

Economic Impact and Policy Implications of the Long-term Decline in Japan's Business Startup Rate

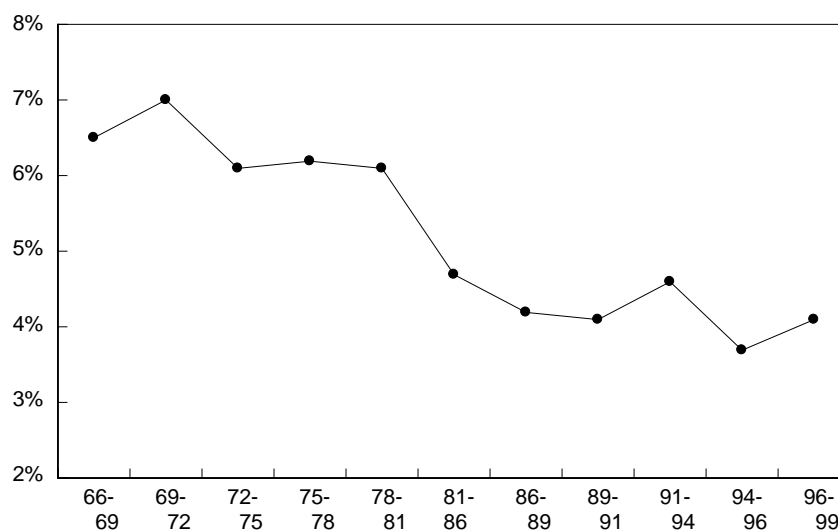
by Keisho Komoto
Economic Research Group

1. Introduction

The rate of new business startups in Japan has continued to decline over the long term, from approximately 7% in 1970 to a recent low of 4%. Both the trend and level are conspicuous when compared to the U.S., where the rate has consistently remained high at around 14% during the same period (Figures 1 and 2).

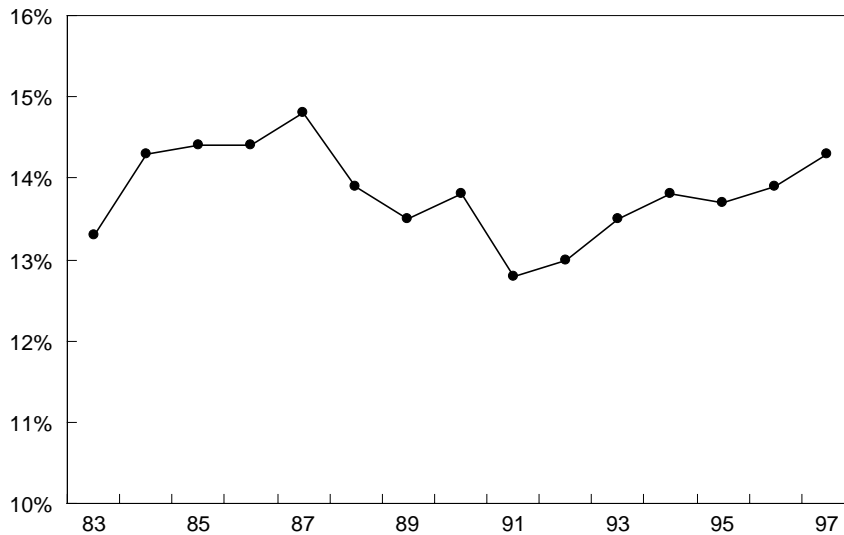
This paper examines two questions: What effect does the declining rate have on the economy? And, if the effect is negative, how can the rate be improved?

Figure 1 Business Startup Rate — Japan



Source: Small and Medium Enterprise Agency, 2001 *White Paper on Small and Medium Enterprises in Japan*.

Figure 2 Business Startup Rate — U.S.



Source: Small and Medium Enterprise Agency, 2001 *White Paper on Small and Medium Enterprises in Japan*.

2. Negative Effect on Productivity and Employment

(1) Decline in Productivity Growth

When considering the implications of the declining business startup rate, what first comes to mind is productivity growth.

