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The Entrepreneurship Vacuum in Japan: Why It Matters and How to Address It

Jan 02, 2013 Asia-Pacific

Empirical research has shown that "opportunity-driven" entrepreneurship is the wellspring of growth in the modern market economy. In Japan, the relative dearth of opportunity-driven entrepreneurship has contributed to the nation's economic malaise over the past two decades — since the asset price bubble burst in 1991.

Although there are encouraging signs — given the sophistication of Japan's technological base, the promise of female entrepreneurs, the advent of start-up incubators and the rise of "intra-preneurship" within established companies — entrepreneurship levels today are markedly low relative both to pre-1991 Japan and to current levels in other developed countries. Ironically, during Japan's two lost decades, foreign-run enterprises, small businesses and entrepreneurs accounted for nearly all job creation. To revitalize its sluggish economy, Japan must create incentives to promote homegrown start-ups and must rapidly commercialize patented, cutting-edge technologies.

Japan is currently facing a myriad of intractable and unprecedented challenges — from a demographic crisis to border conflicts to a strong yen. The population is aging quickly. The energy sector is still reeling from the March 2011 Tohoku earthquake, tsunami and nuclear disaster. The younger generation, having grown up amid deflation and economic stagnation, is loath to take career risks. Students are studying abroad in fewer numbers. Tepid economic growth, combined with massive public sector debt and continued deficits, will likely produce a fiscal crisis in the near future — despite the fact that more than 90% of the debt is held domestically. Gross public debt to GDP now stands at nearly 250%. In spite of government efforts to raise cash by boosting the consumption tax rate, a financial implosion may come soon if interest rates ratchet up. It appears that Japan is stuck in an economic Catch-22.

The Japan Center for Economic Research projected GDP to flat-line for the next 40 years. But this prediction may be too rosy absent any drastic changes in Japan's policies. One former advisor to Prime Minister Hashimoto actually hopes that Japan "will confront a meaningful crisis this decade," so the country will be compelled to alter its policies. With crisis comes opportunity.

GDP growth derives from three factors — an increase in the workforce, invested capital, and the productivity of labor and capital. Given Japan's shrinking population and overstretched government coffers, economic expansion must arise from productivity gains. New companies have propelled most of the productivity growth and job creation. Kyoji Fukao, of Hitotsubashi University, and Hyeog Ug Kwon, of Nihon University, noted that Japanese companies founded after 1996 contributed a net positive of 1.2 million new jobs, whereas older companies shed a net 3.1 million jobs. In 1989, Japan's Ministry of International Trade and Industry (now called the Ministry of Economy, Trade and Industry) cautioned that a reduction in entrepreneurship would result in economic slowdown. The warning was prescient.

How Does Japan Compare to Other Advanced Economies?

The World Bank has shown that, among Organisation for Economic Co-operation and Development (OECD) countries, Japan ranks dead last in the average annual entry rate of new enterprises. This rate recently slumped to less than a third of that in the U.S.

Data from the OECD Science, Technology, and Industry Scoreboard reveals that, both in absolute terms and relative to GDP, Japan trails all other OECD countries in the annual amount of venture capital invested. According to 2008 figures, as a percentage of GDP, the U.S. deployed nearly 20 times more venture capital funding. The Kauffman Foundation found that nearly one out of every eight American adults (11.9%) is currently engaged in "entrepreneurial activity" — among the highest rates for large developed economies. The Global Entrepreneurship Monitor found that 4.9% of U.S. adults between the ages of 18 and 64 are working actively to establish new businesses, compared to only 1.9% in Japan.

Japan has also witnessed a steep decline in the number and volume of IPO filings. According to data from KPMG Japan, the number dropped from 204 in 2000 to 121 in 2007 and to 20 in 2009. In comparison, according to Renaissance Capital, U.S. firms filed 298 IPOs in 2007, 119 in 2009 and 261 in 2011. In addition, the American Chamber of Commerce in Japan has observed that exit opportunities via buyouts, corporate acquisitions or joint ventures remain limited.

A 2009 survey by the Global Entrepreneurship Monitor measured perceptions about entrepreneurship in 20 innovation-based advanced economies. Japanese citizens demonstrated the highest level of fear of failure, while Americans were in the quintile displaying the lowest level. Moreover, Japan, followed by South Korea, had the fewest citizens who saw opportunities in entrepreneurship. The U.S. was close to the median. Japan also ranked last in the proportion of people interested in entrepreneurship as a career. One entrepreneur stated that the eco-system in support of entrepreneurship in Japan is "less than 1% of that in Silicon Valley."

