April 2004

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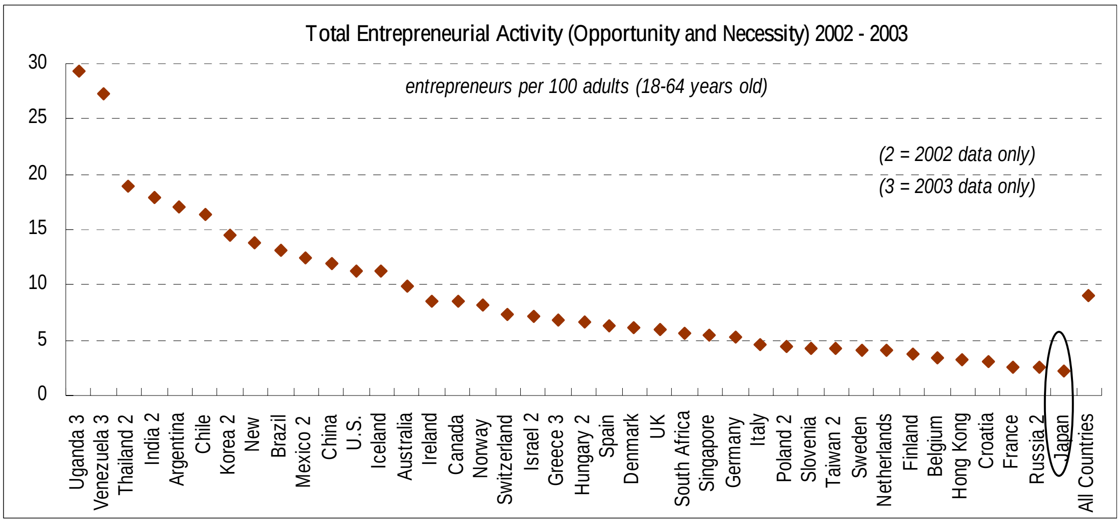
Despite Japan's rising global cool quotient and creative cultural exports, a collection of world class cutting-edge manufacturers and pockets of innovative small and medium sized businesses, an overall lack of business innovation is still one of the main structural weaknesses of Japan's long suffering economy.

The Japanese government has long recognized the lack of entrepreneurship as a weakness in the economy and in the face of press reports of Japanese entrepreneurs setting up companies offshore due to the complexity and high cost of setting up a new business in Japan, made it possible at the beginning of 2003 to set up a company with just one yen, or about one cent in U.S. currency. Despite this one yen initiative, aimed at fostering an entrepreneurial movement, there have been only about 300 applications to set up new businesses and less than 200 new businesses had actually been created by the end of 2003.[1]

Japan's Entrepreneurial Activity World's Lowest

According to the Global Entrepreneurship Monitor (GEM) 2002 and 2003 Global Reports, based on studies of national level entrepreneurial activity of 40 countries conducted by the London Business School and Babson College (ranked number one in entrepreneurship studies in the U.S.) of the U.S., and sponsored by the Ewing Marion Kaufmann Foundation, Japan ranked lowest of all 40 countries surveyed in the study (37 in 2002) in total entrepreneurial activity for the years 2002 and 2003. Total entrepreneurial activity is a combination of necessity-based entrepreneurial activity, which new economic activity is started due to a lack or absence of traditional work opportunities, and opportunity-based entrepreneurial activity, which is the free pursuit of new business chances, even though there are sufficient jobs in the economy. According to the reports 60% of all entrepreneurial activity is opportunity-based and 40% carried out by necessity.



Source: Global Entrepreneurship Monitor 2002/2003 Global Reports

Not only did Japan have the lowest prevalence of total entrepreneurial activity with just 2.3% of the working age population engaged in some form of entrepreneurial activity in those years,

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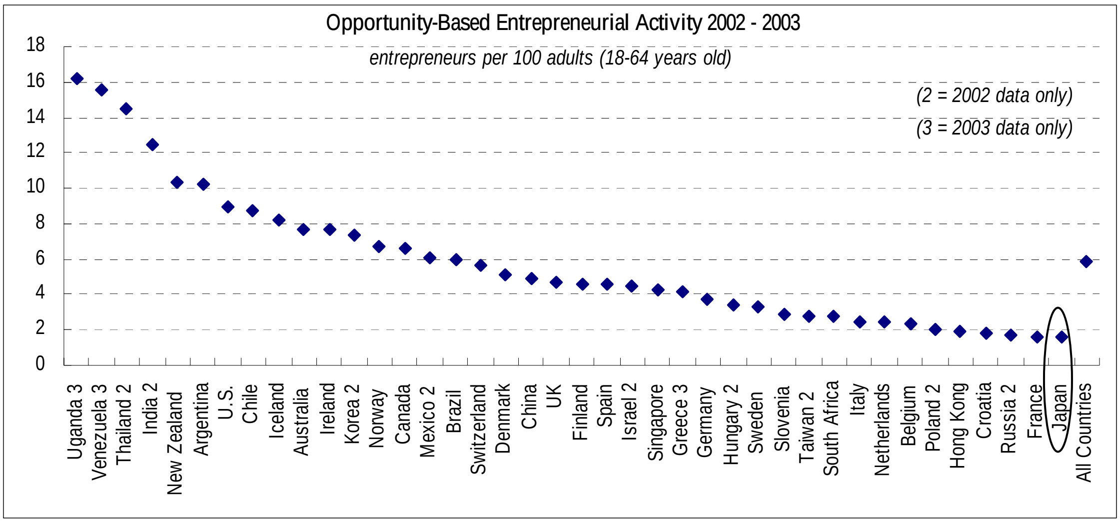
[1] David Ibison, *"Small is Seldom Beautiful for Japanese Entrepreneurs"*, Financial Times, November 23, 2003

