor force, while at the same time slightly increasing in its application to older workers in large companies.

The above still leaves unanswered what has happened to lifetime employment since the beginning of a long recession in 1992. An early survey regarding was carried out in 1993 by the JMOL among large manufacturing companies with over 1000 employees, in which 70% of companies indicated that they had adjusted their labor forces during the then ongoing recession. However, only 2% indicated they had used layoffs or voluntary retirement. In a later 1994 JMOL survey of similar large manufacturing companies, in response to a question regarding their plans toward lifetime employment in the future, 56% of companies answered that they "plan to maintain lifetime employment in the future," 35.7% replied that "partial changes in the system are unavoidable," and only 5.8% said that "fundamental revisions are necessary."[8] Finally, in the most recent survey carried out in January of 1996 by the Japan Productivity Center (JPC) among personnel managers of Tokyo Stock Exchange listed companies, 82.4% replied that their companies supported "maintaining the lifetime employment system as much as possible."[9]

Based upon these results, it seems clear then that the general trend among the majority of large companies is to maintain the lifetime employment system, not abolish it. This conclusion is not changed by the fact that some companies used early retirement options for employees over 45 or 50 during the recent recession, since the percentage of companies offering such programs was a minority and because such retirement systems themselves do not necessarily signal the end of the lifetime employment system since they have been used in the past. Moreover, the above qualifying phrase, "to the degree possible" is the same that most companies have offered to their employees in the past, and indicates that the lifetime employment has never implied an iron clad guarantee but only a statement of principle by companies backed up by legal constraints in Japanese labor law (see below).

As for the seniority-based pay and promotion system (*nenko* wages), however, there is considerably *less* support among larger firms for its future maintenance. In fact, a majority of companies currently support its gradual weakening and in many cases its complete abolishment. But first of all, what does "seniority-based pay and promotion" actually refer to? Again, if we use a JMOL definition, it means "a system or practice which emphasizes number of years of service or age and educational background in determining pay and promotion."[10] Notice that this definition says "emphasizes." This does not mean that seniority measured by the number of years with the company is the only means used to determine pay but rather a primary means.[11] Thus even in companies which use a seniority-based pay and promotion system, among same year entrants to the company there has always been a fair amount of competition and informal evaluations of individual performance begin soon after new employees enter the company, even though they are treated equally in terms of pay and promotion for a number of years. According to a 1994 JMOL survey of 2000 firms with over 1000 employees, for example, just over half (50.3%) gave their first promotion to all new employees of the same year of entry at exactly the same time (an average of 6.3 years after entry). However, after this first promotion, further promotions and wage increases are also tied to individual employee merit, although the merit component in a traditional seniority system is much smaller than seniority as a determinant of overall wage levels. Moreover, in the past ten years, it appears that a wage structure based upon seniority is weakening in large companies. For example, in 1993 the ratio of average wages of 45-49 year olds compared to 20-24 year olds was 277.0%, while in 1983 a similar comparison of the wages of these age groups yielded a ratio of 303.9%. In other words, from 1983 to 1993 the difference between the average wages of older and younger workers decreased, indicating a flattening of the wage curve and thus a weakening of wages based upon seniority. As a result, egalitarianism in terms of wages, already a strong characteristic of large Japanese companies, has increased.[12]

As to how large companies view the seniority system, according to the above mentioned JPC 1996 survey of TSE listed companies, only 10% of companies support maintaining the seniority system as it is. More specifically, their responses can be divided as follows:

- "The lifetime employment system should be maintained to the extent possible but seniority-based pay should be abolished" (76.1%)
- "Both lifetime employment and seniority-based pay should be abolished" (12.0%)
- "Both lifetime employment and the seniority system should be maintained" (6.3%) (JPC, p. 12)

Again, one can read this as an emerging consensus among larger companies that while lifetime employment will be retained, seniority-based pay and promotion will generally be phased out.

Given that it is with the seniority system that the major changes are and will be taking place, let's look in more detail at what these changes have been so far. Actually modifications to the seniority system began as early as the 1950s when a few companies in the private sector introduced "job-based wages" (*shokumu-kyu*) as one part of overall pay, though they were never popular with workers and unions and didn't fit well with the rapidly changing technology environment at the time, which tended to transform the content of many jobs fairly quickly. As a result, "job-based wage" didn't come to be more widely used until after the first oil crisis (1973-1974), when the need for more specialized skills became clearer, and "job ability-based wages" (*shokuno-kyu*) became popular as a way of using an individual job abilities in determining one component of overall pay. More recently, since the early 1990s, such "job ability-based wages" have come to be used by more companies and to focus on individual worker performance over a one year period compared to goals set out at the beginning of the period. As a result they have come to be called by the label, "annual salary systems" (*nenposei*), and a number of books by such organizations as the FJE and JEIC have been published in the past couple of years offering guidelines in their introduction.[13]