Generally, when new businesses enter a market, they at minimum possess the prevailing level of production, technology, and management competence of existing companies. Indeed, having deliberately chosen to compete with established companies, they more likely possess some kind of competitive edge.

When such businesses enter the market, they stimulate competition with existing companies. Theoretically, the process of competition not only weeds out companies with low productivity, but generally improves productivity by promoting cost cutting and new product development.

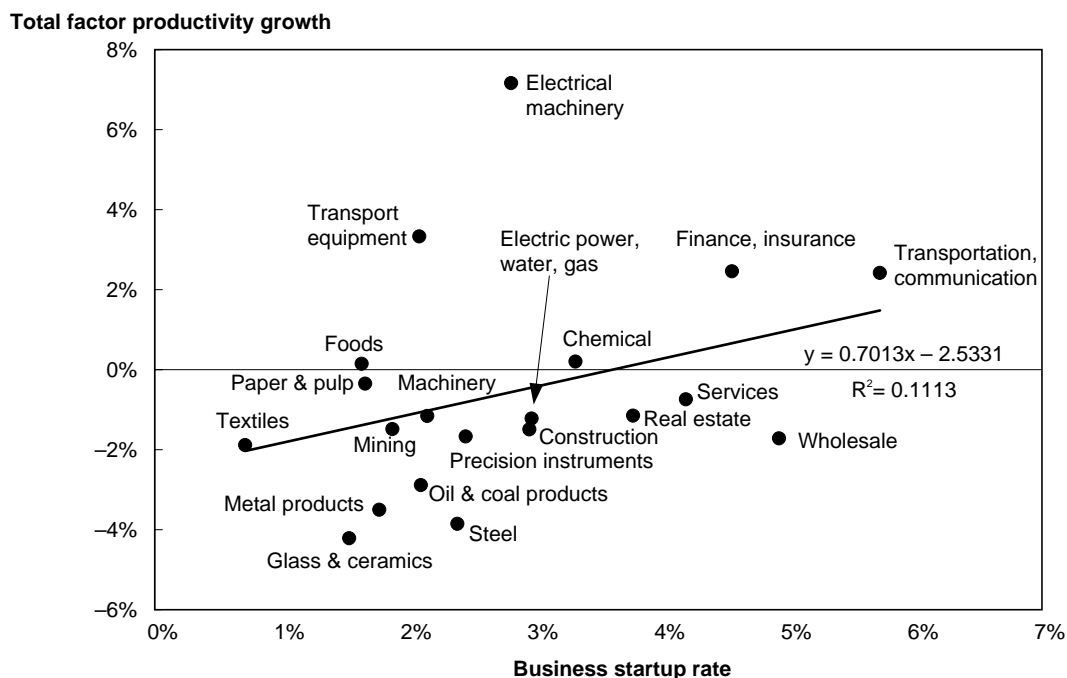
To confirm this point, we examined the correlation between business startup rates and productivity growth. Since startup rates and productivity growth vary significantly across industries, we compiled the data separately for each industry, and examined whether a positive correlation exists.

For the business startup rate, we used data from the *1999 Establishment and Enterprise Census* (Ministry of Public Management, Home Affairs, Posts and Telecommunications), and calculated annu-

al startup rates from 1996 to 1999. Productivity growth data was obtained from the *Annual Report on National Accounts* and *Private Sector Capital Stock Statistics* (Cabinet Office), and *Indices of Industrial Production, Producer's Shipment and Producer's Inventory* (Ministry of Economy, Trade and Industry), from which capacity utilization rates were used to calculate average annual total productivity growth rates from 1996 to 1999.

As the results show in Figure 3, a positive correlation exists between the business startup rate and productivity growth: industries with high startup rates such as transportation & communications, and finance & insurance have high productivity growth, while industries with low startup rates such as glass & ceramics, steel, and metal products have low productivity growth. The correlation is even stronger if we exclude electrical machinery, an outlier for which productivity surged during the period.