Japan's dearth of entrepreneurs is not for lack of technological sophistication. The country's R&D spending rate surpasses that of all other OECD countries, running on average around 3% of GDP. Research conducted by Robert Eberhard and Michael Gucwa, of the Stanford Program on Regions of Innovation and Entrepreneurship, demonstrated that Japan has a considerable patent advantage in Asia, particularly in renewable energies. Given the March 2011 nuclear accident, the impetus to find renewable, eco-friendly sources of power has become even more urgent, and there will likely be more Japanese patents in this area. This vast storehouse of patents could serve as the foundation for dozens of enterprises in the new economy. Thus far, however, Japan's patent base is considerably underutilized and has not translated into many start-ups or commercial products.

Why Is Japan Lagging in Entrepreneurship?

Japan-based venture capitalists, entrepreneurs, CEOs of SMEs, academics, financiers and former government officials have largely attributed Japan's entrepreneurship gap to cultural, societal, educational, legal and financial factors. There is also a failure of political will.

Cultural Factors: The impact of culture cannot be underestimated, as it directly informs behavioral norms. Tomoko Inaba, a former AIG Director and current entrepreneur in Japan, commented that, in general, the Japanese culture is "not one that encourages risk-taking behaviors or the pursuit of unexploited opportunities." It tends to be more cognizant of rules, tradition and customs, and it encourages highly conscientious and detail-oriented behaviors. It emphasizes conventionality, consistency, community and relative risk aversion. In contrast, the American culture tends to embrace individualistic and nonconforming behavior. It tends to foster debate, forgive failure and cultivate the development of open-mindedness and creativity. The Kauffman Report argued that the culture of the U.S. is the strongest force driving entrepreneurship there. In Japan, on the other hand, the fear of failure and resulting social alienation pose a huge psychological barrier for would-be entrepreneurs.

Societal Factors: Toshiko Oka, the CEO and founder of Abeam M&A Consulting Ltd., noted that the status of entrepreneurs in Japan is not high, particularly relative to their counterparts in the U.S. Inaba agreed, commenting that society's perception of entrepreneurs is neutral at best. She added that the "typical Japanese parent often does not support his or her child's aspiration of becoming an entrepreneur." These parents tend to want their children to go to an elite public university and join the bureaucracy or a major conglomerate (*keiretsu*), such as Mitsubishi or Mitsui. A well-known publicly traded firm, such as Toyota or Hitachi, also suffices. Due to historical patterns of lifetime employment (*shushin koyo*), the vast majority of parents still believe these paths present the most stable careers, the highest cumulative pay and the most prestige.

Because of the social pressure on men to support the household, married women can be better situated to become entrepreneurs. Men tend to wait until after age 30 to consider entrepreneurship.

Many successful entrepreneurs in Japan have spent time studying abroad. Kosuke Mori is representative of such entrepreneurs. He graduated from Tokyo University in 2000 and joined Mizuho Financial's leveraged finance unit. In 2004 he moved to California to attend graduate school at Stanford University. After graduation he launched his first company, a financial data aggregator targeting U.S.-based hedge funds. He stated that his education in the U.S. and the connections he formed within the venture capital community gave him the confidence to incorporate his company. He noted that, had he stayed in Japan, he would not have pursued his dream of entrepreneurship. He now runs a company that provides real-time consumer survey data via a smartphone-based app.

When he graduated from Stanford, Mori said he felt that Japanese society was cautiously optimistic. Now the society has become deeply pessimistic and conservative. Neither students nor businesspeople take risks and "the younger generation has become less ambitious." In the 1970s and 1980s, Japan, Inc. aimed to catch or even surpass the U.S. But today that goal seems far-fetched, according to experts. The younger generations are uncertain about economic growth and have come to question the relentless work ethic of the older generations. There is a clear ambition gap. Such a climate, these experts add, does not bode well for entrepreneurship.

Educational Factors: Educational institutions in Japan certainly ought to shoulder more of the onus in presenting entrepreneurship as a viable option to their students. Mori commented that "virtually none" of the students in his graduating class from Tokyo University, the preeminent university in Japan, pursued entrepreneurship right after graduation. He felt that five years later, "no more than 1% of the students were engaged in entrepreneurship." And today, more than 12 years after graduation, he still "does not know anyone in his class who has similarly started a company." The brightest students flock to careers at the largest companies (e.g., Mitsubishi, Mitsui, Nomura, Mizuho and Toyota), foreign-owned companies (e.g., Goldman Sachs, Procter & Gamble, BCG and McKinsey), distinguished law firms (e.g., Morrison & Foerster) and government agencies (e.g., METI).

Robert Laing, co-founder of Gengo, a translation company in Japan, noted that entrepreneurship "needed to start with the universities." Like parents, universities are too risk-adverse and do not "prepare students for business and encourage [them] to go into entrepreneurship." He observed that successful entrepreneurs in Japan have studied abroad, are proficient in English and have connections to the U.S. He emphasized that the last two factors are nearly indispensable. The educational system should do more to promote exchange programs abroad and mastery of English.