Use of such annual salary systems by companies has also been the target of an increasing number of surveys over the past several years. A summary of their results are as follows:

(1) Japan Productivity Center Survey[14]

Companies Surveyed:	2230 TSE listed Cos.
Date of Survey:	January 1996
Return Rate:	22.9 %

<u>Use of Annual Salary System</u>:

Already Introduced:	9.8 %
Specific Plan to Introduce:	7.6 %
Considering Future Introduction:	60.6 %
No Plans to Introduce:	20.2 %

<u>When System Introduced</u>:

1990 or Before:	24 %
1991:	6 %
1992:	8 %
1993:	8 %
1994:	20 %
1995:	30 %

<u>Reasons for Introduction</u>:

Clarify Performance Evaluations:	71.0 %
Apply Stimulus to Workplace:	38.8 %

<u>Target Employees</u>:

General Managers:	80 %
Managers:	40 %

<u>Factors Used to Determine Annual Salary</u>:

Previous Year's Performance:	82 %
Overall Contribution:	56 %
Ability:	42 %

(2) Japan Employment Information Center Survey[15]

Companies Surveyed:	Cos. With 500+ Employees From Various Industries
Date of Survey:	October 1995.
Return Rate:	30 %

<u>Use of Annual Salary System</u>:

Already Introduced:	8.3 %
Not Yet Introduced:	91.7 %

<u>When System Introduced</u>:

1990 or Before:	26.7 %
1991:	6.7 %
1992:	[illegible].3 %
1993:	13.3 %
1994:	26.7 %
1995:	13.3 %

<u>Reasons for Introduction</u>:

Clarify Performance Evaluations:	80.0 %
Encourage Employees to Think Like Managers of Company:	38.8 %

<u>Target Employees</u>:

General Managers:	80 %
Managers:	33 %

(3) Federation of Japanese Employers Survey[16]

Companies Surveyed:	2000 Member Companies
Date of Survey:	1995
Return Rate:	25 %

Use of Annual Salary System:		Target Employees:	
Already Introduced:	14.5 %	Managers:	42.5 %
Not Yet Introduced:	85.5 %	Specialists:	45.2 %

(4) Japanese Ministry of Labor Survey[17]

Companies Surveyed:	Cos. With 30 or More Employees
Date of Survey:	May 1994
Return Rate:	61%

Use of Annual Salary System:	
Already Introduced:	9 %
Specific Plans to Introduce:	1 %
Considering Future Introduction:	9 %
No Plan to Introduce:	80 %

Cos. Using Annual Salary System By Co. Size:	
Over 1000 Employees:	13 %
300-999 Employees:	7 %
100-299 Employees:	8 %
30-99 Employees:	5 %

Based upon the above results, the following conclusions can be drawn:

(1) About 10 % of large companies have introduced an annual salary system

(2) Companies use it primarily for managers and general managers, and not for lower level jobs or employees, though it is also used to an extent for specialists, especially in technical areas

(3) Large companies use such systems a bit more often than smaller companies

(4) The introduction of annual salary systems did not begin with the recent recession but in at least a quarter of companies predated the recession

(5) The primary reason for their introduction has been to support employee evaluation systems based upon performance over the previous year

More specific data from the JPC survey carried out in January of 1996 also shows that companies are using new annual salary systems to break employee assumptions that salaries automatically increase every year, regardless of individual performance. For example:

- In companies using annual salary systems, one out of ten employees under the system have experienced a decrease in their salary from the previous year
- In companies using annual salary systems, one out of four or five employees under the system have experienced no raise in their salary from the previous year
- 53 % of companies using annual salary systems have set no lower limit for salary decreases for employees under the system
- 27.7 % of companies using annual salary systems have set lower limits to pay decreases for employees under the system
- 10.6 % of companies using annual salary systems still guarantee at least the last year's salary level for employees under the system[18]

At the same time, this same survey also indicates that the most important goal of companies using annual salary systems has *not* been to cut white collar labor costs through pay decreases but to raise white collar productivity. For example:

- 43 % of companies currently using annual salary systems said that on average, employees' salaries rose in a way *similar* to what they did before introducing the system
- 37.8 % of companies said that the number of employees with a greater rise in salary than before introduction of the system increased
- 18.9 % of companies said that the number of employees with a smaller rise in salary than before introduction of the system increased[19]

This primary use of annual salary systems to boost productivity was also reflected in company responses to a question asking for their view of the major merits of having introduced an annual salary system. The two most frequent responses were (1) "increasing employee motivation to work harder" and (2) "clarifying performance evaluations," while "cutting labor costs" came in eighth place. Moreover, among companies in the survey which had not yet introduced an annual salary system but either had specific plans to do so in the future or were considering introduction, their major reasons for considering future introduction were "clarifying performance evaluations" (74.4 %) and "helping carry out a system of management by objectives" (42.2 %). In addition, 84.5 % of such companies replied that an ideal annual salary system should be one in which "although decreases in salary were possible, there is a minimum guarantee of salary level appropriate to the employee's job level and qualifications."[20] Again this indicates that the aim of introducing annual salary systems is less based upon a short term perspective of simply cutting labor costs through wage decreases and more upon a long term perspective of increasing productivity through establishing performance as the prime factor in setting pay and promotion.