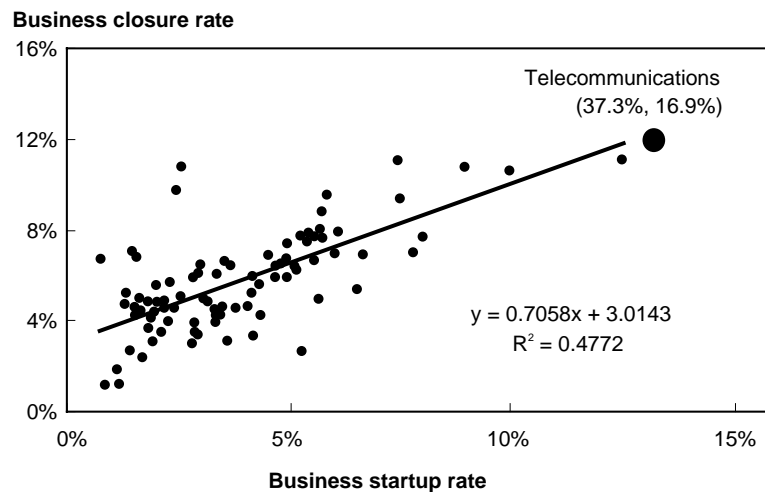
Figure 3 Business Startup Rate and Productivity Growth



Sources: MPMHAPT, *Annual Report on National Accounts*, and *Private Sector Capital Stock*; METI, *Indices of Industrial Production, Producer's Shipment and Producer's Inventory*.

Moreover, we found that the rate of business closings is also higher in industries with a high startup rate (Figure 4). This suggests that the vigorous entry of new businesses stimulates competition, driving more companies out the market. The process of corporate renewal, in which less competitive companies are replaced by new companies with promising new technologies or other competitive advantages, leads to productivity improvement.

Figure 4 Business Startup and Closure Rates



Source: MPMHAPT, 1999 Establishment and Enterprise Census.

(2) Decline in Job Creation

Since newly formed businesses must hire employees, a high business startup rate should contribute to job creation. From 1996 to 1999, persons engaged in newly created establishments comprised 11.7% of persons engaged in all establishments, indicating that new establishments create a sizable number of jobs. But since this proportion has declined from the 12.8% level of 1991 to 1994, (a decline equivalent to 690,000 persons), it appears that the low business startup rate has led to a decline in job creation.

3. Startup Support From the Late 1980s, and the Increase in Prospective Entrepreneurs

Alarmed by the declining business startup rate, the government began implementing measures to support startups in the late 1980s, including the New Business Law (1989), Small and Medium Enterprise Creative Activity Promotion Law (1997), Angel tax system (1997), Law for Facilitating the Creation of New Business (1998), and amendment of the Small and Medium Enterprise Basic Law (1999).

Figure 5 outlines the diverse support structure in place today for startups, ranging from management training in the business planning stage to support with financing and technology in the actual startup process.

Figure 5 Policies for Startup and Venture Business Support, and Small and Medium Enterprise Business Innovation