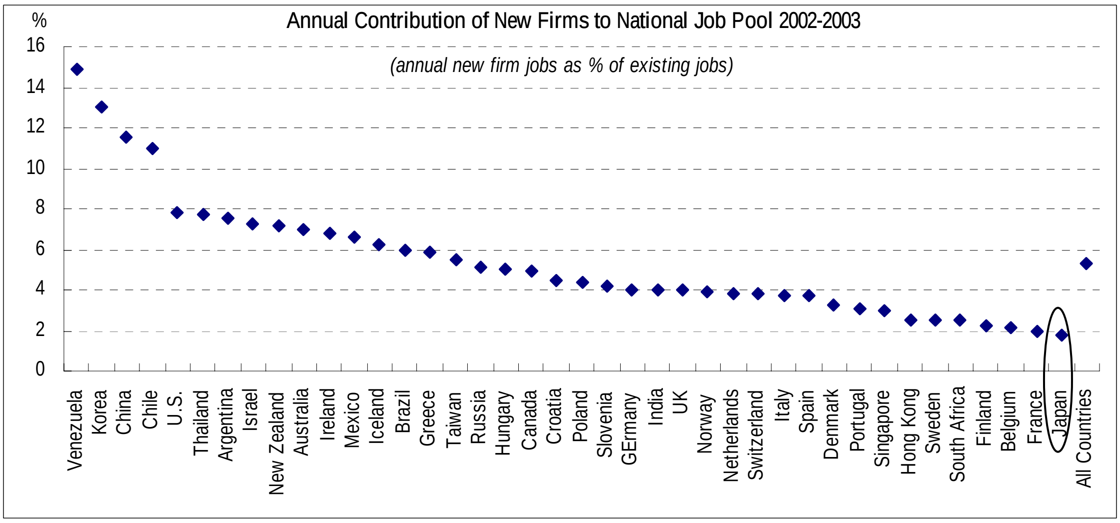
it also has the lowest prevalence of opportunity-based entrepreneurial activity (along with France) of all countries surveyed. Furthermore, the studies state that more than 80% of all new market niches worldwide are the by-product of opportunistic entrepreneurial activity rather than necessity-based business.



Source: 2003 Global Entrepreneurship Monitor Report

Japan's New Firm Contribution to Job Pool World's Lowest, Existing Firm Contribution Near Bottom

Furthermore, according to GEM's 2003 report the contribution of new firms to Japan's job pool is also the lowest of all industrialized countries and of all countries surveyed. New businesses in the U.S. created 10 times as many jobs as did Japan's start-ups in 2003 (U.S. population is 1.48 times Japan's) and represented nearly 8% of all jobs, whereas Japan's account for less than 2%. This would not be much of a problem if existing firms were able to pick up the slack. However, Japan, while not the lowest in the survey, still had very low levels of entrepreneurial activity among existing firms as well, finding itself in last the last quartile well below the average and the lowest among the G-7 nations.[2]



Source: Global Entrepreneurship Monitor 2002/2003 Global Reports

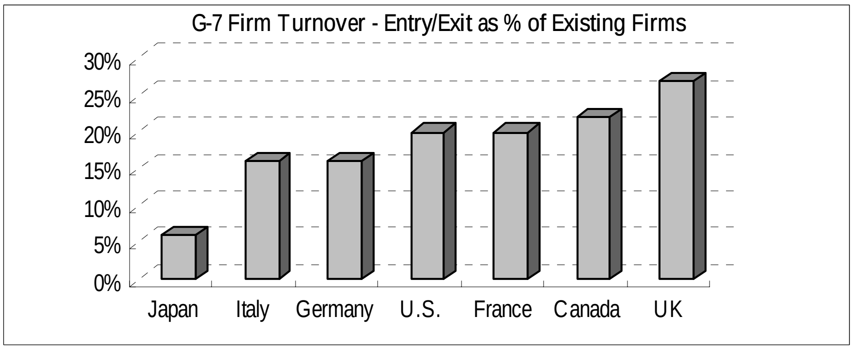
Existing Firm Productivity = Competition Spurred by New Firm Entrants

[2] Paul Reynolds, William Bygrave, Erkko Autio, Michael Hay Global Entrepreneurship Monitor 2002 Global Report, London School of Business/Ewing Marion Kauffmann Foundation/Babson College, November 2002
Paul Reynolds, William Bygrave, Erkko Autio and Others, Global Entrepreneurship Monitor 2003 Global Report, London School of Business/Ewing Marion Kauffmann Foundation/Babson College, November 2003

This brings us to the crux of the problem; the ability of a mature economy like Japan's to create productivity growth, specifically total factor productivity (TFP) growth, depends on the ability of new firms to replace old, inefficient firms. The OECD found in a study of firms in ten industrialized countries that only half of the improvements in total factor productivity (capital, labor and technology inputs) came from within each firm, the other 50% was stimulated by competition among firms. 40% of TFP growth was a result of newer companies replacing older companies and 13% came from more efficient firms taking away market share from less efficient firms in the same industry. It has been found that a considerable amount of the productivity gains of current firms come from the pressure of competition, especially the pressure applied by new firms on old firms.[3]

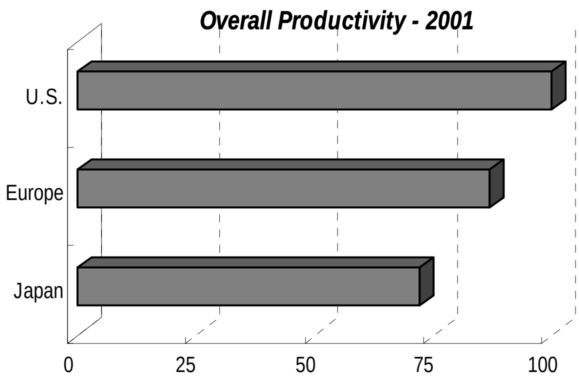
Birth and Deaths - Japan's Firm Turnover Lowest Amongst Advanced Countries, Productivity Too

However, in Japan, not only are new firms not being created, old firms are not being dispatched. The average OECD country averages around 20% in annual turnover of firms, Japan only averaged 6.5% all through the 1990s. And while the exit, or death, of firms has risen since the mid-1990s as a percentage of existing firms, it still remains well below the average for the industrialized world. The seeming fact of the matter is that not only are a sufficient number of new companies not being created, or being snuffed out before they get off the ground, but a sufficient number of old companies are not dying out.



Sources: 2003 White Paper on Small and Medium Enterprises in Japan/OECD Economic Outlook 2001

The proof is in the pudding. It is now common knowledge that Japan's total factor productivity ranks lowest among all the advanced countries. On a scale of 100, with the U.S. at 100, the overall productivity of Japanese firms was 69, while Europe's were 87. At closer look though, by industry sector we find such internationally competitive industries as automobiles and electronics are much more productive than their U.S. or European counterparts, but such domestic centric industries as construction, retail and health care, which are the most "institutionalized", are also the most unproductive.



