

**Corporate governance, political involvement and firm performance: an empirical
investigation in Japan and Taiwan**

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ABSTRACT

This paper investigates the interaction of government and financial institutions in the operation of a company through the relationship of the main bank system and the system of *amakudari* (appointing retired bureaucrats to the board of public companies). The empirical results suggest that governments and financial institutions tend to appoint representatives to the board in order to help troubled companies. On the other hand, a negative relationship is established between the presence of retired bureaucrats (*amakudari*) and subsequent firm performance. Thus, while the system of *amakudari* may use its power in an attempt to save troubled companies, the monitoring ability of the board may be jeopardised to the detriment of firm performance.

Key words: amakudari, political involvement, business-government relations, corporate governance, crony capitalism

* We thank two referees for helpful and formative suggestions. Remaining errors are our own.

Introduction

In contrast to arms-length capitalism, where the market is an important disciplinary mechanism of governance, crony capitalism is a relationship-based system (Raghuram and Zingales, 1998). One of the fundamental characteristics of crony capitalism is the acceptance of representatives with political backgrounds in the governance of public companies. The system of post-retirement employment of former top bureaucrats is called '*amakudari*' in Japanese, which literally means 'descending from heaven'. The phenomenon is very common in Japan and has recently become more common in Taiwan. Such political involvement represents an important issue which has been relatively ignored in the corporate governance literature. This paper examines the influence of political involvement and compares its impact in the cases of Japan and Taiwan.

In crony capitalism (Raghuram and Zingales, 1998), the economy is operated subject to a hidden hand which is controlled by the ruling political party. The ruling party may arrange better treatment for those companies that have the same political ideology and are engaged in economic activities favoured by the government. For managers and directors in this kind of capitalism, developing a harmonious relationship

with the government is critically important. Through the pattern of government ownership and government appointed directors, the government also has the power to control the operations of certain companies, especially government-linked companies¹. Additionally, financial institutions, such as banks, also appoint representatives to boards in Japan and Taiwan. There exists the danger, therefore, that the government and financial institutions will pursue their own interests at the expense of the shareholders by reducing the effectiveness of the monitoring capacity of the board of a company.

The first objective of this paper is to examine how firm performance influences external and internal governance arrangements. Under what conditions do government and financial institutions intervene in the operation of a company? In terms of internal governance, the focus is on the board of directors. In terms of external governance, both private and public aspects are involved. Private external governance involves the intervention of banks, insurance companies, and securities companies. Public external governance relates to how the intervention of the government influences firm performance. The second objective of the paper is to establish whether for companies having directors with political backgrounds subsequent firm performance is, in effect, better.

The existing literature concerning political involvement is limited. In a pioneering work, Agarawal and Knoeber (2001) examine the political roles of outside directors and find that when politics is more important for a company, there are a greater number of directors with political and legal experience. Faccio (2005) examines firms with government-linked directors in 42 countries and finds that politically-connected firms access debt financing more easily, enjoy lower taxation, and have greater market power. In a similar vein, Faccio et al. (2006) finds that politically-connected firms are more likely to be bailed out than similar but non-connected firms. Furthermore, firm performance of these bailed-out and politically-connected firms is inferior to that of non-connected firms.

There are also a few studies about the relationship between Japanese bank performance and the system of *amakudari*. Van Rixtel and Hassink (2002) claim that troubled banks may attempt to employ more retired officials from the Ministry of Finance (MoF) and the Bank of Japan (BoJ), because these retired officials can persuade the relevant regulators to allow the banks to take on more loans as they attempt to improve performance in this way. Furthermore, risky loans increase after these ex-officials are recruited, which is taken to suggest that the purpose of *amakudari* is to buy influence from the government. In an empirical analysis of Japanese regional banks,

Horiuchi and Shimizu (2001) show that those banks which recruit onto their boards ex-officials from the MoF are subsequently able to reduce capital adequacy levels and increase their bad loan ratio. These studies suggest that political involvement influences firm performance.

In the following section, some background is provided relating to political involvement in Japan and Taiwan, and hypotheses are developed. The data and research methods are discussed in the subsequent section. This is then followed by a presentation of the results, and the paper concludes with a summary of the results as they compare with previous findings in this area.

Background on political involvement in Japan and Taiwan

The best known aspect of political involvement in Japan is the post-retirement employment of government officials in private business, so-called '*amakudari*', which involves the reemployment in high-level positions in private or public corporations of top-level government bureaucrats. This kind of reemployment generates extensive personal networks and alliances among many different elements of Japanese society,

encompassing business, politics, and the government civil service (Kuji, 1998). When the former bureaucrats move to their new positions, they bring with them their personal networks and invaluable knowledge concerning their ministry's administrative procedures and policies, which they have acquired during their careers in government. The system of *amakudari* thereby provides a mechanism for sharing information and resources across legislative, bureaucratic and business institutions (Colignon and Usui, 2003).

There are numerous definitions of *amakudari*. An obvious one is that *amakudari* involves the movement of retired bureaucrats from the public sector to the boards of public listed companies. This definition is somewhat narrow, however. In a broader sense, political involvement manifests in another form. This is '*shukko*' (employee transfers), which means 'on loan to another company' (Carpenter, 2003, p.93). These bureaucrats will be assigned temporary positions in public companies for two or three years. This is common both in Japan and in Taiwan. According to Keehn (1990, p.1032), discussing the deployment of Japanese ministry directors in *shukko* positions, about 80% of all Japanese directors in ministries had previously held *shukko* positions in other organisations during their career. The benefits of *shukko* include better access to political information, improved understanding of administrative and bureaucratic rules

and the establishment of informal networks with the government. In Taiwan, it is particularly common for legislators and other high-ranking government officials to have directors' or auditors' positions on a board in a public listed company (Zun, 2002). This paper will class both '*amakudari*' and '*shukko*' as political involvement.

Political involvement in Taiwan is pervasive but often goes unnoticed because the Kuo-Min-Tang (KMT) party was the ruling party for almost fifty years in Taiwan. In this type of situation, people can come to regard political involvement as natural. Government-linked companies (GLCs) can be found in various industries, such as banking, electronics, steel, energy, and telecommunications. Compared with western countries, the percentage of government ownership in listed companies is very high in Taiwan. According to our calculation, at the end of 2004, the government ownership of shares across all Taiwanese listed companies amounted to 2.21% of the total number of listed shares, and the weighted-market-value of government ownership amounted to 12.34%.