Finally, it is extremely relevant that among companies in the JPC survey who have not yet introduced annual salary systems, the two major factors cited as most crucial for its spread in the future were: (1) a weakening of a "seniority system mentality" among employees (56.9 %), and (2) clearer evaluation standards for employee evaluations (43.4

%).[21] Both of these factors indirectly point to potential employee backlash to their introduction as one of the current obstacles to the wider spread of performance-based systems.

In summary then, the major recent changes in Japanese companies' domestic employment practices have centered upon revisions to the seniority system and not lifetime employment. As a result, the seniority system seems to be in a process of being replaced by a new individual job performance-based pay system increasingly labeled as an annual salary system. However, while it appears that such performance-based pay systems will eventually replace current seniority-based systems in the majority of larger Japanese firms, so far this has only occurred in a minority of firms (about 10%) and within these firms to only a minority of total employees, in most cases primarily general managers and managers. At the same time, press reports about the end of the lifetime employment system clearly seem premature, not only since a majority of large companies indicate plans to retain it but because it continues to offer a number of strong positive points for them, namely, encouragement of strong employee loyalty and motivation and fostering of excellent informal communication and coordination systems within the company, while its drawbacks in terms of fixed labor costs are manageable.[22]

CHANGING INTERNAL AND EXTERNAL BUSINESS ENVIRONMENTS AND THEIR EFFECTS UPON THE EVOLUTION OF THE EMPLOYMENT PRACTICES OF LARGE FIRMS

The current employment system of large firms, largely defined by the practices of lifetime employment and seniority-based wages and promotion, is generally a product of the immediate post-World War II period, although important antecedents to current practices can be traced back to the wartime period (1940-1945) and even further back to the 1920s. Beginning in 1941, for example, wages based upon levels of experience, education, sex and region of the country became institutionalized, and the idea of wages as based upon workers' "living costs," i.e. guaranteeing that wages would cover workers minimal living costs, was instituted. Following this, in 1942 yearly wage increases based partly upon age and length of service became obligatory in many industries. At the same time, both labor mobility and companies' ability to dismiss workers were curtailed.[23]

In the early postwar period, unions fought to preserve this guarantee of "living wages," (*seikatsu-kyu*). The electrical power industry workers trade union in particular was a leader in reaching an agreement with managements on setting wages based upon the worker's life stage and marital status, with the idea being a guarantee of wages to cover living costs at a time when high inflation was hurting Japanese workers' ability to keep up with such costs. This agreement, reached in 1946, quickly spread to other industries and was eventually adopted by most managements in exchange for labor peace. The system then became the basis for seniority-based wages and promotion and together with the lifetime employment system was viewed by management as a way of securing labor peace and of retaining skilled workers, advantages which managements of selected large companies had recognized as far back as the 1920s.[24] From unions' point of view, on the other hand, lifetime employment and seniority wages were seen as ways to stave off management tendencies to use layoffs to adjust labor costs and to beat the threat of inflating living costs. Additional support for the establishment of lifetime employment were various Labor Court rulings in the 1950s which established "principles regulating the right to dismiss" and required that companies specify "legitimate reasons for fair dismissal." (Such laws would be tightened further in the 1960s.) At the same time, in order to achieve flexibility in labor costs and provide lifetime employment to a core work force, managements of companies *limited* lifetime employment to a core work force, created a separate group of temporary workers who could be laid off easily, instituted twice yearly bonuses whose amounts varied partially according to company financial results, varied workers' overtime hours, and squeezed suppliers in times of recession in order to adjust overall system labor costs[25] As a result, contrary to the image that managements alone created these systems in the postwar period in order to deal with the need to retain skilled workers or that they were simply the natural result of Japanese cultural values, in many ways they were also the direct result of unions' demands for "living wages" and no layoffs, followed by managements' acceding to these demands for core employees, incorporating them into an overall system which still maintained overall labor cost flexibility.[26]

Following their initial introduction in the late 1940s and early 1950s, however, seniority-based wages and lifetime employment *remained* in place into the 1960s and 1970s even after inflation fell and wage levels rose far beyond what was required for simply covering "living costs" because of the following factors:

(1) a long period of high economic growth rates which allowed large companies to pay steadily increasing wages to all workers, guarantee employment, and not tie wages to specific jobs or individual performance since high growth created plenty of work for everyone to do

(2) a "catch-up" based economy, i.e. an economy based upon catching up, first with prewar levels of Japanese output, and second with levels of technology in the West. In such an economy, mass production and process-oriented innovation ruled the day. As a result, human resource strategies could focus on training and development of generalist workers able to absorb and improve existing technologies rather than specialists or workers focused upon innovative technology