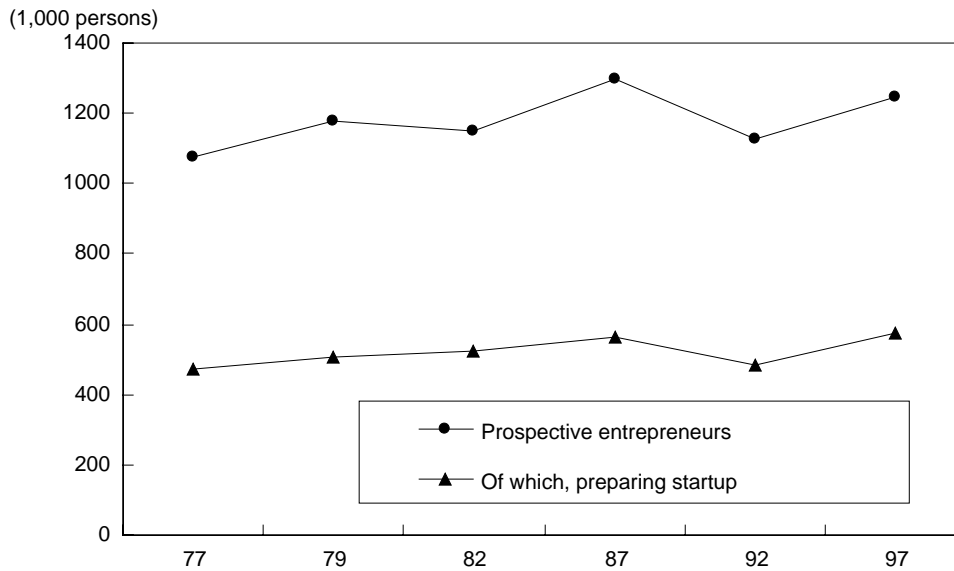
Category	Description
Management	
Training, seminars, etc.	<ul style="list-style-type: none"> • Startup seminars by Central Federation of Societies of Commerce and Industry (CFSCI) and Japan Chamber of Commerce and Industry (JCCI) • Short intensive courses (startup classes) by CFSCI and JCCI • Entrepreneur training support by Japan Small and Medium Enterprise Corporation (JASMEC) • Total support centers for small & medium enterprises (SME) and venture businesses • Prefectural support centers for SME • Local support centers for SME
Events	<ul style="list-style-type: none"> • Venture Plazas • Venture Fairs
Financing	
Loans	<ul style="list-style-type: none"> • Marukei loan to new entrepreneurs • Special startup loan from National Life Finance Corporation • System for funding of equipment for small enterprises • Special growth business incubation loan by Japan Finance Corporation for Small Business
Credit guarantees	<ul style="list-style-type: none"> • Debt guarantee for corporate bonds by credit guarantee corporations • New business guarantee by credit guarantee corporations
Investment	<ul style="list-style-type: none"> • Stock and bond underwriting by venture foundations • Investment in new business areas by SME limited liability partnerships • Investment by Small and Medium Business Investment Consultation Company (SBIC) • Promotion of direct financing by individual investors with Angel tax system
Subsidies	<ul style="list-style-type: none"> • Subsidization of new areas of business • Subsidization of organizations promoting new business development
Taxation	<ul style="list-style-type: none"> • Special depreciation and tax reductions for capital investment • Loss carryback
Cooperation mechanisms	
	<ul style="list-style-type: none"> • Further use of SME partnership system • Conversion from partnership to company
R&D	
	<ul style="list-style-type: none"> • Small business innovation research (SBIR) funding for new technology development under the Law for Facilitating the Creation of New Business • Subsidization of R&D on creative technology and creative technology contributing to regional revitalization • Promotion of technical innovation to meet specific needs (survey and development)
Relevant laws	
	<ul style="list-style-type: none"> • Small and Medium Enterprise Creative Activity Promotion Law • Law on Supporting Business Innovation of Small and Medium Enterprises

Source: Small and Medium Enterprise Agency web site.

Moreover, the support structure has recently grown to include nonprofit organizations (NPO) that support venture companies and entrepreneurs, while a bill is scheduled to be introduced that recognizes startup support as an area of activity under the NPO Law.

Meanwhile, according to the *Employment Status Survey* (Ministry of Public Management, Home Affairs, Posts and Telecommunications), the number of prospective entrepreneurs in the past two decades grew from 1.075 million persons in 1977, to 1.244 million persons in 1997, while the number of persons preparing to start a business grew from 475,000 persons to 573,000 persons (Figure 6). Indications are that interest in entrepreneurship has kept growing, helped in part by the accelerating pace of corporate restructuring.

Figure 6 Number of Prospective Entrepreneurs



Source: MPMHAPT, *Employment Status Survey*.

4. Macroeconomic Issues Related to the Startup Rate

Despite the extensive policies implemented to boost the startup rate, and the growing number of prospective entrepreneurs, why has the business startup rate failed to increase?

The problem can be addressed from a macroeconomic and microeconomic perspective. On the macroeconomic side, two challenges that come to mind are achieving sustained economic growth and nurturing new growth industries.