In addition to political involvement, Japan and Taiwan are also similar in company board structure. Japanese companies operate under a two-tier system, with a board of directors and a board of statutory auditors. Similar to Japan, Taiwanese companies also

possess a board of directors and a board of supervisors (Filatotchev et al., 2005). Having supervisors (statutory auditors in Japan) on a board is regulated by Commercial Code in Japan and by Company Law in Taiwan². Given this similar political background and board structure, it is interesting to investigate whether the same empirical governance relationships are observed in both Japan and Taiwan.

As a first step in this direction, the issue of why the government and other financial institutions intervene in the operation of a company is examined. Previous literature indicates that the system of *amakudari* is not solely used as a reward system but is also used for trouble shooting (Van Rixtel and Hassink, 2002). That is, these retired bureaucrats from government institutions are sent into the troubled companies experiencing a financial crisis or under a threat of insolvency and use their political networks to help the company, for example by petitioning for a loan deadline to be extended or by asking for additional funding from the government.

Moreover, Sheard (1994) claims that Japanese companies are more likely to have bank executives on their boards the more heavily they rely on bank loans. The argument here is that, in order to improve firm performance and help a company solve its financial problems, representatives of financial institutions may be dispatched to these

boards to exercise a monitoring function. Since it takes some time for the government, financial institutions, and the board to realise poor firm performance and thereby take actions, there is a time lag between performance and other factors. Thus, we hypothesise:

Hypothesis 1: The relationship between firm performance (t) and political involvement (t+1) is negative.

Hypothesis 2: The relationship between firm performance (t) and other financial institutions' involvement (t+1) is negative.

According to previous studies, on the one hand, the monitoring ability of the board has an influence on firm performance, while, on the other hand, poor firm performance may also have an influence on the structure of the board of directors (Carpenter and Sanders, 1998; Denis and Sarin, 1999). In order to improve firm performance, the composition and quality of the board of directors should be changed to effect a better monitoring ability. Therefore, we hypothesise:

Hypothesis 3: The relationship between firm performance (t) and the monitoring ability of the board (t+1) is negative.

The second question to be asked is “Does the subsequent firm performance improve after the government and other financial institutions intervene in the operation of a company?” In crony capitalism, this kind of business-government relationship can help a company gain more support from the government and help the top management team effect better strategies. Thus, we hypothesise:

Hypothesis 4-1: The relationship between political involvement (t) and firm performance (t+1) is positive.

On the other hand, however, troubled companies may be more willing to employ retired bureaucrats because they need the help and contacts of these former bureaucrats. Generally speaking, troubled companies are inclined to invest in risky projects but the regulations which are set by the government may restrain them from so doing (Van Rixtel and Hassink, 2002). In this sense, such companies may need retired bureaucrats to persuade the government to extend their loans and to allow them to take up high-risk investment projects. Hence, the *amakudari* system may be used here to buy influence from the government. Furthermore, political involvement has long been considered inefficient (Shleifer, 1998). Therefore, one further hypothesis is:

Hypothesis 4-2: The relationship between political involvement (t) and firm performance (t+1) is negative.

Similar to the relationship between political involvement and the subsequent firm performance, other financial institutions will also appoint representatives to the board to help the company solve its problems. They too may be used in a monitoring function. Mirroring Hypotheses 4-1 and 4-2, another source of influence is also possible. The hypotheses of the relationship between the involvement of financial institutions and subsequent firm performance are as follows:

Hypothesis 5-1: The relationship between the involvement of financial institutions (t) and subsequent firm performance (t+1) is positive.

Hypothesis 5-2: The relationship between the involvement of financial institutions (t) and subsequent firm performance (t+1) is negative.

It is also of interest to examine the relationship between the board and other governance factors. Much has been said about the efficacy of such corporate governance mechanisms, although the results are not always consistent (Bhagat and

Black, 1999, 2001). But, based on the previous literature (Gompers, et al., 2003), a company with a board with better monitoring ability, such as more outside directors and higher board ownership is expected to have better performance. In this paper, we hypothesise:

Hypothesis 6: The relationship between the monitoring ability of the board (t) and firm performance (t+1) is positive.

The *amakudari* system in Japan and Taiwan reveals that the government and financial institutions can appoint representatives to the board. This phenomenon allows the board of directors to play an intermediate role between the government/financial institutions and firm performance. To focus on this implicit relationship, we hypothesise:

Hypothesis 7: The board of directors may mediate the relationship between performance and the intervention of government and financial institutions.

Data and Methods

For Japan, the sample of firms comprises 203 Japanese companies from the Nikkei 225 index³. As there is no similar index in Taiwan which covers comparable numbers of companies, 200 companies from all listed Taiwanese companies are chosen according to the highest capitalisation on 1st August, 2004 and data availability. For both countries, the observed time period comprises the three years 2001 through 2003.

Due to poor detail in reporting, it is difficult to obtain the required Japanese data using annual reports⁴ alone. For this reason, use is made of several additional sources of data that are published in Japanese: *Kaisha Shikihou* (Quarterly Report for Listed Companies), *Yakuin Shikihou* (Employee Report), *Nippon Kinyu Meikan* (Directory of Executives in the Japanese Finance Industry), and *Yukashoken Hokokusho* (Securities Report). In Taiwan, the database Taiwan Economic Journal (TEJ) plus company annual reports are used to obtain the necessary financial data and the corporate governance data.

Structural equation modelling (SEM) is used to test the hypotheses and to calculate path coefficients. Structural equation modelling has a major advantage when dealing with concepts such as governance, board monitoring or institutional intervention. While these concepts have a clear meaning in the literature, they generally lack a unique

or well-defined measure by which they can be quantified or gauged. SEM allows a group of variables to be associated with each underlying concept (e.g., 'internal governance'). While it is difficult to point to a single measure of a concept such as 'internal governance', it is far easier to specify a range of measures that, by general agreement, capture the notion of board monitoring. SEM also enables the relationships among these underlying but difficult-to-measure concepts to be quantified.