(3) a labor force which consisted of a large number of young workers and to which the application of seniority-based wages with steep wage/ age curves (i.e. low wages for young workers) meant overall low wage costs for companies

(4) labor union support for lifetime employment a the seniority system and opposition to the introduction of more individual performance-based pay systems

In the 1980s and 1990s, however, a number of factors both *internal* and *external* to large firms have contributed to increasing pressure for change in the seniority system. Major *internal* factors have been:

(1) falling profit margins, predating the early 1990s recession but becoming acute after its inception

(2) a rising percent of employees in white collar jobs and their much slower productivity growth than blue collar workers

(3) a rapidly aging work force, with an excess of older workers, especially among white collar staff (with estimates of their numbers varying between 10-20 % of all white collar workers in 1994[27]

(4) changes in employee attitudes toward work and the seniority system, especially among the younger work force

Falling profit margins in large firms began after 1970, a year when average operating margins for TSE listed firms were still as high as 6 % on average for non-financial companies. Operating margins thereafter began to drop, especially after the first oil shock in 1974-1975 when they fell to under 4 %, before recovering and climbing above 4 % in the 1980s, and then falling again to less than 2 % during the early 1990s. Return on equity trends were similar, starting as high as 16.6 % in 1970, dropping to 9 % after the first oil shock, then climbing back above 13 % in the early 1980s, before dipping below 6 % in the early 1990s and by 1994 falling as low as 2 %.[28] Although the causes for this gradual long term deterioration of returns are many, two in particular are: (1) large firms' overwhelming emphasis on retaining market share rather than profitability, itself made possible by relatively tolerant long term oriented shareholders, and (2) low white collar productivity in an environment in which the percentage of total workers who were white collar increased dramatically from 36% in 1970 to 50% in 1990. One survey of 1000 large firms from 1982-1992, for example, found that while blue collar productivity allowed average gross profits to rise by 68 %, when white collar employee costs were added in, there was only a 6 % gain in operating income for the same time period.[29]

Another major factor of course is the rapidly aging Japanese population and its equivalent within the Japanese company, a labor force age chart that is no longer a pyramid but an elliptical shape, with an excess of baby-boomer employees in the middle who as they age contribute to steadily rising labor costs under traditional seniority-based wages.[30] Such excess middle age and older workers were much more easily tolerated when the economy was growing fast and profit margins were higher. Now that these are no longer the case, the productivity of such excess collar staff becomes a major issue.

Finally, attitudes among *younger* employees are becoming much more accommodating to the principle of equality of opportunity that a performance-based pay system implies and increasingly less tolerant of the principles of equality of results and patiently waiting for one's chance that the traditional seniority system implies. Such younger workers are also generally less loyal to the company and more family and/ or leisure-oriented than older generations and so are more prone to push themselves less for the company. They are also somewhat more prone to change jobs than their elders, though this seems at least partly due to the seniority-based pay and promotion system itself, which does not reward young high achievers fast enough. Higher job mobility also seems to be the result of a changing economy and an increase in specialized jobs in areas such as software and certain fields of engineering which face shortages of qualified workers.[31]

When we switch our analysis to environmental factors *external* to the large firm, the role of non-cost-based factors becomes even larger. Major *external* factors can be categorized as follows:

(1) the maturing of the Japanese economy, in terms of both lower growth rates and growth of the service sector (which has traditionally been more performance-based in employment practices), and the end of the "catch-up" economy, with further economic

They also allow for the much greater use of specialist employee tracks rather than generalist routes as a path to greater status for talented specialists. Moreover they allow companies to more easily hire mid-career specialists necessary to develop new technologies or enter new fields.

Such rapid internal technical innovation and movement into new fields is also necessary since an earlier Japanese strategy of dependence upon Western technology is less a feasible option. This is because Western firms are less willing to sell advanced technology and because in many areas Japanese companies have no option but to develop new technologies themselves since Western firms' technologies are no more advanced than their own.[32]

Seniority-based wages and promotion, therefore, are widely seen within large companies as needing revision while performance-based wages and multi-track or specialist track employment where talented individuals can rise through the ranks and be rewarded for their expertise without being a generalist are being increased. Although these trends actually began in the 1980s, it is during the 1990s that they are slowly becoming the mainstream trend.[33]

STRATEGIC IMPLICATIONS OF CHANGES (AND NON-CHANGES) IN EMPLOYMENT PRACTICES

What then are the strategic implications of these changes in human resource policies, both for large Japanese firms themselves and for Western firms in competition with them? First, although much has been said in the popular business press about Japanese companies' greater focus on profitability and diminished focus on market share, and although there is some truth to this, to the extent that the majority of larger firms retain lifetime employment for core employees, this need to guarantee employment will necessitate that companies continue a fairly strong emphasis on *growth* as a core strategy.

