

Japanese Entrepreneurship: Changing Incentives in the Context of Developing a New Economic Model

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The Japanese economy has transformed itself radically over the past 150 years. Stages of the Japanese economy range from the late Tokugawa feudal economy to a national integrated economy during the early Meiji period, to rapid industrialization and central control before World War II, to rapid post-war growth. Many elements of the economic system created during the post-war rapid growth era persisted even after rapid growth slowed in the 1970s, contributing to the bubble economy of the late 1980s. After the bursting of Japan's speculative bubble, it has become increasingly clear that the Japanese economy must transform itself once again to remain internationally competitive and to sustain Japan's high level of prosperity. The economic model gaining widest attention in Japan is the Silicon Valley model, which successfully brought the United States out of the recession of the late 1980s and early 1990s, allowing the United States to reassert its position as the dominant leader of the global economy in the late 1990s.

This paper is an analysis of the Silicon Valley economic model and Japan's potential for adapting to a similar one. Specifically, I am taking main actors in the Silicon Valley model – entrepreneurs, employees, and investors – and examining the incentives they face in Silicon Valley, and then I am contrasting them to incentives faced by similar actors in Japan. In my analysis, I break down economic systems into legal factors, societal factors, and entrenched business practices (also referred to hereon as economic *structure*). In the United States, these three main factors that determine the incentives of the principle economic actors are aligned to maximize the potential economic function of start-up enterprises. The post-war Japanese economic system offers a sharp contrast, where these three factors combine to act as disincentives for Silicon Valley model actors to function efficiently. However, the Japanese economic system is currently in the midst of another transformation, and changes in these factors have begun aligning incentives of actors more toward the Silicon Valley model. Yet, due to extremely entrenched characteristics from the rapid growth economic system and the country's demographic trajectory, Japan's evolution into an economic system in-

corporating Silicon Valley model incentives is bound to gain Japanese characteristics.

In sum, this paper illustrates the legal, societal, and economic structural factors of Silicon Valley that create incentives for the main actors, contrasting them to rapid-growth era Japan's factors and recent changes to those factors. It identifies causes for persisting disincentives, suggesting improvements and examining potential economic developments in Japan that signal a different evolutionary trajectory from Silicon Valley-led U.S. development.

POTENTIAL ENTREPRENEURS:

WHO ARE THE ENTREPRENEURS AND WHAT ARE THEIR INCENTIVES?

The United States

In the United States, notable entrepreneurs are usually students from top universities, professors and researchers from academic institutions, and technical professionals or researchers from large companies and labs.

Within society, interest in entrepreneurship is high in universities, and American society generally accepts a wide variety of career paths. Also, widespread ideas hold that working for small enterprises is more rewarding than working for large firms because they move faster, and individual contribution to the business is easily judged. The U.S. economic system has developed in such a way that industry-academia ties are close. University professors benefit from a lack of legal impediments, and depending on the university, professors can sit on the board of directors of a venture business, devoting one day or so of the week to it, and sometimes even taking sabbatical leave to assist founding or operating companies.¹ Business schools provide a direct link of human resources between industry and academia, and a general business orientation in scientific research allows research outside pure science, focusing on practical applications, to be accepted.² U.S. business practices have also evolved to create a fluid labor market for technical professionals, where highly skilled researchers working for large corporations or research labs often have

few qualms about leaving their posts to start a company. Perhaps most importantly, legal, societal, and economic structural factors combine to create an accepting atmosphere for failed entrepreneurial attempts. Favorable bankruptcy laws, combined with a fluid labor market and societal acceptance of failure, allow entrepreneurs to attempt founding a business without risking personal bankruptcy.

Japan

In Japan, however, this same group of top university students, professors, and technical professionals face a very different set of incentives, rendering entrepreneurship much less attractive. In Japan's rapid growth era economic system, societal, legal, and structural factors created strong disincentives for entrepreneurship. However, many of these factors have been changing rapidly since the 1990s.

Rapid-Growth Era Japan

In Japanese post-war society, a clear and entrenched mainstream prestige track let students with academic potential enter high-level junior and senior high schools and take entrance examinations for top universities. From there, the elite path took students to large corporations, medical schools, or elite government bureaucracies. In a society where relative income equality rather than instant wealth was stressed, with almost 90 percent of citizens identifying themselves as middle class, societal prestige was attained by identifying oneself as an employee of a large corporation or a powerful bureaucracy. Identifying oneself with a middle or small-sized businesses was a social indicator of failure to make it to top universities, which in turn displayed a lack of ability or motivation to study hard and attain success.

Regulations and the social structure of Japanese academia were not conducive to professors becoming involved in entrepreneurship. Prestigious national universities attract the best human resources, but regulations prevented national university faculty and staff to serve on boards of venture firms or become active in entrepreneurship until 1998.³ Since discord in academia during the 1960s, orientation of university research has tended toward pure science rather than practical applications,⁴ decreasing the number of potential marketable research outcomes. The entrenched business practices of long-term employment entailed most employees being directly hired from the undergraduate level and taught firm-specific skills, preventing development of business schools to fuse industry and academia.

Entrenched business practices from the rapid growth era also created disincentives for professionals to become entrepreneurs. As a result of long-term employment by large firms, possible largely because of keiretsu organizations,

engineers and workers had virtually no contact outside their own company. Thus, there was little or no chance for professionals to network and share ideas with others possessing similar skills working for different companies. Furthermore, because employment was long-term and workers usually experienced multiple job rotations during their careers, few people started and continued their entire careers as researchers or engineers. Accumulated knowledge by individuals was therefore relatively firm-specific rather than technically advanced. Long-term employment also led to few mid-career hiring opportunities, which created rigid labor markets.