Source: The Conference Board 2001

Government Working at Cross-Purposes

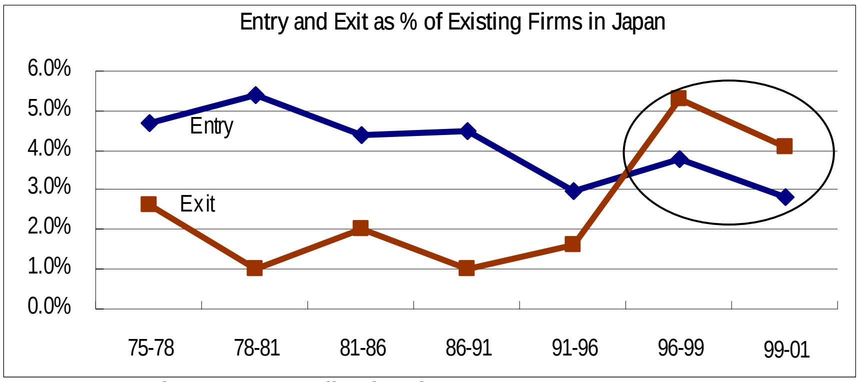
Interestingly, the Japanese government, aware of this anomaly, is basically committed to seeing the number of new firms reach 360,000 annually within the next few years, there were 85,000 created in fiscal 2002. This figure seems untenable though (even during the bubble economy

[3] Productivity and Firm Dynamics: Evidence from Microdata, OECD Economic Outlook, June 2001

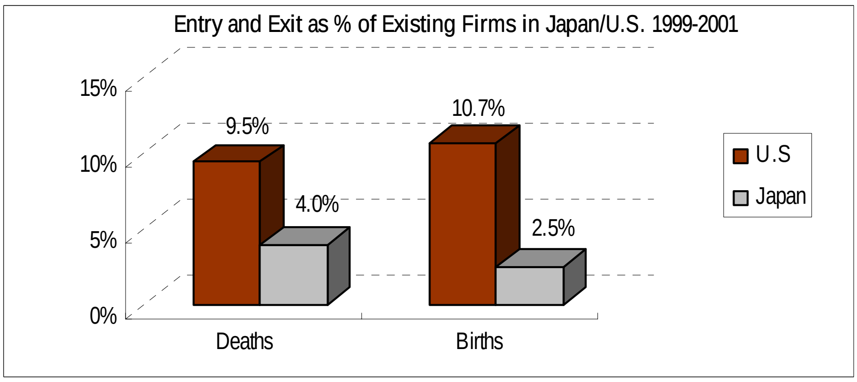
this figure was only about 170,000), as the government seems to be working at cross purposes with itself. While the government is talking about the importance of new business formation in creating future growth industries, it props up, where possible, incumbent firms in the name of employment and blocks, where possible, new entrants in the name of local and vested interests, vested interests often being the incumbent firms themselves. Even much of the increased M&A activity in Japan is serving to rationalize existing industries and in the process reduces the number of potential competitors. Of course, job protection is a political staple in all countries, as witnessed by the current debate by U.S. Democratic presidential hopefuls (overseas white collar outsourcing, etc.), however the data suggests that it is much more entrenched in Japan than in other countries.[4]

Not "Creative Destruction", Just Destruction (Long-Term Fall in Number of Companies)

What is a bit alarming is that with the number of new entrants falling to historical lows (according to Japan's Justice Ministry, new business formation continued to fall in 2002, but rose very slightly in 2003) the data shows the actual number of companies in Japan is decreasing. While this might be normal in times of economic recession, the fact that it has been going on for so long, since the mid-1990s, does not bode well for the employment picture in Japan. Undoubtedly, a certain amount of economic rationalization in Japanese industry is in order, however, Japan's current predicament does not fit the pattern of "creative destruction" in most other advanced countries. For example, even in the U.S. recession of 1990-1992, in only one year, 1990-1991, did the number of exiting companies exceed the number of new firm entrants. Between 1991 and 2001 the number of firms in the U.S. increased by 11%, meaning firm births exceeded firm deaths, while the number of Japanese firms fell by 5.4%, meaning more firms exited then entered. This seems to fit a pattern of government protection, (promoting mergers while barring new entries, maintaining the status quo, etc.) rather than market rationalization (letting old, inefficient firms die and allow newer, more efficient firms to enter). It seems that the forces of job preservation in the Japanese government, in their bid to maintain employment levels in Japan, might well be producing an opposite, unintended effect.[5]



Source: 2003 White Paper on Small and Medium Enterprises in Japan

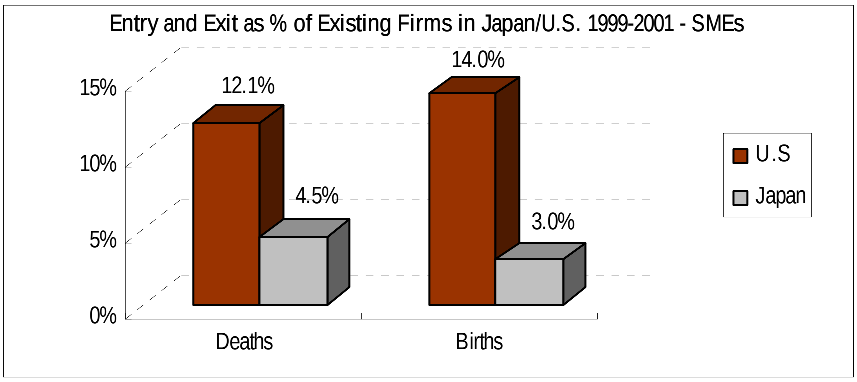


Source: Statistical Abstract of the U.S.: 2003/2003 White Paper on Small and Medium Enterprises in Japan

[4] Revive Japan DREAM GATE Project, Japan Ministry of Economy, Trade & Industry/Venture Enterprise Center, February 2003

[5] Statistical Abstract of the U.S.: 2003, U.S. Census Bureau

Sources: Statistical Abstract of the U.S.: 2003
2003 White Paper on Small and Medium Enterprises in Japan



Dearth of Young, Growing Companies in Japan = Dearth of Jobs

The contrast in firm turnover of small and medium sized enterprises between the U.S. and Japan is even more striking than it is for all firms, as large firms, by nature, witness less entry and exit. In recent years, U.S. small firm turnover has been about 20% higher than Japan's. In fact, in 2002 the U.S. created more than 5 times the number of new businesses per capita. The degree to which Japan has protected existing companies while discouraging new entries might be illustrated by this fact; of the 192 U.S. companies in the 2003 Global Fortune 500, fully 26 of them, or 14% did not even exist in 1968, of the 88 Japanese companies every single one existed in 1968. In fact, almost all of the Japanese companies were already large entities in 1968. In the last 35 years, which is a little less than one person's working life, not one new Japanese company has entered the Global Fortune 500. Furthermore, just these 26 U.S. companies have created nearly 2 million jobs.

26 U.S. firms non-existent in 1968 are now Fortune Global 500 firms.

Japan has not seen 1 "new" company enter the Fortune Global 500 in that time.