The SEM technique is similar to linear regression but less restrictive. Based on hypotheses, variables are classified in different groups. SEM finds the weights to assign to each variable that brings the predicted variance-covariance matrix among the grouped variables as close as possible to the observed relationship in the raw data. As an arbitrary scaling device, within each group the strongest connection is assigned the unit value 1.0 (Schumacker and Lomax, 2004). The emphasis of the approach is, therefore, relationships among groups of variables where the groupings are designed to represent a managerial concept (or 'latent variables') impossible to capture in a single measured variable. The principal software used in this paper is LISREL 8.7.

We include four indices to measure the model fit in the estimated relationships. The goodness-of-fit index (GFI) and the adjusted goodness-of-fit index (AGFI) measure

the level of the observed matrix which is predicted by the estimated matrix (Hu and Bentler, 1995, p.85). In general, GFI and AGFI are greater than 0.90 in a good model (Hu and Bentler, 1995, 1999). The root mean square error of approximation (RMSEA) measures the amount of discrepancy between the model and the data, considering the complexity of the model (Schumacker and Lomax, 2004, p.84). A acceptable model should have RMSEA lower than 0.10 (Browne and Cudeck, 1993). The standardised root mean square residual (SRMR) is a measure of the size of the residuals (Schumacker and Lomax, 2004, p.103). In a good model, the SRMR should be less than 0.08 (Hu and Bentler, 1999). As will be seen below, based on these goodness-of-fit indices, both Japanese models and Taiwanese models are acceptable.

The measurement variables discussed below are grouped into four latent variables: internal governance (BOARD), financial institutions (INST), political involvement (GOV), and firm performance (PERF). Each of these main headings and their respective constituent measured variables will be discussed in turn.

(BOARD) - Internal governance: BDOWN; OUTSIDE; MANOWN; BD_Q.

The descriptors of board composition used to evaluate the direct and indirect

influences of the board of directors on firm performance include their percentage of board ownership (BDOWN) and the percentage of outside directors (OUTSIDE). Also included is the fractional equity ownership by the CEO and his immediate family (MANOWN). Owing to data availability, the Japanese model does not include the MANOWN variable⁵. Finally, the variable BD_Q is included to measure the quality of directors. The National Association of Corporate Directors guidelines (NACD, 1996) recommended that senior corporate executives and CEOs should hold no more than three outside directorships. BD_Q captures the percentage of directors who occupy more than three executive or director positions in other companies (Perry and Peyer, 2005).

(INST) - Financial institutions: FINOWN; CROSS; BLOCK; BANK_D.

In addition to the government, the main bank, and other *keiretsu* partners⁶ will also appoint representatives to the board to help their troubled partner tackle financial problems. The first variable used to capture this phenomenon is financial ownership (FINOWN), which is measured by the ratio of financial institutions' shares to total outstanding shares. Cross shareholding ownership (CROSS) measures the ownership owned by other companies, and is computed as the ratio of cross-shareholding shares to

total outstanding shares. In addition, the percentage of ownership accounted for by the top ten blockholders is captured in the variable BLOCK. Finally, to take account of the number of bank appointed directors on the board, these are expressed as a proportion of the total number of directors (BANK_D).

(GOV)- *Political involvement*: GOVOWN; GOV_I; GOV_APP; GAKUBATSU.

The first variable included in this group is government ownership (GOVOWN), which is measured by the ratio of government shares to total outstanding shares. The second variable is the number of shareholdings which represent government-linked agencies (GOV_I). Another key variable is the number of government appointed directors (GOV_APP) (Van Rixtel, 2002). This variable measures the phenomena of ‘*amakudari*’ and ‘*shukko*’. The two types of director are combined into the same measurement variable here. Whether a director is a retired bureaucrat (i.e. *amakudari*) or an incumbent government official who is on loan to a company temporarily (i.e. *shukko*), he/she is regarded as a director with the political background. GOV_APP is the ratio of the number of directors who possess such political backgrounds to the total number of directors on a board.

There is an additional phenomenon which commonly occurs in Japan, namely, the significance of university cliques, or so-called ‘*gakubatsu*’, which establish strong support and group consciousness within and between large Japanese companies (Van Rixtel, 2002; Colignon and Usui, 2003). In Japan, top-level bureaucrats have a similarity of education that produces a very exclusive environment and a special elite culture, which is very hard for other people who do not share the same experience to enter (Van Rixtel and Hassink, 2002). To measure the importance of academic background, the variable GAKUBATSU is constructed as the ratio of the number of graduates from the five most prestigious universities in Japan (so-called the ‘Big five’⁷) to the total number of directors in a board. Because of the absence of a similar phenomenon in Taiwan, the Taiwanese model does not include the variable GAKUBATSU.

(PERF) - Firm performance: TSR; ROE; ROA.

Three alternative variables are used to measure firm performance: total shareholder return (TSR), return on equity (ROE), and return on assets (ROA). TSR is the total return on shares assuming dividends are reinvested. In this paper, ROE is computed as the net income divided by the shareholder’s equity, and ROA is calculated by dividing a

company's annual earnings by its total assets.

Empirical Results

Japan: Why is there intervention from the government and financial institutions?

As explained above, the variables in the Japanese model can be classified into four latent groups – BOARD, INST, GOV, and PERF. Summary statistics are presented in Table 1 where it can be seen that the structure of corporate governance in Japanese companies is different from that of western companies. For example, financial ownership (FINOWN) is 45.01%, which suggests that banks and other financial institutions may play an important role in the operation of a company (Morck and Nakamura, 1999). Moreover, the average ratio of blockholder ownership (BLOCK) is 38.81%, which is close to the 37.4% reported by Kang and Shivdasani (1995) and is another characteristic of the Japanese corporate governance structure.

In the government group (GOV), the average ratio of government appointed directors is 3.08%, which is high compared with western companies in arms-length

capitalism where the phenomenon is virtually non-existent. Furthermore, the average ratio of *gakubatsu* is 53.37%, which is extremely high. Since sample companies come from the Nikkei 225, it is possible to conclude that most directors in Japanese large companies graduate from one of the 'Big Five' universities. This implies that their personal network, which is based on having similar university backgrounds, may be a critical factor in Japan.