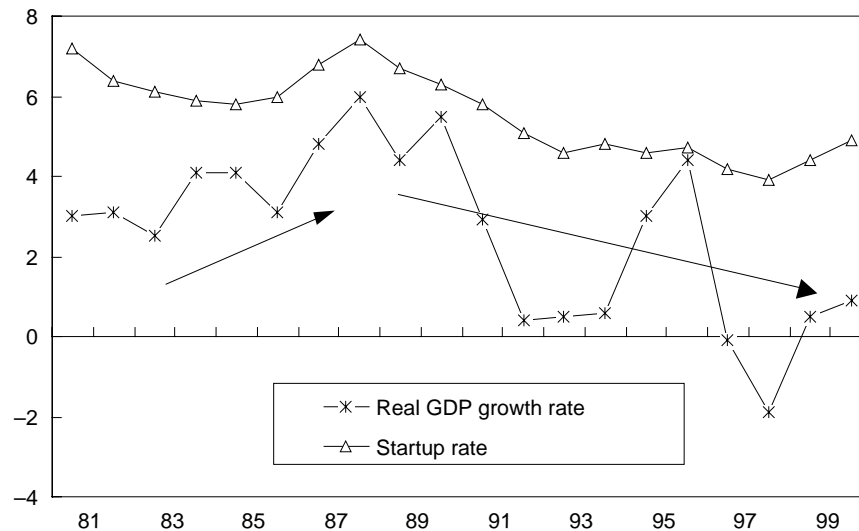
(1) Achieving Sustained Economic Growth

The decision to start a business is heavily influenced by economic conditions and prospects. In a strong economy where the outlook for demand is bright, prospects of mild competition and good earnings will encourage more entrepreneurs to start up business. However, in a sluggish economy where the outlook is uncertain, more entrepreneurs will decide to wait for a recovery, and thus postpone the startup. The presence of deflation only lends support to the decision to wait.

The relationship between economic conditions and new businesses is shown in Figure 7, which plots the real GDP growth rate and business startup rate. Although the real GDP growth rate is more volatile, in periods when it is trending upward, the startup rate tends to rise as well.

Since the early 1990s, Japan's economy has been floundering, and according to the BOJ *Tankan* survey, business conditions have worsened lately. If the structural reforms and economic policies aimed at achieving sustained growth prove to be successful, they should also help turn around the business startup rate.

Figure 7 Real GDP Growth Rate and Business Startup Rate



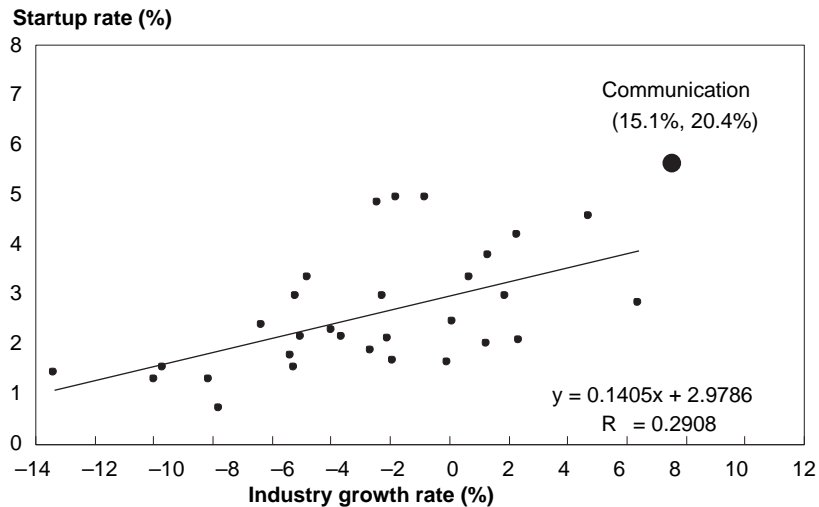
Sources: MPMHAPT, 1999 *Establishment and Enterprise Census*; Cabinet Office, *Annual Report on National Accounts*.

(2) Nurturing New Growth Industries

Large disparities exist in the business startup rate by industry. We confirmed that startup rates are positively correlated with value-added growth rates (Figure 8). That is, new businesses are attracted by the profit-making opportunities of growth industries. The declining startup rate in recent years can be attributed in part to the lack of growth in promising new industries, which diminishes their attractiveness.