U.S. Global Fortune 500 Companies Non-Existent in 1968

	Company	Employees		Company	Employees
1	Home Depot	300,000	14	Tech Data	7,900
2	Cardinal Health	50,000	15	Advancepcs	6,000
3	Costco	69,000	16	Gap	165,000
4	Dell	39,100	17	Solectron	68,500
5	Microsoft	50,500	18	Express Scripts	7,561
6	Valero Energy	19,830	19	TJX	89,000
7	Intel	78,700	20	Staples	43,864
8	UnitedHealth Group	32,000	21	Office Depot	43,000
9	Sysco	46,800	22	Pacificare Health Systems	7,800
10	Fedex	184,953	23	Waste Management	53,000
11	HCA	178,000	24	MNBA	261,000
12	Autonation	28,500	25	AES	36,300
13	Cisco	36,000	26	Health Net	9,400
				Total Employees	1,911,708

Marubeni Research Institute based on the 2003 Global Fortune 500 and each company's home page

This would be of little concern if Japan's existing companies were creating jobs. Obviously, large job growth took place throughout the Japanese economy from the 1970s into the early 1990s. For example, between 1980 and the mid-1990s major companies like NEC, Toshiba, Toyota and Honda doubled their workforces. Overall between 1986 and 1996 employment grew around 10% in small and medium sized businesses and 20% in large companies in Japan. However, nearly all of this employment came from existing firms. From around 1996 Japan's job growth completely reversed course. Japanese companies' job growth was a negative 5%

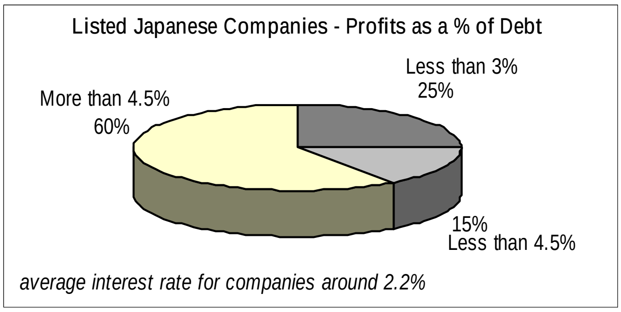
2003 White Paper on Small and Medium Enterprises in Japan, Japan Small and Medium Enterprise Agency between 1996 and 2001 (the latest data), with small and medium sized businesses (companies of under 300 employees) showing a minus 2% and larger firms a 14% drop in jobs. Japan's unemployment rate grew from around 2% (2.1% in 1990) in the early 1990s to about 5.5% by the end of 2003.[6]

Employment Comes from New and Growing Companies

In contrast, in the U.S. between 1990 and 2000 new companies of less than 500 people created 1.15 million more jobs than were lost from dying firms. For large companies the same figure was minus 20,000. Small and medium-sized firms and establishments in total increased the number of jobs by a total of 6 million between 1990 and 2000, while interestingly larger medium sized and major firms saw job creation rise by more than 30%, or about 13 million jobs. However, according to our own research, the largest 500 companies in the U.S. cut their workforce by a little over 20% between 1986 and 1996, and have since increased jobs by between 8% and 10%. Job growth in the U.S. has been spurred by new business formation and relatively young companies growing into larger, more powerful ones. Microsoft went from a handful of employees to more than 50,000 in about 20 years. In nearly the same time frame IBM cut nearly one-third of its workforce, but then, beginning in the mid-1990s, grew its workforce by about 10%. From the data, it is more than evident that new competition has not only provided a new source of employment in the U.S., it has forced existing U.S. companies out of the market (old firm deaths exceeded new firm births by 30% for larger firms) or to become more efficient. The ensuing new job creation by new and more competitive existing firms has more than made up for job losses from bankrupt or less competitive firms.[7]

Political Dilemma - Job Protection = Hidden Unemployment

According to statistics from Japan's Financial Services Agency the non-performing and problem loan situation at Japanese banks during the last fiscal year saw the first substantial improvement since 1996. But, while these high risk loans fell 10%, the amount is still quite huge at $284 billion (31.2 trillion yen). What must be remembered is that for every non-performing/problem loan there is a potential non-performing borrower, or what worries Japanese politicians, potential unemployment. Actually, a non-performing/problem borrower is more worrisome than a non-performing/high risk loan, as not all of a non-performing borrower's loans are considered non-performing or problem if they are backed up by collateral. According to a study carried



Source: Goldman Sachs 2001

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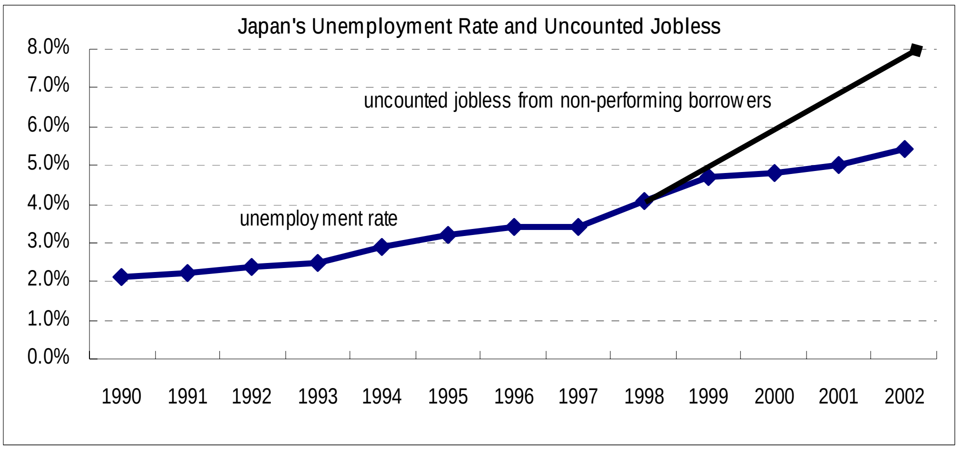
[6] Fortune Magazine – May/August 1970 Issues, /May 7/August 23, 1982 Issues, April 27/August 23, 1987 Issues, July 27, 1992 Issue, August 5, 1996 Issue and July 21, 2003 Issue
Statistical Abstract of the U.S.: 2003, U.S. Census Bureau
1998 and 2003 White Papers on Small and Medium Enterprises in Japan, Japan Small and Medium Enterprise Agency

[7] Fortune Magazine - May 7/August 23, 1982 Issues, April 27/August 23, 1987 Issues, July 27, 1992 Issue, August 5, 1996 Issue and July 21, 2003 Issue
Statistical Abstract of the U.S.: 2003, U.S. Census Bureau
"Global Competitiveness: U.S. Firms Emerge", Marubeni Research Institute, June 2002

out by the Tokyo Office of Goldman Sachs in 2001 of 2,800 corporations listed on the Tokyo Stock Exchange in 2001, 16% did not have enough operating profit to pay the average interest rate of 2.2% paid by these companies on their loans. Applying this to the entire Japanese economy for fiscal 2002, we estimate that 10.75 million people work for companies with non-performing or very troubled loans. Using historical data (50% retained/40% of other 50% re-employed), we estimate that somewhere in the vicinity of 2 million people would be left unemployed if companies with non-performing loans (overdue) were liquidated or restructured, adding around 3% to Japan's unemployment rate. (Please note that Japan's unemployment security net is underfunded, with a large portion of workers not covered by unemployment insurance.) Given though, Japan's falling new business formation ratio, this figure could go even higher. This is the dilemma facing Japanese politicians. Without strong new business formation there is no outlet for this hidden employment, however, without the exit of inefficient firms there is no room (barriers, often hidden, remain in place) for new firms and more efficient firms to enter. The point is you can't have it both ways.[8]



