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Measuring the extent and implications of corporate political connections in prewar Japan☆,☆☆

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ABSTRACT

This paper explores the extent of political connections of firms, and examines the implications for firm values, using firm-level data from prewar Japan. We collect data from publicly traded companies in Japan in the late 1920s and early 1930s regarding their directors and presence of members of the House of Representatives, stock prices, and financial performance. We find that almost 20% of these publicly traded companies had political connections through politician directors. In particular, firms in regulated industries, including the electrical utility and railroad industries, were more likely to have political connections. Regression analyses reveal that the stock returns of firms with newly- obtained political connections improved from the pre-election to post-election periods. Furthermore, this positive effect accrued to non-regulated industries, while it did not to regulated industries.

1. Introduction

Anecdotal evidence from various countries around the world today indicates that firms with political connections can obtain benefits such as preferential treatment for government procurement, easier access to public funds, and tax exemptions, among others. Motivated by these observations, a number of studies in the fields of political science and economics have addressed the issue of firms' political connections. Specifically, many studies have investigated whether politically-connected firms actually benefit from those connections (Fisman, 2001; Johnson and Mitton, 2003; Faccio, 2006). For example, Faccio (2006) examined data on listed companies in 47 countries and found that some firms were politically connected in 35 of those countries, and that these political connections added to firm values, especially in countries with weak political institutions. Fisman (2001), Johnson and Mitton (2003), and Goldman et al. (2009) confirmed that political connections increase firm values in developed as well as developing countries. In a recent historical study, Grossman and Imai (2016) found that the appointment of Members of Parliament to

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directorships decreased the stock returns of British banks, using data on English and Welsh banks from 1879 to 1909. Thus, the empirical results on whether political connections add to firm values are mixed.[1]

This paper focuses on Japan in the 1920s and 1930s to investigate the extent and implications of corporate political connections. Japan in this period provides a compelling environment to examine the implications of corporate political connections because democracy was fairly developed at this time. Universal male suffrage was established in 1925, whereby all male citizens aged 25 and above had the right to vote in the general election for members of the House of Representatives (*Shugiin*). Further, it was a de facto rule (*kensei no jodo*) from 1925 to 1932 that the first political party chosen by the general election held the reins of government. In this sense, we explore the role of the political connections of firms at the peak of democracy and party politics in prewar Japan.

We identify a firm's political connection if the firm had at least one director or auditor who was simultaneously a member of the House of Representatives. Using data of the general elections in 1928 and 1930 (the sixteenth and seventeenth general elections), we discover that approximately 20% of publicly traded companies had political connections through politician directors after these elections. Firms in regulated industries, such as the electrical utility and railroad industries, were more likely to have political connections. Regression analyses reveal that firms with newly-obtained political connections significantly increased their values. While firms in non-regulated industries could benefit from having newly-obtained political connections, those in regulated industries hardly benefitted.

This study contributes to advance our understanding of the political economy and economic development in prewar Japan. First, Masumi (1979) stressed that the relationship between the major political parties and private firms became closer during and after World War I because the political parties needed more money for elections, on the one hand, while on the other hand private firms wanted connections with the political parties to obtain more political power (pp. 232–233).[2] However, to our knowledge, no study has provided hard evidence regarding how the connections between firms and politics were pervasive in prewar Japan. This study not only provides quantitative evidence of the extent of firms' political connections, but also examines their effects on firm performance. Second, the literature on Japanese economic history has revealed that there were extensive networks between firms and banks through director interlocking in prewar Japan and has shown that those networks had significant economic implications (Okazaki et al., 2005, 2007; Okazaki and Sawada, 2012). Our study indicates that networks through directorship spread within both business and political circles and that political networks also had significant economic implications.

2. Identifying firms' political connections

The Constitution of the Great Japan Empire (*Dainippon Teikoku Kenpo*), which was promulgated in 1889, prescribed the status of the Diet (*Teikoku Gikai*). Although the role of the Diet was formally limited to supporting the Emperor (*kyosan*), in reality the Diet had legislative powers and the power to approve the national budget. The Diet was composed of the House of Peers (*Kizoku-in*) and the House of Representatives (*Shugi-in*), both of which had essentially the same powers. While the members of the House of Peers were appointed by the Emperor from among peers, high tax payers, scholars, and the like, the members of the House of Representatives were appointed by the public through general elections. Additionally, universal male suffrage was introduced following the 1925 Election Law amendment, whereby all male citizens aged 25 and above had the right to vote in the general election.

Further, the authority of the House of Representatives increased in the late 1920s, which was reflected in the de facto rule for the appointment of the Prime Minister. The Prime Minister was officially appointed by the Emperor throughout the prewar period; this appointment was based on the recommendation of a small number of informal political leaders called *Genro*, who had played leading roles in the Meiji Restoration. From 1925, the de facto rule (*kensei no jodo*) within this system became that the *Genro* recommended as Prime Minister the leader of the political party with a majority in the House of Representatives. There were two major political parties, *Seiyukai* and *Minseito,* during this period. That rule remained in place until 1932, when a military coup overthrew Inukai Tsuyoshi's cabinet based on *Seiyukai* (the May 15 Incident).[3] In this sense, the period from 1925 to 1932 is regarded as the period of the de facto party cabinet and it represents the peak of democracy and party politics in prewar Japan.

Considering the aforementioned institutional background of prewar Japan, this study identifies a firm as politically connected if it had at least one director or auditor who was simultaneously a member of the House of Representatives.[4] Our definition is similar to that of Braggion and Moore (2013), who defined a firm as politically connected if at least one of the

[1] Recent literature has focused on the channels through which politically connected firms have benefitted or suffered, such as finance and government procurement. Khwaja and Mian (2005) and Claessens et al. (2008) confirmed that politically connected firms actually obtained preferential treatment in bank financing, based on data from Pakistani and Brazilian firms, respectively. Braggion and Moore (2013) examined data on British firms from 1895 to 1904 and found that political connections increased the stock returns of new technology companies and that firms benefitted from politician directors in terms of easier access to external capital. Goldman et al. (2013) analyzed data from the United States, which indicated that politically connected firms are more likely to obtain government procurement contracts.

[2] See also Masumi (1988), pp. 97–98.

[3] *Minseito* was founded in 1927 through a merger of *Kenseikai* and *Seiyuhonto*.

[4] Some studies focus on top executives in identifying political connections (Faccio, 2006; Fan et al., 2007). However, because ordinary directors and auditors also significantly influenced managerial decisions in banks and firms in prewar Japan (Okazaki et al., 2005; Okazaki, 2015), we use information on all directors and auditors.