Table 2 presents the fitted model and the completely standardised coefficients⁸ which are estimated under our hypotheses. Describing the hypothesised relationships, the estimated coefficients in Table 2 can be used to define Path Diagram 1. The completely standardised coefficients in Table 2 and Path Diagram 1 provide strong support for Hypothesis 1 and Hypothesis 2 in the sense that the coefficient of the direct relationship between performance (PERF) and political involvement (GOV) is -0.25 ($t = -2.45$), which is significant at the 5% level, and the coefficient of the direct relationship between performance (PERF) and financial institutions (INST) is -0.19 ($t = -1.92$), which is significant at the 10% level. The finding is consistent with Kaplan and Minton (1994) and Van Rixtel (2002) that a company with poor performance is more likely to accept government appointed directors and bank representatives on the board. In this way, it can build a tighter relationship with the government and financial institutions, so

enlisting their help in solving its financial problems.

In Japan, the system is seen to exist to promote the interests of the company, the employees and the whole of society rather than merely the shareholders (Monk and Minow, 2004). In this kind of system, the government sees itself as a protector of domestic industry (Analytica, 1992). Based on this phenomenon, when a company does not perform well or has a financial crisis which causes instability, the government and other cross-holding institutions will intervene in the operation of the company. Our empirical results are consistent with this argument.

In addition to financial institutions (INST) and political involvement (GOV), the coefficient of the direct relationship between firm performance (PERF) and internal governance (BOARD) is also significant and negative (-0.10, $t = -2.63$), which is consistent with Hypothesis 3. This result implies that poor firm performance will make the company enhance the monitoring ability of the board of directors, in ways such as increasing the percentage of outside directors and board ownership. The minor paths – the relationship between internal governance (BOARD) and political involvement (GOV) – as well as the relationship between financial institutions (INST) and political involvement (GOV) – are not significant. Hypothesis 7 is not supported in the case of

Japan. These results imply that the influence of political involvement in Japan is direct.

The intermediate role of Japanese boards is not significant.

Japan: Is subsequent firm performance better?

The question is whether intervention by the government and financial institutions is associated with improved firm performance. Table 3 follows from the hypotheses introduced above and presents the completely standardised coefficients and the model statistics on which Path Diagram 2 is based. Here, it can be seen that the direct relationship between political involvement (GOV) and firm performance (PERF) is significant but negative. According to the empirical analysis, therefore, Hypothesis 4-1 is not supported – political involvement is not positively associated with subsequent firm performance. The empirical result does, however, support Hypothesis 4-2 (coefficient = -0.26, $t = -1.97$), which hypothesises that the relationship between political involvement (GOV) and the subsequent firm performance (PERF) is negative. This result suggests that political involvement is inefficient and the system of *amakudari* jeopardises the soundness of the Japanese corporate governance mechanism. Hypothesis 4-1, that *amakudari* is used for monitoring, is rejected.

The coefficient of the direct path between INST and PERF is significantly negative (-0.19, $t = -1.73$), which means that Hypothesis 5-1 is rejected but Hypothesis 5-2 is supported by the empirical results. Because of the main bank system and the phenomenon of concentrated shareholders, the Japanese corporate governance mechanism is mainly based on the external monitoring – government, financial institutions, and companies in the same *keiretsu* group (Monks and Minow, 2004). However, financial support may lead to poor firm performance. The empirical analysis presented here supports this view. With respect to the Japanese corporate governance mechanism, Table 3 suggests that the influence of the internal monitoring system on performance in Japan is not significant. The path between BOARD and PERF is not significant, which indicates that Hypothesis 6 and Hypothesis 7 are not supported.

Taiwan: Why is there intervention from the government and financial institutions?

The Taiwanese summary statistics are also shown in Table 1 (in parentheses). Compared with the Japanese data, it can be seen that financial ownership (FINOWN) is smaller in Taiwan, whereas board ownership (BDOWN), the outsider ratio (OUTSIDE), government ownership (GOVOWN), and the ratio of government representatives (GOV_APP) are all larger in Taiwan. Generally, the summary statistics suggest that the

political involvement and corporate governance mechanisms are different in Taiwan as compared to Japan.

The completely standardised coefficients reported in Table 4 and the derived Path Diagram 3 allow the maintained hypotheses to be tested. The estimated Taiwanese model is very different from that found for the Japanese model. Specifically, the direct paths of PERF - GOV and PERF - INST are not significant. However, this does not mean that there is no significant relationship at work. In contrast to the direct significant paths in Japan (see Table 2 and Path Diagram 1), there is an indirect significant relationship between PERF and GOV through the intermediate BOARD. From Path Diagram 3, it can be seen that the indirect influence of PERF on GOV is $(-0.38) \times (0.18)$, which equals -0.07 . The indirect path between PERF and GOV is significant at the 1% level. Similarly, the significant indirect influence of PERF on INST is $(-0.38) \times (0.31)$, which equals -0.12 . This indirect path between PERF and INST is significant at the 1% level. The relationship between PERF and BOARD is also negative (-0.38) and significant at the 1% level. The empirical results are therefore consistent with Hypothesis 1, Hypothesis 2, and Hypothesis 3.

In contrast with the Japanese model, the Taiwanese government does not seem to

intervene directly in the operation of a company. Instead, the Taiwanese government affects firm performance indirectly through the board of directors. This supports Hypothesis 7. Path Diagram 3 shows that the relationship between PERF and BOARD is negative. It can be argued that faltering performance induces the board of directors to eagerly seek the help from government and the financial institutions, and thereby build a positive relationship between BOARD and GOV/INST. In other words, our empirical results suggest that boards in Taiwan play a significant intermediate role in relationship between the government and financial institutions, whereas the boards in Japan are less effective.

Taiwan: Is subsequent firm performance better?

Table 5 reports the completely standardised coefficients for the hypothesised relationships and leads to Path Diagram 4. From Path Diagram 4, it can be seen that the direct relationship between GOV and PERF is not significant. Neither is the direct relationship between INST and PERF significant. The indirect paths, however, are significant. Through the latent variable, BOARD, the relationship between GOV and PERF is $(-0.19) \times (0.29)$, which equals -0.06 and is significant at the 5% level. This allows Hypothesis 4-1 to be rejected, but supports Hypothesis 4-2. The relationship

between INST and PERF is $(-0.35) \times (0.29)$, which equals -0.10 and is significant at the 1% level. This allows Hypothesis 5-1 to be rejected, but supports Hypothesis 5-2.