Legal Factors: Certain Japanese legal frameworks must also be adjusted. William Saito — a renowned entrepreneur, venture capitalist, professor and public policy consultant — declared that the very first thing that needs to be addressed to promote domestic entrepreneurship is to "change bankruptcy laws." If start-ups receive debt financing (and occasionally even equity financing), the assets of both the company and the individual are collateralized. The legal restriction on "piercing the corporate veil" is not clear-cut in Japan and is not strictly enforced. Furthermore, debt is transferrable. In other words, if the start-up fails, the founder's guarantor or family then assumes responsibility for the unpaid debt. Even if the founder dies, the family is still liable for the debt. Saito argued that the law of limited liability is not nearly as clearly delineated as in the U.S. This burden of shared risk inordinately skews the risk-reward structure for entrepreneurs in Japan. In Saito's opinion, it is one of the primary factors blocking would-be entrepreneurs there.

Financial Factors: The final component is the financial aspect. By far, the most challenging task for start-ups is raising capital. Capitalization of start-ups in Japan is a huge problem. There is a fairly even distribution of wealth, and the average income hovers around US$45,000 per year. As such, entrepreneurs are largely unable or unwilling to turn to their family or friends for financial assistance. It is even difficult for them to secure a financial guarantor. The angel investor community in Japan is quite limited. Saito knew only a handful of active and engaged angels. The first generation of successful entrepreneurs is mostly unwilling to support the second generation partly because the older generation is comprised of "one-hit wonders" who are fairly conservative with their investments, preferring Japanese government debt securities or U.S. public equities.

Banks are unwilling to lend to entrepreneurs, and even if they did, their onerous lending rules would impose harsh conditions on start-ups. In particular, the banks would demand to collateralize all of the assets. Large trading corporations, such as Mitsubishi, Mitsui and Sumitomo, or large companies, such as DoCoMo, do make strategic acquisitions of established young companies. Foreign-based venture capital firms have almost no presence in Japan, with the exception of DCM Capital and a smattering of other firms.

U.S.-based venture capitalists are generally disengaged from Japan and see the Japanese market as too small. They are willing to interact only with Japanese start-ups whose founders speak English proficiently or are interested in expanding their services outside the limited Japanese market. (Japanese refer to companies' inability to expand outside the archipelago as the "Galapagos Syndrome.")

That leaves the domestic venture capital firms. The structure, nature and composition of this sector in Japan act as a serious deterrent to the emergence of a vibrant start-up culture. In some ways, a vicious cycle is at work. There is a low level of venture capital funding in Japan, given that there are relatively few opportunities to chase. But, because minimal venture capital funding is available, would-be entrepreneurs are unwilling to launch, knowing they will have difficulty securing capital. Many start-ups that do launch are unable to "make it" due to lack of funding, leading to fewer viable early-stage companies in which to invest.

Saito called the Japanese domestic venture capital community "conservative, cowardly and unprofessional." Local venture capital firms are administered primarily by "salary men" who have no operational experience running start-ups. They tend to make decisions that are as risk-averse as possible, which is difficult to do in the venture capital business given its inherent riskiness.

Promising Signs Ahead

There have been several notable successes in Japan, such as Rakuten, Gree and DeNA. A few promising start-ups are also emerging within the renewable energy and tech sectors. And there are increasing numbers of female entrepreneurs, despite the "titanium ceiling" confronting them in the Japanese business world. Saito noted that he sees more passion for entrepreneurial endeavors among his female students.

A number of incubators are operating successfully throughout Japan, particularly in Kyoto and Tokyo. Examples include IMPACT Japan, Startup Weekend, Open Network Lab (an incubator resembling U.S.-based Y Combinator), EGG Japan, Souzei Village and Saito's MOV Lounge in Shibuya.

Would-be entrepreneurs have ample flexibility to innovate within established large enterprises. A comprehensive study of this "intra-preneurship" activity in Japan is necessary to understand the benefits and costs of such a model.

Concerted promotion of opportunity-driven entrepreneurship can help lift Japan out of economic gloom. Women, in particular, hold significant promise. Japanese policymakers, school administrators and the media need to showcase the advantages of entrepreneurship and put in place incentives that reduce the risk calculation for would-be entrepreneurs. Furthermore, they need to encourage universities to give studentsthe confidence and skills necessary to start new businesses. Veteran entrepreneurs should discuss their failures and successes openly with the younger generations and should support promising young entrepreneurs with capital commitments. Japan can also look to the Israeli model, which generated a robust venture capital and entrepreneurship sector by encouraging FDI; promoting immigration; reallocating government spending; building private-sector incubators; aligning research institutions, the military and entrepreneurs; and highlighting entrepreneurship in schools across the country.

This article was written by Andrew R. Karlin, member of the Lauder Class of 2014.