growth increasingly dependent upon internal technical innovation, a move to higher value-added products and major cuts in government regulation

(2) a decline in large Japanese companies' international competitive position, primarily due to yen appreciation and a declining ability of companies to squeeze out more costs from suppliers and factory production. As a result, large firms are in fierce competition with both Western firms in high value-added products on technological grounds and price, and in lower value-added products with Asia's rising NIEs. The result is simultaneous pressure on firms both to develop more high value-added products through innovation, and to shift more and more of the manufacture of their lower value-added products out of Japan. This will require greater white collar innovation and productivity at the same time that it eliminates both white and blue collar jobs. Although such jobs are usually lost through attrition rather than layoffs, the Japanese government and Japanese companies (urged on by the government) are mounting a major effort to replace these lost jobs with new jobs in high growth areas

(3) increasing internationalization of Japanese companies' operations, which creates the need for more specialist tracks for Japanese employees and exposes management more and more to different ways of managing workers prevalent overseas

The above factors indicate that greater innovation is a key to competition in the higher value added sectors which large Japanese manufacturing companies tend to compete in. High quality production of standardized products in mass quantities, or even large varieties of quality products in smaller lots are no longer sufficient in themselves. Rather large firms will increasingly need to develop unique or innovative products which cannot be easily copied and to continually move up the value-added chain with new innovations before others can catch up. This requires companies to develop entirely new technologies more and more often and to do it much more quickly than before. Performance-based wages help by incentivizing motivated workers and forcing slackers to either improve their performance or risk lower and lower pay and demotions in job levels.

Moreover, with the growing concerns in both the government and private levels over a major "hollowing out" of Japanese domestic manufacturing as companies move more and more lower value-added manufacturing overseas,[34] there is already a mindset among both companies and the government that new jobs in growth sectors of the economy must be created. Yet, on the individual firm level this focus on growth is not only with creating new jobs in new industries but on growing market share in existing markets at the expense of other companies. This is readily apparent in the current behavior of such representative companies as Toyota (whose new president has made regaining a 40% market share in Japan a major company goal) and other major auto companies such as Honda, Nissan, Mitsubishi. It can also be seen in the behavior of major electronics companies such as Hitachi, NEC, Fujitsu and Toshiba, all of which are in the midst of a major new push into the PC market as both a way to grow and because of the strategic implications of not being in this key product sector for their future.[35] Both such firm behavior and the hollowing out effect of the shift to overseas manufacturing implies that large Japanese companies' emphasis on growth versus profitability has not and will not change that much, though there will be effort toward trying to increase profitabililty ratios from their historic lows. The implication for Western companies seems to be not to expect a complete reversal of Japanese companies' previous market growth and market share-oriented strategy but only minor adjustments to it, with growth still very much a primary concern of large Japanese firms.

Second, the new international competitive dynamics large Japanese firms face (discussed in the previous section) are forcing them to put much greater strategic emphasis on innovation in products, services and market positioning, and in labor productivity improvements. In addition, awareness among Japanese companies that in order to be more innovative they must foster greater free thinking and creativity among their employees extends widely among large firms.[36] As a result, Western firms competing with Japanese firms should be prepared for an onslaught of innovative and non-traditional products and services coming out of Japanese companies, combined with non-traditional marketing and partnering strategies as well.[37] Second, as productivity increases helped by use of performance-based pay systems (and the shift to more overseas production) gradually kick in, Japanese companies' overall cost competitiveness should improve and be reflected in their pricing of products (albeit dependent upon future yen appreciation).

Third, although early retirement plans and implicit layoffs at some larger Japanese companies in the past few years have been made much of in the Japanese press, most Japanese companies' focus is not on layoffs, a short term strategy anyway, but the longer term objective of major improvements in white collar productivity in order to improve competitiveness and grow faster. The reasons are simple. First, layoffs are still mainly negative in their effects for large companies, not only for public image, but for both current employee morale and new recruitment efforts. Second, as U.S. companies have found out recently, although layoffs can alleviate short term cost problems or boost short term profitability, they do not address long term growth issues.[38] Third, Japanese large firms are *more* concerned with the productivity of the majority of white collar employees who remain with the company, since it is their productivity that will have the greater effect upon long term competitiveness. Although performance-based pay systems are an important means to increase such productivity, they are not the *only* means and Japanese companies will continue to try to re-design work processes within their companies in order to increase productivity. Given their track record in managing workflow on the factory floor, it seems at least possible that they might do an equally good job in the office over time. The implication of these potential changes for Western firms is to expect a gradual but steady resurgence in Japanese firms' competitiveness.