According to the empirical results, even when these troubled companies employ many such retired bureaucrats to build an informal network, firm performance in Taiwanese companies may not improve. Because of the insignificant direct path between GOV and PERF, the total effect from GOV on PERF is not significant in the Table 5, whereas the total effect from GOV on PERF in the Japanese model (Table 3) is significant. Furthermore, Hypothesis 6 is also supported in that the relationship between BOARD and PERF is significant and positive, which suggests that the board with better monitoring ability can improve firm performance in Taiwan.

Note that although the final conclusion of the Taiwanese model is similar to that of the Japanese model, the processes are different. The direct relationships between GOV/INST and PERF in the Japanese model are significant and negative. In the Taiwanese model, however, GOV influences PERF via the latent variable, BOARD. The negative relationship between GOV and BOARD in Taiwan indicates that more political involvement may damage the monitoring ability of the board. At the same time, a less than robust board of directors may result in poor firm performance, because these

government appointed directors may attempt to extract rents for the ruling party itself, possibly by operating non-profitable projects to implement politically desirable policies at the expense of firm performance.

The negative relationship between INST and BOARD suggests that too much intervention from the financial institutions may also damage the monitoring ability of the board and finally engender a negative influence on subsequent firm performance (PERF). Although Japan and Taiwan are similar in board structure, Hypothesis 7 is supported by Taiwanese estimates but not in the Japanese estimates. This may be because most directors in Japan are insiders who may not monitor executives efficiently (Kaplan and Minton, 1994).

Conclusion

This paper has examined the direct and indirect influence of political involvement and financial institutions on firm performance. This study breaks new ground by utilising structural equation modelling (SEM) to examine political involvement from the viewpoint of corporate governance, *shukko*, and *amakudari* in Japan and Taiwan. It is

only owing to the very recent improvement in the level of disclosure of governance data in Japan and Taiwan that this analysis has been possible. In due course, with longer data series, it may be possible to tease out the company-specific and year-specific effects that have been subsumed in the analysis above. But, it is hoped that these results at least point the way to the interesting insights available regarding governance effects that are made available through the use of SEM in this context.

The empirical results support the view that the relationship between firm performance and the subsequent political involvement is significant and negative. This result suggests that companies with poor firm performance may try to recruit more retired bureaucrats to gain support and buy influence from the government. In this, our results are consistent with the findings in Van Rixtel and Hassink (2002).

One point which merits mention is that the significant negative relationships between firm performance and political involvement/financial institutional intervention are direct in Japan, whereas they are indirect in Taiwan. In Taiwan, the negative influence goes through the board of directors, which indicates that the board of directors plays a mediating role between the government/financial institutions and the company. Compared to the Japanese situation, the board of directors in Taiwan appears to assume

a more influential role.

The empirical results also suggest that political involvement and financial intervention is not accompanied by improved subsequent firm performance. This finding is similar to Horiuchi and Shimizu (2001), in that political involvement may jeopardise capital adequacy, but it contradicts Van Rixtel and Hassink (2002), whose results suggest that political involvement will improve profitability in the finance industry. The empirical results concerning political involvement/financial institutional intervention and the subsequent firm performance are also different in Japan and Taiwan. Once again, in Japan, the influence is direct, whereas in Taiwan political involvement and financial institutional intervention have their influence on subsequent firm performance via the board of directors.

In both Japan and Taiwan, however, the results confirm that troubled companies tend to recruit retired bureaucrats (*amakudari*) and bank representatives to build the business-government network and thereby gain support from the government. Such involvement from governments and financial institutions, however, is not positively associated with subsequent firm performance and the subsequent monitoring ability of the board.

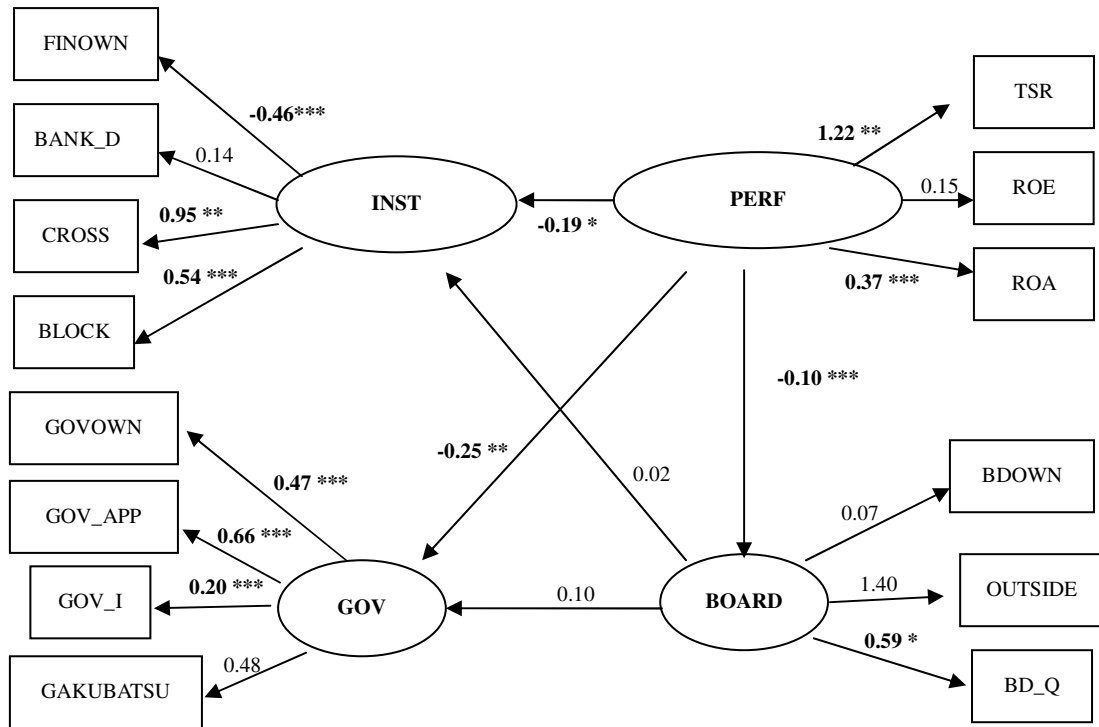
Table 1 Summary Statistics: Japan and Taiwan

(Data for Taiwan are in parentheses)