Sources: 2003 White Paper on Small and Medium Enterprises in Japan
Marubeni Research Institute based on data from "Japan Phoenix by Richard Katz

Japan Not Financially Supportive of New Business

According the Global Entrepreneurship Monitor's 2002 report on entrepreneurship, cultural and social norms and financial support were given as the two strongest deterrents to new business formation in Japan. In terms of financial support the evidence seems to back up the theorem. From 1999 to 2003 Japan consistently finished at the bottom of the ranking for informal venture capital invested, that is capital lent by friends, family, associates and other personal contacts, and nearly at the bottom for classic (formal) venture capital invested, or capital lent by venture capital firms and other official investors, as a percent of GDP. The total amount of venture capital invested in Japan, both informal and classic, hardly registers in the GEM surveys.

Most developing countries rely almost entirely on informal investment, while even in developed countries informal venture capital makes up the major portion of total venture capital invested. However, since the mid 1990s classic venture capital has grown rapidly as countries try to

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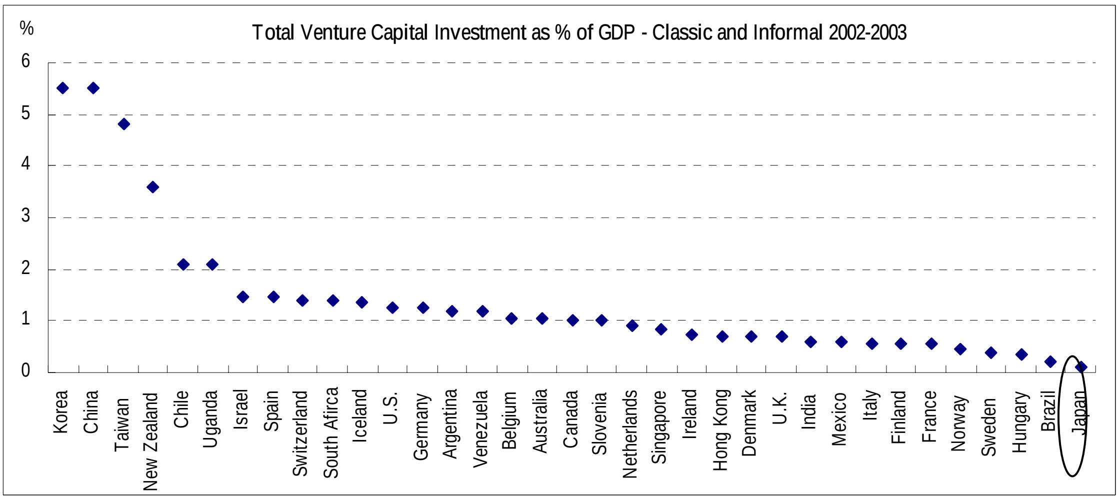
[8] Risk Loan Situation (1st Half Fiscal 2003), Financial Services Agency
Richard Katz, Japanese Phoenix: The Long Road to Economic Revival, M.E. Sharpe Inc. 2003
David Atkinson, *"Totally Rethinking Japanese Asset Quality"*, Goldman Sachs, July 2001

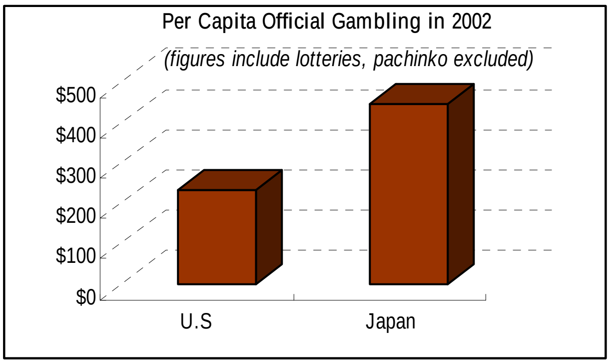
imitate some of the success of the U.S. market, which is still home to about 75% of all classic venture capital invested. As it stands most start-ups (seed money to build a start-up) are built on informal investment and most formal capital goes to early start-ups and expanding companies. In either case, Japan's performance is rather dismal to say the least.



Source: Global Entrepreneurship Monitor 2002/2003 Global Reports

Japanese Not Culturally Averse to Risk-Taking

Certainly informal investment is affected somewhat by social and cultural values. According to the Financial Times, in a survey of U.S. and Japanese citizens asked if entrepreneurs were socially valuable, 91% of the U.S. respondents answered favorably, while only 8% of the Japanese did. Does this mean the Japanese have a cultural aversion to risk-taking? This is rather doubtful. Japan's proclivity for gambling on pachinko, on horse, dog, boat, motorcycle and bicycle races, and on various types of lotteries points to a nature that is no less risk averse than the citizens of other countries. In fact, according to Datamonitor, in 2002 there were more on-line internet gamblers per capita in Japan than in the U.S. Legalized gambling revenues in the U.S. were $68.7 billion in 2002, while government controlled gambling in Japan generated $57.3 billion in 2002 (both figures include lotteries), a per capita figure nearly double the U.S. And, pachinko, which is not officially considered a gambling activity in Japan, took in $234 billion in 2002, more than triple the revenue of casinos in the U.S.[9]



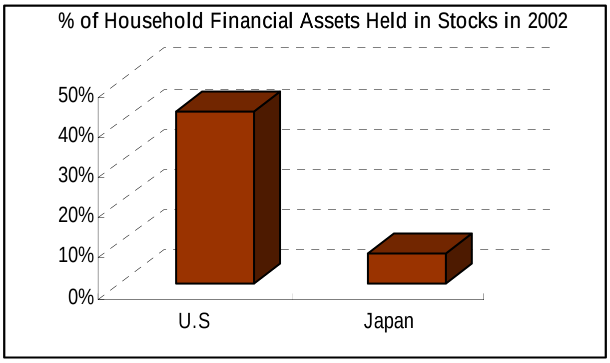
Sources: See sources in footnote 9 below

Individual Stock Holdings Low

In 2002 the percent of Japanese household financial assets held in stocks (excluding those pension funds) came to 7.7%, while the corresponding figure in the U.S. was 43% (56% if stocks in pension funds are included). Furthermore, the share of all stock holdings by individuals in Japan was 19.7% in 2002, an all time low, compared to about 50% in the U.S. (if 401K pensions were counted the U.S. figure would be much higher compared to the Japanese