While the government's role in nurturing new industries is limited, we would suggest the importance of pursuing deregulation. Many industries, primarily social services such as medical care and education, could still benefit from further deregulation. To encourage growth in these new industries, it is critical to lift restrictions that block out or hinder innovative private companies.

Figure 8 Industry Growth Rate and Business Startup Rate



Sources: MPMHAPT, 1999 *Establishment and Enterprise Census*;
Cabinet Office, *Annual Report on National Accounts*.

5. Microeconomic Issues Related to the Startup Rate

Microeconomic issues related to improving the business startup rate include enhancing the support structure and PR activities, educating entrepreneurs, and giving them a second chance.

(1) Enhancing and Publicizing the Support Structure

While the government has built an extensive structure to support business startups, jurisdictional issues among government offices make the system unnecessarily complex and confusing to the public. This, and the complexity of the programs themselves, often prevent entrepreneurs from taking full advantage of available services. For example, according to the *Survey of Business Startups* conducted by the National Life Finance Corporation in fiscal 2000, the participation rate was a dismal 10% for entrepreneurship seminars and schools held by public entities, and 18% for those held by private organizations (Figure 9). In addition, since the application procedure for public financial assistance is complex and time consuming, many people are discouraged from even applying.

To make the support structure more accessible, measures that come to mind include streamlining the menu of services for greater ease of use, informing users through public relations activities, and establishing a single source for support services such as small and medium enterprise support centers.

Figure 9 Participation in Entrepreneurship Seminars

	Participation rate	Found it useful
Public seminars	10.60%	74.80%
Private seminars	17.70%	80.30%

Note: "Found it useful" response pertains to those who participated.

Source: National Life Finance Corporation Research Institute, *Survey of Business Startups*.

(2) Educating Entrepreneurs

In starting up a business, entrepreneurs must grapple with many issues including financing, tax treatment, accounting, and regulatory procedures. Many prospective entrepreneurs know too little about such basic matters, frustrating their efforts to formulate a viable business plan. Despite the low participation rate in entrepreneurship seminars, 80% of those who do participate characterize the seminars as helpful (Figure 9). Thus it is important to enhance entrepreneurial training, and to publicize the availability of such training.

In addition, it is critical to make entrepreneurial training available to young persons. While such training in Japan is still underdeveloped, programs aimed at school-age children already exist in the West. In the U.S., a nonprofit organization called Junior Achievement has developed a program with 172,000 participating students, while in the U.K. an entrepreneurial training program has formally been adopted into the school curriculum. Entrepreneurial training is also increasingly available at the college level. Since introducing young persons to entrepreneurship at an early age is essential to creating a pool of future entrepreneurs, we must enhance entrepreneurship training from elementary school all the way to the college level.

(3) Allowing for Second Chances

Given the decline in land prices in the post-bubble era and deflation in recent years, the cost of starting a business should have decreased. However, according to the NLFC's *Survey of Business Startups*, costs have not declined significantly in the past decade. The survey found that startup costs amount to approximately 40 million yen if real estate is purchased, and 10 million yen otherwise. Moreover, the self-financed portion amounts to 29.4%, with the remainder coming from relatives, followed by private financial institutions and public institutions. Thus most persons start a business with a massive amount of debt. This indicates that entrepreneurs are at great risk should the business fail; they would lose their entire wealth, and be unable to start over.

To improve the startup rate, the risk level confronting entrepreneurs needs to be reduced. Specifically, the Angel tax system, which is limited to investment loss carryovers and reduction of transfer gains,

needs to be expanded to cover direct financing. Reducing the proportion of debt financing will enable entrepreneurs to seek opportunities for a second chance. In addition, a bill scheduled to be presented in 2002 would reduce the exposure to losses associated with loans. Under the current bankruptcy law, all personal assets of entrepreneurs are at risk except the following: (1) movable assets necessary for daily living such as clothing and bedding, (2) food necessary for two months of subsistence, (3) minimal living expenses, and (4) public benefits such as pensions. The exposure to loss needs to be reduced to a level comparable to the U.S., where one's home and car are protected, so that entrepreneurs can enjoy an environment that gives them a second chance. It is hoped that the enactment of this bill will reduce the risk exposure of entrepreneurs.