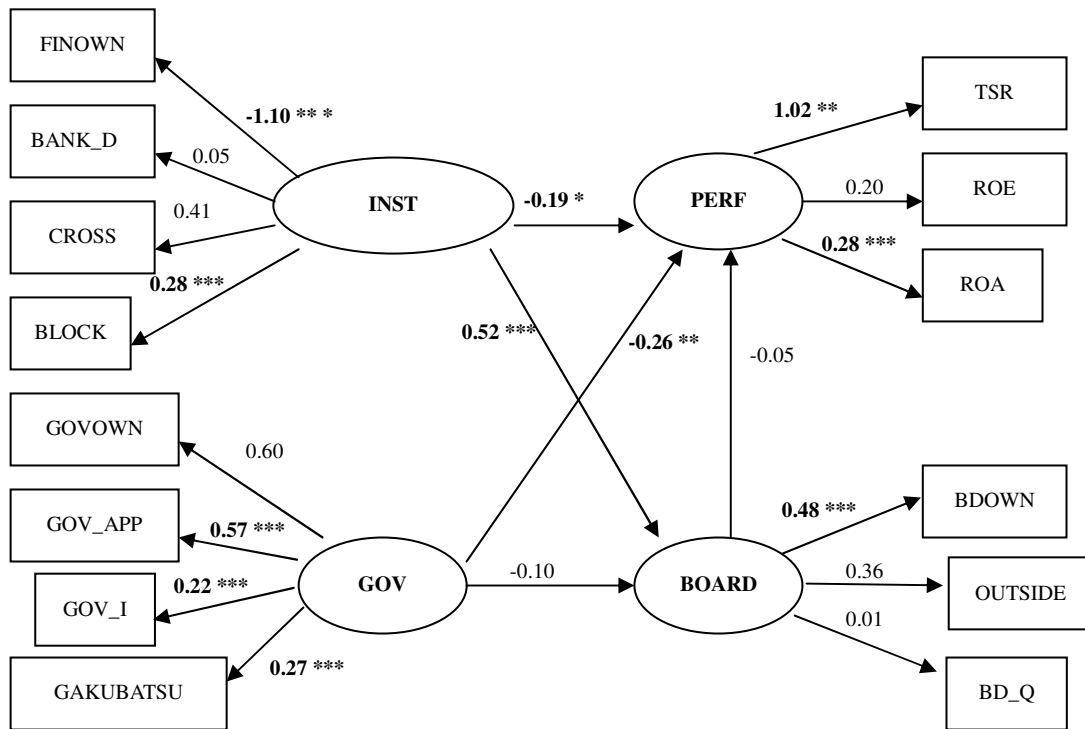
Latent variable	Measurement Variable	Mean	St. Dev.	Max	Min
BOARD	BDOWN (%)	0.55 (9.79)	2.66 (11.07)	37.43 (60.12)	0.00 (0.00)
	OUTSIDE (%)	17.22 (44.35)	9.38 (22.61)	53.33 (100.00)	0.00 (0.00)
	MANOWN (%)	--- (2.76)	--- (5.65)	--- (42.26)	--- (0.00)
	BD_Q (%)	6.42 (28.80)	10.23 (24.29)	53.85 (100.00)	0.00 (0.00)
INST	FINOWN (%)	45.01 (3.40)	11.58 (6.02)	68.83 (55.88)	3.91 (0.00)
	CROSS (%)	13.41 (23.62)	12.46 (18.96)	86.00 (79.60)	0.70 (0.01)
	BLOCK (%)	38.82 (37.73)	10.82 (16.47)	81.59 (87.50)	17.45 (5.03)
	BANK_D (%)	5.44 (5.49)	7.72 (11.27)	60.00 (70.00)	0.00 (0.00)
GOV	GOVOWN (%)	0.64 (3.73)	5.69 (10.04)	66.74 (95.33)	0.00 (0.00)
	GOV_I	1.82 (3.90)	5.95 (5.09)	63.00 (38.00)	0.00 (0.00)
	GOV_APP (%)	3.08 (7.00)	5.15 (18.02)	33.33 (100.00)	0.00 (0.00)
	GAKUBATSU (%)	53.37 (---)	20.07 (---)	100.00 (---)	5.56 (---)
PERF	TSR (%)	7.28 (36.51)	51.23 (81.01)	425.10 (659.51)	-78.17 (-76.37)
	ROE (%)	-2.4 (8.24)	80.48 (14.36)	80.35 (67.78)	-1771.75 (-78.58)
	ROA (%)	1.18 (6.17)	5.20 (8.31)	63.87 (50.64)	-63.82 (-35.51)

The number of companies is N=203 in Japan and N=200 in Taiwan.

Path Diagram 1: Firm Performance (t) and Governance (t+1), Japan



Path Diagram 2: Governance (t) and Firm Performance (t+1), Japan



*** p<0.001, ** p<0.05, * p<0.01

Table 2 Path Coefficients: Firm Performance (t) and Governance (t+1), Japan

Description of path	Performance (t) and Governance (t+1)	
	path coefficient	t value
OUTSIDE <-- BOARD	1.40	
BDOWN <-- BOARD	0.07	0.20
BD_Q <-- BOARD	0.59	1.69*
BANK_D <-- INST	0.14	
FINOWM <-- INST	-0.46	-2.58***
CROSS <-- INST	0.95	2.56**
BLOCK <-- INST	0.54	2.62***
GAKUBATSU <-- GOV	0.48	
GOVOWN <-- GOV	0.47	3.58***
GOV_APP <-- GOV	0.66	5.10***
GOV_I <-- GOV	0.20	2.65***
ROE <-- PERF	0.15	
TSR <-- PERF	1.22	2.15**
ROA <-- PERF	0.37	3.93***
Direct Effect		
BOARD --> INST	0.02	0.19
BOARD --> GOV	0.10	0.20
PERF --> INST	-0.19	-1.92*
PERF --> GOV	-0.25	-2.45**
PERF --> BOARD	-0.10	-2.63***
Indirect Effect		
PERF-->BOARD-->INST	-0.002	-0.19
PERF-->BOARD-->GOV	-0.01	-0.20
Total Effect		
PERF --> INST	-0.19	-1.94*
PERF --> GOV	-0.26	-2.80***
Observations	406	
GFI	0.90	
AGFI	0.84	
SRMR	0.09	
RMSEA	0.10	

*** p<0.001, ** p<0.05, * p<0.01

GFI = the goodness-of-fit index; AGFI = the adjusted goodness-of-fit index; RMSEA = the root mean square error of approximation; and SRMR = the standardised root mean square residual.