Fourth, it is *not* likely that there will be any breakup of the larger *keiretsu* groups, based either on major sales of inter-locking shares or breakups of supplier networks. At the same time, *keiretsu* will become more open, both in terms of allowing in more outsiders or new suppliers and perhaps some sales of inter-locking shares. The reasons for this are various and have much to do with the various continuing advantages of *keiretsu* affiliation. From an employment system point of view, however, it is large companies' stated intention to continue to offer lifetime employment for core employees that is important here, and in order to do this, *keiretsu* affiliations are a major advantage. Again, this does not imply an ironclad guarantee (and never did) on the part of large companies toward lifetime employment but only a statement of principle that it will be upheld as much as possible. For example, instances of transferring employees to other firms, sometimes permanently, and of early retirement with extra pay have been used since the first oil crisis and will continue to be used in the future.[39] Moreover, although supplier groups are becoming more open and memberships more changeable, there are important strategic reasons for large firms to keep key suppliers within a tighter long term circle, both to preserve confidentiality of key technologies and because communication and coordination costs will continue to be lower among established parties than in the case of frequently changing relationships. The implications of all of this for Western firms is that while opportunities to enter into Japanese *keiretsu* networks as suppliers will increase, such entrance, unless it involves very proprietary technology, will have less of a tendency than in the past to mean necessarily a long term relationship.

Fifth, and perhaps least surprising is that the continuing high cost of labor in Japan will drive more and more large Japanese manufacturing companies to shift production overseas, in particular to Asia. Asia is the logical choice for much of this manufacturing not only because it is close to Japan, its local markets are booming and its labor rates are still relatively low (though increasing), but because it simply is the only major overseas market where Japanese manufacturing consistently makes profits, while U.S. and European Japanese manufacturing facilities have been in the red for years. The implication of this for Western firms is to expect continued fierce competition in local Asian markets and lower prices from Japanese competitors in more mature product sectors as they move them increasingly to overseas production.

CONCLUSION

In conclusion, it may be helpful to return briefly to the historical and situational elements in the establishment of the lifetime employment and seniority systems in large firms in Japan. That is, although these practices can be partly explained as the natural response of postwar firms to a fast growing environment and a "catch-up economy," a comparison with Korea in the 1980s shows that equally high growth rates and a similar "catch up economy" can be accompanied by a higher rate of labor mobility and layoffs and a more flexible "lifetime employment" system.[40] How does one explain this? The answer seems to be that rather than high growth rates and a "catch up" economy alone, the particular form of lifetime employment and seniority practices in Japan have been equally the product of specific historical decisions made in the early postwar period by unions and managements and the institutionalization and gradual adjustment of these practices over time. Although such practices became partly out of sync with large companies' objective needs as time passed, they were gradually adjusted to fit the changing needs of the business environment, and as a result, the seniority aspect of wages has declined.

Given this past history, there is reason to think even more adjustments, even major ones such as a gradual elimination of the seniority system and its replacement with a new system based upon individual performance, can be made while at the same time retaining in principle lifetime employment for core employees. Why then would large Japanese companies wish to abandon Japanese style lifetime employment in favor of U.S. style layoffs and labor mobility rates, given the former's benefits in terms of high levels of employee loyalty and motivation and excellent internal communication and coordination? Moreover, since Japanese style "lifetime employment" itself never has been truly "lifetime" for everyone even in large companies, the system has been flexible enough to adjust to most environmental changes without getting rid of the principle of lifetime employment for core employees. In addition, while the system clearly has contributed to higher white collar costs and a lack of productivity growth recently, these problems seemingly can be solved by the introduction of performance-based wages which will both reward high producers and punish laggards.

That such adjustments rather than a shift to an entirely U.S. style system are the most probable future course for large Japanese companies is supported by JMOL survey results, which point to most companies' goals as being "keeping the merits of the existing system while getting rid of its demerits." In practice this means maintaining lifetime employment for a core labor force while introducing performance-based wages to more and more employees, in an earlier time in their career, and with a shorter period of evaluation (i.e. annually). At the same time, the key challenges are viewed by companies as establishing new performance systems which are seen as fair by employees and use evaluation criteria which do not overly focus on short-term performance to the detriment of the long term interests of the company.[41]

In short, "continuing evolution" rather than "abrupt revolution" seems to best characterize the current process of changes in the human resource practices of large Japanese companies. While some observers argue that such an incremental approach to changes only postpones the larger transformation necessary before large firms can regain greater competitiveness,[42] the evidence that drastic employment practice changes (for example abolishment of lifetime employment) will actually occur at most large firms is weak. Instead, since both government policies and national attitudes favor social stability and there is an apparent national consensus that lower economic growth is both inevitable and superior to maximizing short-term corporate profitability through massive layoffs of redundant employees, the most likely course for most large companies will be to accept such redundant employees while gradually decreasing their numbers through attrition and increasing overall labor productivity levels through squeezing out more productivity from all employees. Such squeezing of productivity gains is something most large companies have tremendous experience in over the past 40 years (albeit more at the factory level than in the office) and the new performance-based wage systems will make it much easier to do this. Consequently, the pieces seem to be in place for large firms to manage their current employment issues through a shift to performance-based pay without eliminating lifetime employment.