9 The Gross Annual Wager of the United States: 2002, Christiansen Capital Advisors, LLC., February 2003
2003 White Paper on Leisure in Japan, Japan Productivity Center for Socio-Economic Development

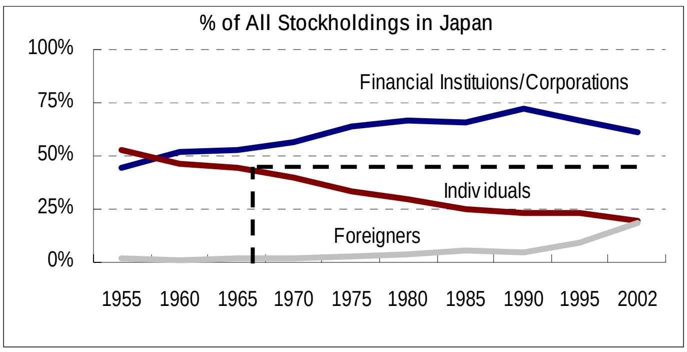
figure). Currently, around 60% of all stock on Japan's stock exchanges is held by financial institutions and companies. As recently as the mid-1990s two-thirds of all Japanese stocks were held by financial and business institutions, much of it by "friendly" shareholders, meaning many of these shares were in the form of cross-share holdings, or even if not, basically they would not be traded. However, it is not so much that Japanese individuals do not like to invest, it is just that there is very little incentive to do so.



Sources: Statistical Abstract of the U.S.: 2003
2003 Statistical handbook of Japan

First, dividends paid out by companies on average in Japan are even lower than interest rates. Secondly, there is a belief among individuals that the market is "fixed" against them, for example, investment banks guaranteeing the returns on stock investments made by large companies and other corporate stock scandals in the 1980s and 90s, toward large institutions. Furthermore, there is the notion that the government's price keeping operations skew the market so values can't actually be trusted. Then there is the simple truth that capital gains are not very attractive as the stock market, for all practical purposes, has been on a downward trajectory for the past 15 years. Combine this with fact that there have been very few new and attractive young, growing companies to invest in and it is no wonder that Japanese aren't investing in the stock market. (There are also regulations that discourage individual investors, such as having to buy stock in large "allotments".) This has not always been so. Between 1950 and 1970 individual ownership of all stocks in Japan average nearly 50%, similar to current U.S. levels. Could it be the Japanese would rather gamble than invest in the stock market because they see the risk-reward relationship in gambling as more attractive? There isn't really anything very cultural about this. The problem of risk-taking in Japan does not seem to be primarily cultural, but rather institutional.[10]

Institutionalization of Japanese Economy Begins in 1970s

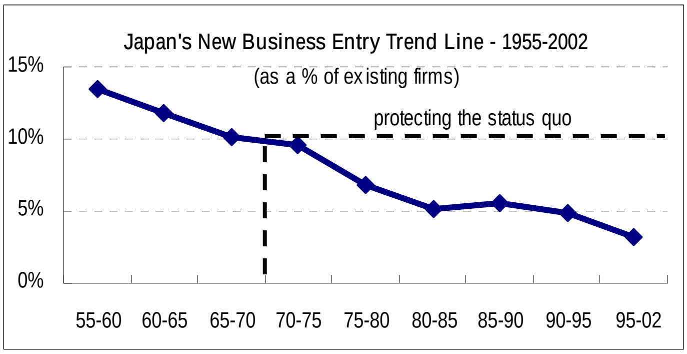


Sources: Japan Statistics Illustrated: 100 Years of Japan Statistics
Tokyo Stock Exchange Factbook 2003

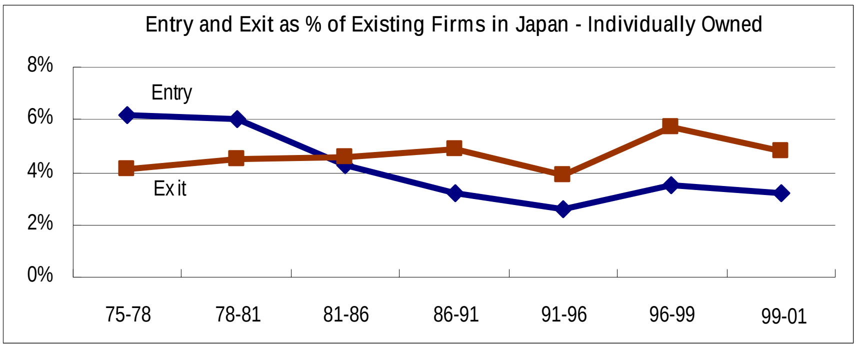
The decline in individual participation in the stock market and rise in institutional ownership seemed to gain momentum in the late 1960s eventually falling 18% by the mid 1980s. Interestingly, dividend payments by Japanese firms, which had previously been relatively high, began to decline around the same time. Furthermore, the decline in new business formation in Japan began to take place in the early 1970s. In fact, until that point new business formation, by international standards, was also quite high in Japan, averaging around 12% of existing firms from 1955 to 1973. By the 1980s though, decreases in the actual numbers of small and medium size businesses and individual and individual establishments began to take place. It does not

[10] Japan Statistics Illustrated: 100 Years of Japan Statistics, Kokuseisha/ Yano Tsuneta Kinenkai, 2000
2003 Japan Statistics Illustrated, Yano Tsuneta Kinenkai

seem coincidental that all this took place along side the rise of "money politics" (factions) and the so-called vested interest "tribes" of Japan's ruling Liberal Democratic Party (LDP) (the "tribes" sprang out of the LDP Policy Research Committee formed in the late 1960s), and the continued rise in the government deficit, except for a brief respite during the bubble economy, at which time new business formation also rose temporarily. The irony is that a number of smaller vested interests now sat alongside the traditional "iron-triangle" of big business, bureaucrats and politicians, the result being the semi-cartelization of a broad swath of the economy in Japan. What this meant was basically protection of the status quo, whether it was big business or the local mom and pop shop. Although the government couldn't protect everybody in times of economic malaise, it could make it difficult for new enterprises, domestic and foreign, to enter markets, or assist existing industries and companies. (Bureaucrats, traumatized by the 1st oil shock also began to "rationalize" industries in the name of "stability".) So while the number of business deaths has risen ever so slightly, mostly from the mid-1990s, the appearance of new businesses has been on a downward trajectory since the 1970s. Interestingly, one of the definitions of institutionalism is "the spirit that exalts established institutions as opposed to individualism". It looks as if this is exactly what has happened in Japan since the 1970s.