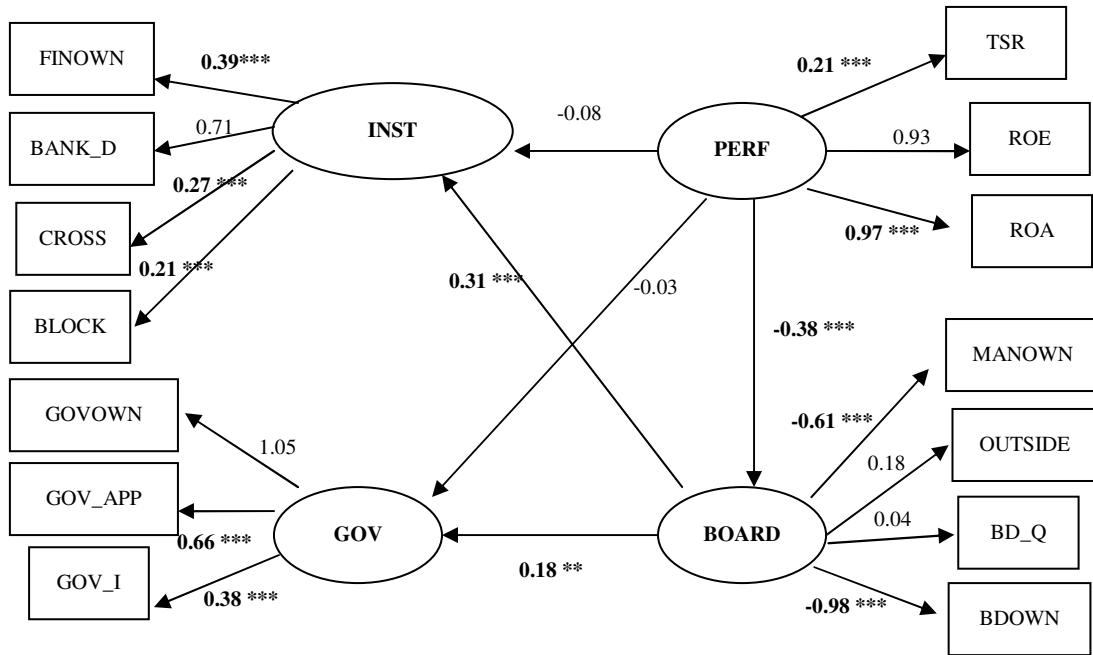
Table 3 Path Coefficients: Governance (t) and Firm Performance (t+1), Japan

Description of path	Governance (t) and Performance (t+1)	
	path coefficient	t value
OUTSIDE <-- BOARD	0.36	
BDOWN <-- BOARD	0.48	3.49***
BD_Q <-- BOARD	0.01	0.06
CROSS <-- INST	0.41	
FINOWM <-- INST	-1.10	-4.26***
BANK_D <-- INST	0.05	1.17
BLOCK <-- INST	0.28	7.32***
GOVOWN <-- GOV	0.60	
GOV_APP <-- GOV	0.57	5.83***
GOV_I <-- GOV	0.22	3.21***
GAKUBATSU <-- GOV	0.27	3.93***
ROE <-- PERF	0.20	
TSR <-- PERF	1.02	2.51**
ROA <-- PERF	0.28	3.45***
Direct Effect		
INST --> BOARD	0.52	3.59***
GOV --> BOARD	-0.10	-0.65
INST --> PERF	-0.19	-1.73*
GOV --> PERF	-0.26	-1.97**
BOARD --> PERF	-0.05	-0.41
Indirect Effect		
INST --> BOARD --> PERF	-0.03	-0.41
GOV --> BOARD --> PERF	-0.01	0.34
Total Effect		
INST --> PERF	-0.22	-2.11**
GOV --> PERF	-0.27	-1.97**
Observations	406	
GFI	0.91	
AGFI	0.87	
SRMR	0.07	
RMSEA	0.08	

*** p<0.001, ** p<0.05, * p<0.01

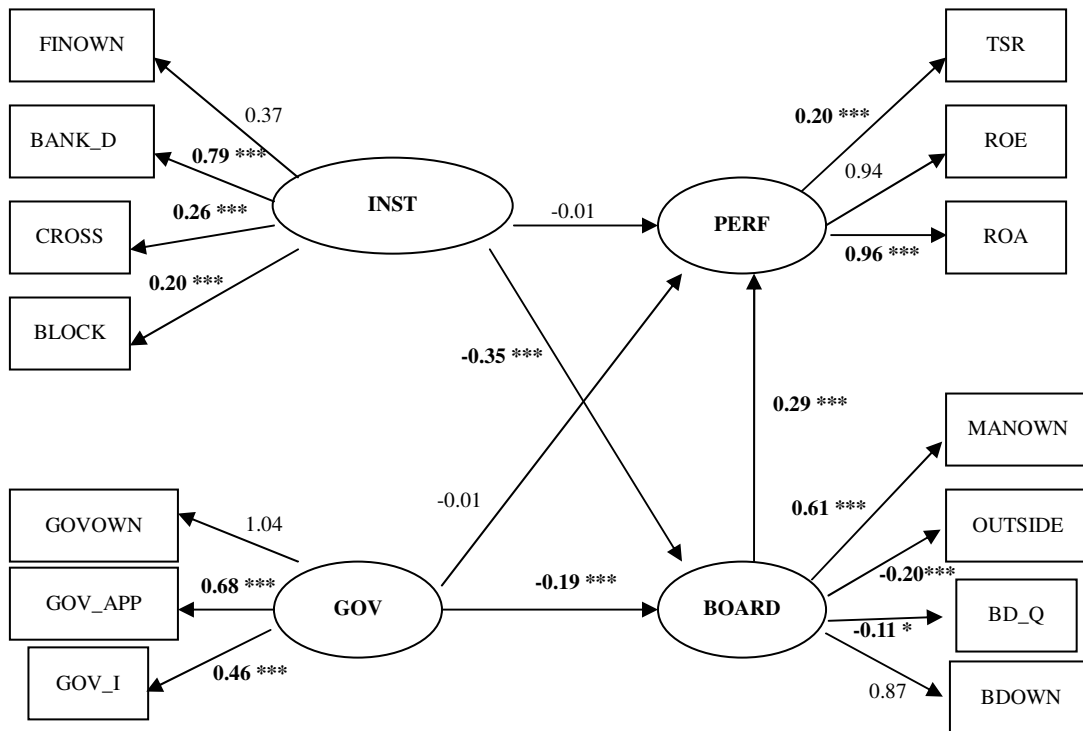
GFI = the goodness-of-fit index; AGFI = the adjusted goodness-of-fit index; RMSEA = the root mean square error of approximation; and SRMR = the standardised root mean square residual.