Perhaps the *strongest* evidence that the above course is the most likely one, however, is the recent record of success of companies such as Honda, one of the first large companies to shift to a performance-based system. Since that time (1992) Honda has been able to revitalize itself without any layoffs of core employees by using this new performance system along with a strong focus on new product innovation and partnering strategies.[43] Similar reforms underway at Toyota, Nissan, Fujitsu, Toshiba, and Matsushita indicate that other large companies are following a similar strategy.

NOTES

[1]Gary Saxonhouse, "Is Japanese Capitalism Different?" *Tokyo Business Today*, Vol. 7, November 1992, pp. 20-24.
[2]Peter Drucker, "The New Productivity Challenge," *Harvard Business Review*, Vol. 69, November-December 1991, pp. 69-79.
[3]See for example Brenton Schlender, "Japan's While Collar Blues," *Fortune*, Vol. 129, March 21, 1994, pp. 97-104; Sebastian Mallaby, "Japan Survey," *The Economist*, Vol. 332, July 9, 1994, pp. 1-18; "Great Changes in the Employment System (Toyo dai henka)," *Shukan Toyo Keizai*, No. 5373, September 16, 1995, pp. 16-34; Kishi Eiji, "Has Japanese Style Management Ended? (Nihon teki keiei wa owata ka)," *Voice*, January 1995, pp. 70-79; "What's Killing Japanese Business? - Japanese Style Management," *Tokyo Business Today*, Vol. 8, July 1993, pp. 24-26; Kishi, Nobuhito, "Use and Throw Away White Collar Workers (Howaitokara tsukaisute)," *Ekonomisto*, Vol. 74, May 23, 1995, pp. 26-36.
[4]Japanese Ministry of Labor, *The Present Situation and Future Prospects of the Japanese Style Employment System* (Nihon teki toyo seido no genjo to tenbo), (Tokyo: JMOL, 1995). p. 2.
[5]Kazutoshi Koshiro, "The Employment System and Human Resource Management," in *Business Enterprise in Japan*, ed. Kenichi Imai and Ryutaro Komiya, (Cambridge: MIT Press, 1994), p. 228.
[6]JMOL, p. 3.
[7]JMOL, pp. 2-4.
[8]JMOL, pp. 3-4.
[9]JPC, *The Present Situation and Future Prospects of Our Country's Annual Salary System* (Waga kuni nenposei no genjo to tenbo), (Tokyo: Japan Productivity Center, 1996), p. 12.
[10]JMOL, p. 4.
[11]Kenichi Imai and Ryutaro Komiya, "Characteristics of Japanese Firms," in *Business Enterprise in Japan*, op. cit., pp. 20-22.
[12]JMOL, pp. 4-5.
[13]Federation of Japanese Employers, *Design and Operation of Japanese Type Annual Salary Systems* (Nihon gata nenposei no sekkei to unyo),(Tokyo: Nikkeiren Communications Dept., 1996); Japan Employment Information Center, *Issues and Methods in the Advancement of the Annual Salary System* (Nenposei no susumekata to kadai), (Tokyo: JEIC, 1996).
[14]JPC, 1996.
[15]JEIC, 1996
[16]JEIC, p. 32.
[17]JEIC, pp. 30-31.
[18]JPC, p. 7.
[19]JPC, p. 26.