Sources: 2003 White Paper on Small and Medium Size Businesses in Japan



Sources: 2003 White Paper on Small and Medium Size Businesses in Japan

Entrepreneurship/Competition Essential to Japan's Revitalization

Japan's current economic revitalization is dependent on increased total factor productivity growth in existing firms on the one hand and on developing new products, services and technology, even industries - new products and services in the name of consumption and new technology in the name of productivity, on the other hand. This is basically a combination of efficiency and innovation. Both the Global Entrepreneurship Monitor reports and OECD studies on entrepreneurship, productivity and firm dynamics clearly show that new firms, in general, typically use a more efficient mix of labor, capital and technology than existing firms, meaning higher total factor productivity. And, industries that have high entry and exit rates show much better productivity than industries with low rates, spurred by competition from new firms and the exit of low productivity firms. Furthermore, industries with higher numbers of exiting firms have higher numbers of entering (i.e. new) firms. Interestingly, in newer industries, new firms with new technology or firms that exploited technological opportunities (usually new or younger firms) drove growth, and in mature industries, growth was propelled by productivity within existing firms spurred by competition and the exit of old firms.[11]

A favorable overall entrepreneurial climate and understanding of the dynamics of entrepreneurship is a base ingredient in maintaining or “regenerating” economic vitality, especially in advanced industrialized countries. The report on global entrepreneurship is very clear on the relationship between government and entrepreneurship; “where government is directly responsible for a large share of economic activity there is less entrepreneurship”. According to the book “Japanese Phoenix” by the economist Richard Katz and based on statistics from Japan’s Cabinet Office and McKinsey & Co., in 1990 55% of Japan’s GDP and 46% of its work force was in highly regulated industries. In all likelihood it remained near this level until the mid-1990s.

Japan’s Structural Reform = Deinstitutionalization

This is what Japan’s structural reform is basically all about; deinstitutionalizing large swaths of the Japanese economy, mostly the unproductive domestic centered sectors (construction, food processing, retail, health care), in order to revitalize it. “Emphasis on organization at the expense of other factors”, “to incorporate into a highly structured and highly formalized system, “established by authority”, “the spirit that exalts established institutions as opposed to individualism”, are some definitions attached to the word institutional (ism). Deregulation of industry (Large-Scale Retail Store Law, financial “Big Bang”, etc.), privatization of a good portion of the 77 government corporations and over 3,000 subsidiaries (Japan Highway Corporation, postal savings system, etc.) restrictions on bureaucrats parachuting into private companies in industries they regulate or “descent from heaven”, the loosening of labor restrictions and many other like initiatives are all part and parcel of Japan’s structural reform.

Japan Wises Up to Entry, Not Exit

As a whole, the Japanese government understands the importance of new firm creation, and to a lesser extent competition in existing industry, in the dynamic of Japan’s economic revitalization. This is evident in the various attempts now being made to promote entrepreneurship (new business) and university and business tie-ups (new ventures using intellectual property and patents) through the Hiranuma Plan and even a warming to FDI (competition) by the government in Japan evident in their current “Invest Japan” campaign. In fact, the Hiranuma Plan, released in 2001, tackles just about every issue imaginable related to creating new markets and jobs through everything from doubling the number of new businesses to encouraging cross-fertilization of industry to investment in new and growing fields to labor mobility to maintaining job safety nets, just to name a few. It even mentions exit strategy, the acceleration of bad loan disposal. To expedite this plan the Revive Japan DREAM GATE Project, supported by Japan’s METI was set up with specific purpose of fostering start-ups and new businesses to create new business fields to help revive Japan’s economy (the 1-yen initiative). Even the theme of 2003 White Paper on Small and Medium Enterprises in Japan is “The Road to Regeneration and the Creation of an Entrepreneurial Society”. This is all well and good. Still if the dichotomy of calling for entrepreneurship and new business on the one hand, while shoring up and protecting older, uncompetitive firms on the other, is not

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[11] Dirk Pilat, “*Sources of Productivity Growth in the 21st Century– Findings From The OECD Growth Project*”, OECD, June 2003

remedied, new business formation, in any real sense, will unlikely occur.[12]

Vertical Integration (Hierarchy) as Opposed to Horizontal Integration

The dichotomy, in the Japanese context, is not difficult to understand. From the macro perspective the Ministry of Economy, Trade and Industry, which takes more of a bird's eye view of the Japanese economy, has been at the forefront of promoting new business formation and entrepreneurship in Japan. However, other ministries, together with "special interest" politicians have often worked, to repeat, at cross purposes and in seemingly opposing fashion. This is due to the hierarchal, separate and stand alone nature that has developed in these organizations through the long period of institutionalization and the consequent focus on core constituencies instead of the overall national interest (or broader picture). The main point here is that due to little horizontal integration in Japan's institutional diaspora, the dichotomy of creating new business, while protecting the old, has become more pronounced than it should be.

> *It is just this problem, at a different level, that has been at the bottom of Japan's inability to conclude any meaningful trade agreements with other countries and has Prime Minister Koizumi calling for the cross gathering (horizontal) of related ministry officials under the authority of the Cabinet Office (or the creation or a centralized trade body) to try and bring some cohesion and consistency to issues, trade in this case, reflecting the national interest. (This issue came to the fore in recent free trade negotiations with Mexico, with Prime Minister Koizumi finally stepping in to override the farm lobby and disparate ministry negotiations).*[13]

This same type of hierarchial institutionalization, to a lesser extent, can also be found in many of Japan's large organizations where labor mobility has been nearly non-existent (no job market) and where little competition (cartelization) or outside influence have been able to penetrate until the onslaught of globalization and IT (cross-fertilization of organizational units/industry). This is not a very conducive atmosphere for fostering entrepreneurial ventures. The recent strategic battle cry of Japan's big business of "selection and concentration", which means to select one's strong areas of business and concentrate one's resources in them, is a reflection of the failed attempt at business diversification by Japan's major companies that has been taking place since the 1970s. This is why entrepreneurship and creating a climate and infrastructure for it is so important.

Government Meddling and Entrepreneurship a Bad Mix

Without an understanding of the underlying concepts behind new business formation by both politicians and bureaucrats, and to some extent large companies, the development of new business in Japan will be doomed to constantly swimming upstream. One of the fundamental concepts for fostering entrepreneurship is for government to stop meddling in areas where market forces and the private sector are perfectly capable and better equipped to handle the job themselves. While creating a climate and the general infrastructure conducive to

[12] *"Focus: Hiranuma Plan"*, JETRO Focus Newsletter, May 25, 2001
Yuichi Takano, *"The Revive Japan DREAM GATE Project"*, IIST World Forum
The Revive Japan DREAM GATE homepage

[13] "*Koizumi Gets Direct Control of FTA Talks"*, Asahi Shimbun, November 24, 2003
Yasushi Azuma, *"Japan To Develop Coordinated Trade Policy Amid Era of FTA Talks"*, Japan Times December 31, 2003

entrepreneurship and new business formation, it must also create a climate and general infrastructure conducive to exit, or failure (meaning, in some cases, as little infrastructure as possible).