Path Diagram 3: Firm Performance (t) and Governance (t+1), Taiwan



*** p<0.001, ** p<0.05, * p<0.01

Path Diagram 4: Governance (t) and Firm Performance (t+1), Taiwan



*** p<0.001, ** p<0.05, * p<0.01

Table 4 Path Coefficients: Firm Performance (t) and Governance (t+1), Taiwan

Description of path	Performance (t) and Governance (t+1)	
	path coefficient	t value
OUTSIDE <-- BOARD	0.18	
MANOWN <-- BOARD	-0.61	-3.36***
BD_Q <-- BOARD	0.04	0.78
BDOWN <-- BOARD	-0.98	-3.24***
BANK_D <-- INST	0.71	
FINOWM <-- INST	0.39	6.26***
CROSS <-- INST	0.27	4.45***
BLOCK <-- INST	0.21	3.59***
GOVOWN <-- GOV	1.05	
GOV_APP <-- GOV	0.66	9.18***
GOV_I <-- GOV	0.38	6.28***
ROE <-- PERF	0.93	
TSR <-- PERF	0.21	4.23***
ROA <-- PERF	0.97	18.33***
Direct Effect		
BOARD --> INST	0.31	2.83***
BOARD --> GOV	0.18	2.46**
PERF --> INST	-0.08	-1.19
PERF --> GOV	-0.03	-0.59
PERF --> BOARD	-0.38	-2.99***
Indirect Effect		
PERF-->BOARD-->INST	-0.12	-3.55***
PERF-->BOARD-->GOV	-0.07	-2.90***
Total Effect		
PERF --> INST	-0.20	-3.19***
PERF --> GOV	-0.10	-2.01**
Observations	400	
GFI	0.89	
AGFI	0.83	
SRMR	0.09	
RMSEA	0.10	

*** p<0.001, ** p<0.05, * p<0.01

GFI = the goodness-of-fit index; AGFI = the adjusted goodness-of-fit index; RMSEA = the root mean square error of approximation; and SRMR = the standardised root mean square residual.

Table 5 Path Coefficients: Governance (t) and Firm Performance (t+1),Taiwan

Description of path	Governance (t) and Performance (t+1)	
	path coefficient	t value
BDOWN <-- BOARD	0.87	
MANOWN <-- BOARD	0.61	6.79***
OUTSIDE <-- BOARD	-0.20	-3.34***
BD_Q <-- BOARD	-0.11	-1.92*
FINOWM <-- INST	0.37	
BANK_D <-- INST	0.79	6.18***
CROSS <-- INST	0.26	3.33***
BLOCK <-- INST	0.20	3.13***
GOVOWN <-- GOV	1.04	
GOV_APP <-- GOV	0.68	10.24***
GOV_I <-- GOV	0.46	7.43***
ROE <-- PERF	0.94	
TSR <-- PERF	0.20	4.01***
ROA <-- PERF	0.96	14.05***
Direct Effect		
INST --> BOARD	-0.35	-4.21***
GOV --> BOARD	-0.19	-3.32***
INST --> PERF	-0.01	-0.16
GOV --> PERF	-0.01	-0.25
BOARD --> PERF	0.29	3.83***
Indirect Effect		
INST --> BOARD --> PERF	-0.10	-2.90***
GOV --> BOARD --> PERF	-0.06	-2.55**
Total Effect		
INST --> PERF	-0.11	-1.79*
GOV --> PERF	-0.07	-1.31
Observations	400	
GFI	0.88	
AGFI	0.81	
SRMR	0.09	
RMSEA	0.11	

*** p<0.001, ** p<0.05, * p<0.01

GFI = the goodness-of-fit index; AGFI = the adjusted goodness-of-fit index; RMSEA = the root mean square error of approximation; and SRMR = the standardised root mean square residual.

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¹ By 'government-linked companies' we mean companies which have one or more directors from the government/state-owned enterprises or companies whose government ownership exceeds 5%.

² In Japan, Commercial Code, §260-3(1), §260-3(3,4), §274(2), §274-3, §275-2, and §275-4 regulates the principal powers of auditors. In Taiwan, Company Law, §213, §214, §218, §219, §245, §274, and §418 lists the responsibilities of supervisors.

³ 21 companies were deleted from the sample because they did not have complete data or have been merged into a new company. The rule of deleting companies in Taiwan is the same as in Japan.

⁴ This comment includes the annual reports as published in Japanese.

⁵ Since April 2003, large Japanese companies have been permitted to choose between the traditional statutory auditor system and the committee system. Most Japanese companies, however, have adopted the statutory auditor system rather than the committee system and seldom use the titles of CEO, CFO, and COO (only a few companies have adopted the committee system, such as SONY).

⁶ Japanese companies interlink each other through share purchases to form horizontally-integrated alliances, so-called *keiretsu*. Companies in the same *keiretsu* also supply one another, making the alliances vertically-integrated to some extent as well. The *keiretsu* is usually centred on one main bank, which lends money to the member companies and holds equity of these companies. Each main bank has control over the member companies in the *keiretsu* and acts as a monitoring entity as well as an emergency bail-out entity.

⁷ The “Big five” includes the University of Tokyo, University of Waseda, University of Keio, University of Kyoto, and University of Hitotsubashi

⁸ When observed variables have different scales, it is necessary to standardise structural parameters to aid interpretation. This is done in the usual way of subtracting the mean and dividing by the standard deviation of the respective variable. Standardised structural parameters emerge from analysis of this transformed data. ‘Completely’ in ‘completely standardised coefficients’ signifies that all of the raw data and not just the estimated latent variables have been subjected to such standardisation.