[20]JPC, pp. 38, 54.
[21]JPC, p. 66.
[22]Imai and Komiya, pp. 23-26; Hiroyuki Itami, "The 'Human-Capitalism' of the Japanese Firm as an Integrated System," in *Business Enterprise in Japan*, op. cit., pp.80-82.
[23]Yukio Noguchi, *The 1940 System* (1940 nen taisei), (Tokyo: Toyo Keizai, 1995); Hiroshi Hazuma, *The Lineage of Japanese Style Management* (Nihon teki keiei no keifu), (Tokyo: Bunshindo, 1993); Koshiro, 1993, op. cit.; Ronald Dore, "Industrial Relations in Japan and Elsewhere," in *Japan: A Comparative View*, ed. Albert Craig, (Princeton: Princeton University Press); and D. H. Whittaker, "The End of Japanese Style Employment?" (Cambridge: Harvard University, Program on U.S.-Japan Relations), 1989), pp. 31-32. .
[24]William K. Tabb, *The Postwar Japanese System*, (New York: Oxford University Press, 1995), pp. 78-82; Whittaker (1989), p. 32; Dore (1979); JEIC (1996), pp. 10-11;
[25]Koshiro (1994), pp. 228-230.
[26]Andrew Gordon, *The Evolution of Labor Relations in Japan: Heavy Industry 1853-1955*, (Cambridge: Harvard University Press, 1985; Koshiro, p. 230.
[27]Mallaby, 1994.
[28]"What's Killing Japanese Business? - Japanese Style Management," *Tokyo Business Today*, Vol. , July 1993, pp. 24-26; Mallaby (1994), p. 13.
[29]Mallaby (1994), p. 11; Schlender (1994), p. 25.
[30]Every increase of five years in the average age of a firms' work force under a traditional seniority wage system can result in wages rising by approximately 25 %. Whittaker (1989), p. 5.
[31]"The I [illegible]e of Leisure," *The Economist*, Vol. 323, May 2, 1992, p. 83; Shintaro Hori, "Fixing J[illegible]an's White-Collar Economy: A Personal View," *Harvard Business Review*, Vol. 71, November-December 1993, pp. 157-172.
[32]The movement away from dependence upon Western technology is reflected in Japanese technology trade figures over the past 15 years. See Japan - An International Comparison, (Tokyo: Keizai Koho Center, 1981-1996).
[33]Already in 1987, for example, 32% of all large companies with 5000 employees or more had multi-track employment systems, while service sector companies such as finance and insurance in particular had 6 %. See Whittaker (1989), p. 22. Although in the 1980s many of these specialist tracks still used seniority-based pay systems, in the mid-1990s they are gradually being switched over to performance-based systems
[34]Predictions are for the proportion of manufacturing done overseas to increase from 8.6% in 1994 to 15% in the abo[illegible] 2001. See Sumie Kawakami, "Exporting a Surplus," *Far Eastern Economic Review*, Vol. 159, July 4, 1996, pp. 45 and Yuiichi Kaneko, "Reform and Innovation Will Revitalize Japan," *Nikkei Weekly*, December 23, 1996.
[35]Satoshi Isaka, Toyota's Drive for 40% Angers Rivals," *Nikkei Weekly*, December 23, 1996; Alex Taylor, "Toyota's Boss Stands Out in a Crows," *Fortune*, Vol. 134, November 25, 1996, pp. 116-122; David Kirkpatrick, "Your Next PC May Be Japanese," *Fortune*, Vol.134, October 28, 1996, pp. 141-148.
[36]The promotion of Hiroshi Okuda to Toyota's presidency recently is a good example of this. Toyota, a company known for its risk-averse attitudes, promoted a decidedly outspoken person whose personal style sets the tone for what the company seems to want

from its employees as a whole. The introduction of a new pay and promotion system recently giving more weight to performance, and the mandatory removal of general managers and managers from these posts at ages 55 and 50 to make way for younger people who it is thought will bring newer thinking to the jobs, are two more examples of Toyota's moves to change its personnel practices to encourage greater innovation and free-thinking. See Taylor (1996), "Toyota's Boss." See Nagao (1996) for a similar but much more gradual approach at Hitachi.

[37]This onslaught of new product innovations seems to have already started. See Steven Brull, "The Wave of Gizmos Coming Soon From Japan," *Business Week*, No. 3503, November 25, 1996, pp. 62-67; and Kirkpatrick (1996). The move toward greater use of non-traditional partnering strategies also can be seen in more tie-ups between traditional rivals and between large firms and smaller high tech firms. See Alex Taylor, "The Man Who Put Honda Back on Track," *Fortune*, Vol. 134, September 9, 1996, pp. 92-100; and Hirotsugu Nagao, "Computer Makers Try to Mix Oil and Water," *Nikkei Weekly*, December 23, 1996, p. 26.

[38]As the father of the re-engineering movement in the U.S. put it recently in a seminar to companies: "The real point of this is longer term growth on the revenue side. It's not so much getting rid of people. Its getting more out of people." See "Re-engineering Gurus Take Steps to Remodel Their Stalling Vehicles," *Wall St. Journal*, November 26, 1996, p. 1; and "Restructuring is Out, Replaced by Growth," *Wall St. Journal*, December 9, 1996, p. 1.

[39]A recent example is Nippon Steel. See "Great Changes in the Employment System" (Toyo dai tenka), *Shukan Toyo Keizai*, Vol. , September 16, 1995, pp. 16-34.

[40]Soonkyoo Choi, Jangho Lee, and Tom Roehl, "What Makes Management Style Similar and Distinct Across Borders? - An Examination of the Influence of Growth, International Experience and National Culture in Korea and Japanese Firms," *Association of Japanese Business Studies Best Paper Proceedings*, ed. Mitsuru Wakabayashi and Allan Bird (San Luis Obispo: The Association of Japanese Business Studies, 1996), p. 64; and Roger L. Janelli, *Making Capitalism: The Social and Cultural Construction of a South Korean Conglomerate* (Stanford: Stanford University Press, 1993), pp. 152-155.

[41]JMOL (1996), pp. 13-14.

[42]This seems to be the argument of among others Koichi Hori of Boston Consulting Group's Tokyo Office. See Schlender (1994), p. 98.

[43]Taylor, "The Man Who Put Honda Back on Track," (1996), op. cit.