In 2002, on the heels of the Hiranuma Plan, Prime Minister Koizumi won approval for an economic stimulus package which included $12.7 billion for small and medium sized businesses, included new ones that were in financial need. The problem here is that the government, and behind the scenes politicians, determined which companies would get what funds. From what we could discern very little of it, if any, went to new ventures or start-ups. Rather it went to traditional, old-line SMEs in mature industries in distressed regions. This is a case of providing unemployment insurance by blocking exit rather than attempting to foster employment by aiding entry (or young firms). What we have is the government determining which businesses will receive loans, or in another sense, investment, when the private sector has the better capabilities and skills to do the job. The government is not looking to maximize the return on its investment, whereas the private sector would. Japan's low total factor productivity is not the result of unproductive labor, although misallocation of labor may contribute, it is unproductive capital or investment.[14]

If meddling in the banking sector (although in some cases needed) weren't enough, the recent pronouncement by the government backed Industrial Revitalization Corporation of Japan (IRCJ) that it would inject public funds into the struggling lifestyle products conglomerate Kanebo, despite a bid by the home products firm Kao to purchase Kanebo's cosmetics business is an example of both strong institutionalism by the company itself and contradiction by the government of accelerating bad loan disposal and letting the private sector do as much as it can. Kanebo, a typical example of over-diversification by a Japanese company, was urged by its main bank Mitsui-Sumitomo to sell of its profitable cosmetics business to pay off much of its debt and attempt to restructure its other businesses. Kao, a stronger and more productive company, would have gained synergy from the purchase. Kanebo turned to the IRCJ (which itself is eager to try out its turn-around techniques) in attempt by management and employees to save the entire company. While the government, to avoid criticism of a simple government bailout, eventually forced the main management to step down, the prospect is that it will just prolong the life of the loss-making businesses, resulting in a loss of taxpayers money and will have to eventually sell off the cosmetics (possibly to Kao) and other businesses anyway.[15]

Crowding Out New Business

Without normal functioning capital markets, business in general in Japan is mostly financed by banks (indirect financing). Funding for SMEs by banks has been falling every year since 1994. The injection of public funds into banks by the government has, as shown above, to a great extent, served to prop up existing companies to avoid the political problem of unemployment. However, it is serving to crowd-out potential funding for new businesses as well. The only alternative would be investment from "angel" investors or private venture capitalists. However, with an "institutional" culture in place rather than a "new venture" culture, there are only about 1,500 venture capital investors in Japan compared to 400,000 in the U.S. according to METI.

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[14] Irene Kunii, *"Don't Stifle Your Entrepreneurs, Japan"*, Business Week, February 7, 2003

[15] David Pilling and Michiyo Nakamoto, *"Japan Chooses Cosmetic Change"*, Financial Times, March 4, 2004
"Editorial - The Kanebo Effect", Asahi Shimbun, March 12, 2004

This has resulted in venture capital investment of about $9.34 billion, or about 30 times less than the U.S.

Irony - Japan Creative and Entrepreneurial

Herein lays the irony in all of this; Japan is both creative and entrepreneurial. It is just that it has been thwarted, unintentionally, in a broad swath of the economy. Japanese advertising, animation, design (fashion, industrial, architectural and otherwise) comics, video games (both hardware and software) are either world class or world leading. And while contemporary Japanese films, music and TV dramas are not widely known in the West, they are in Asia, and combined with the above-mentioned, have made Japan an Asian pop culture superpower. Furthermore, most of these industries have been built almost completely on entrepreneurship over the last 30 years, fashion being a prime example, as they lay outside Japan's institutionalized sectors where in most cases entry was easier, but competition was stiffer. Even Japan's convenience stores, led by 7-Eleven (7-Eleven took over its U.S. counterpart in the early 1990s), have become hotbeds of innovation in Japan's unproductive retail sector, much by virtue of competition. Moreover, Japan has the most number of patents, researchers and R&D investment as a percentage of GDP than any country in the world, although Japan is notorious for the high percentage of patents that are not commercialized, which comes from hierarchial, stand alone tendencies. However, as an aside, Toyota's world class and innovative manufacturing system was not built on vertical integration but the horizontal integration of everything from marketing to engineering. (Note though that a certain amount of hierarchy is necessary in all business; someone has to make a decision.) This is not a society without an innovative disposition or an entrepreneurial bent, nor does it necessarily have an underlying cultural bias toward risk.[16]

So why do only 8% of the Japanese feel the entrepreneurs are socially valuable? With so few old businesses departing and new businesses emerging and relatively high economic growth from the late 1960s to the 1990s, few saw the advantages of creating one's own business. Parents, always practical, steered their offspring toward the relative security of an existing company or institution, the bigger the better. In a climate that clearly favored existing companies over new ones, start-ups per capita have fallen by more than half since 1980 (MPHPT), people became prejudiced toward existing institutions. However, people will change there attitudes quickly if new and growing companies begin to emerge and traditional companies that are inefficient begin to exit.

Japan's anti-structural reform faction would do well to take in the lessons of new business formation. You can't have your cake and eat it too. Despite the growing pro-entrepreneurship stance of both government and private business, and even with the better environment for new business in Japan, the continued propping up of inefficient companies in the name of job protection will only serve to crowd out Japan's future "Microsofts". This money, or investment if you will, would be better used providing for a much stronger security net for Japan's workers, affordable continuing education and specialized training, and more supportive bankruptcy laws that will make institutional exit easier. And although it should be recognized there are certain

[16] *"A Special Report on Asia's Pop Culture Superpower"*, Time Magazine, August 11, 2003
"The Creative Economy", Marubeni Research Institute, January 2003

cultural attributes at work here, it is really the more modern “culture of institutionalization” that is acting as a drag on entrepreneurship and the creation of new jobs in Japan. The funny thing is Japan need look no further than its own creative industries and historical background for inspiration. What may hang in the balance is whether Japan becomes “a country built on opportunity based entrepreneurship” or “a country built on necessity based entrepreneurship”.[17]

P. Ryan
Marubeni Research Institute

Note: The views and opinions contained in this article are those of the writer and not necessarily those of the Marubeni Research Institute

[17] “Japan, a country built on…” is from the English translation of the Japanese phrase which is currently in wide use, for example, “Japan: A Country Built on Tourism”, etc. Also see “*Japan’s Tomorrow: A Country Built on Culture”,* from the Seminar Series - Cultural Power and Corporate Strategy, Tsutomu Sugiura, Marubeni Research Institute, October 10, 2003