Finally, entrepreneurial failure has traditionally been punished both personally and professionally. Bankruptcy laws, to be expanded on later, have severely punished bankrupt firms and individuals, and society attaches a stigma to those whose businesses have failed, making reentry into the top level labor market almost impossible.

Cutting Edge Changes in the Japanese Economic System

Changes occurring in society, regulations, and entrenched business practices since the 1990s have removed many disincentives from the rapid-growth era economic system. However, changes have yet to permeate the whole economy. Within society, university students' interest in Japanese venture businesses has increased dramatically over the past decade. Although the number of students who actually become entrepreneurs straight out of college is still low⁵ compared to the United States, many major universities host lecture series and seminars about entrepreneurship.⁶ Venture businesses are gaining ground in terms of societal acceptance as influential newspapers, such as the *Nihon Keizai Shinbun*, publish articles related to entrepreneurship with increasing frequency and as books written by or about successful entrepreneurs - such as the founders of Softbank, Oracle Japan, and Rakuten - have become best-sellers. Most people have heard of Shibuya's bit valley in the media, which is portrayed as a destination for talented youth attempting to break free of old corporate culture and exert creativity.

At the same time, large Japanese companies have suffered a general decline in popularity among top university students. Increasing numbers of students want to work for foreign firms in Japan, and competition for positions in bureaucracies has decreased.⁷ The trend - although still in its early stages - away from large companies is largely due to changes in entrenched business practices. With the prolonged recession and progressive deregulation, strict keiretsu organizations have started to break down, and implicit lifetime employment is increasingly becoming abandoned. Large companies have engaged in layoffs, and an

increasing number of companies are adopting yearly wage contracts. Furthermore, the labor market for large firms is becoming more flexible, with mid-career hiring increasing.⁸ Thus, incentives toward large firms due to guaranteed job security and in-house training are becoming weaker.

Deregulations since 1998 allow national university professors to receive income from private industry while retaining employment at national universities. Furthermore, laws such as the 1998 "University Technology Transfer Assistance Law"⁹ have allowed major institutions such as Tokyo University to set up Technology Licensing Offices to excavate technology from research labs and apply for patents. Such institutions can be expected to strengthen societal ties between industry and academia, and combined with deregulations, increasing numbers of professors can be expected to become active in entrepreneurship.

Remaining Barriers and Potential for Independent Japanese Evolution of Entrepreneurs

Although the Japanese economic system is steadily aligning incentives for potential entrepreneurs, failure of an enterprise still constitutes one of the strongest disincentives. Bankruptcy laws, originally formulated in 1922, have only been reformed once, in 1952. However, with highly skilled labor markets becoming more liquid with the breakdown of lifetime employment, difficulty in finding employment after failure is becoming less of a disincentive. Furthermore, most people who have studied or are involved with the Japanese entrepreneurial scene recognize that since venture businesses are high-risk, high-return enterprises, extreme personal damage resulting from failure is possibly the largest disincentive faced by potential entrepreneurs. It is possible that the end of social ostracism of failed entrepreneurs may be close in sight. With business practices and societal values pressing for acceptance of failure, pressure for deregulation can be mounted, hopefully resulting in changes in bankruptcy laws.

So far this analysis has examined incentives in Japan faced by the same group of people who become entrepreneurs in the United States. It may be argued that Japanese entrepreneurs need not come from the same group of people. While this may be true to some extent, in the long run it seems likely that the best and brightest people in society, hence the same group as seen in the United States, will become the best human resource pool of entrepreneurs as venture businesses enter the mainstream economy. In the short run, though, those Japanese outside the prestigious track defined during the rapid-growth era probably face less difficulty engaging in entrepreneurship, as they have no need to break free from established norms. Employment for middle and small-sized firms has not been long-term, and skilled labor markets for such firms have been comparatively liquid.

Thus many currently successful entrepreneurs either were not part of, or decided not to take part in the mainstream social prestige track.¹⁰ The effect these non-mainstream prestige elite may have on the Japanese entrepreneurial culture, such as the potential for full utilization of female labor, may become increasingly clear as the culture develops.

Thus the potential incentives Japanese entrepreneurs face are somewhere between the rapid-growth era disincentives and the most recent changes in the Japanese economic system. Large companies and the bureaucracy still attract most of the best and brightest people, long-term employment has not yet died out altogether, the labor market for large companies is still relatively rigid, and failure is punished severely. At the same time, many contemporary entrepreneurs are not from the mainstream prestige track, opening the door to a systemic evolution with characteristics diverging from the Silicon Valley model.

Employees of Venture Businesses Attracting People to Venture firms – why they are attractive/unattractive.

Successful venture firms require talented employees and partners in addition to driven entrepreneurs. Legal, societal, and business practice differences result in vast differences in incentives faced by employees of venture firms in the United States and Japan.

In Silicon Valley-style start-ups, financial incentives for employees are attractive. Stock options provide the potential for rapid wealth, a stake in the welfare of the company, and a sense of partnership in running the firm. The heavier work-loads faced at venture firms in comparison to large corporations, resulting in more responsibility per worker, also signify each employee's ability to feel the consequences of their efforts more directly, making long hours more rewarding. In terms of job security, there is little trade-off between working for a start-up and a large corporation because large corporations shed workers easily, and fluid skilled labor markets allow relatively easy job placement even if a venture firm fails. U.S. workers therefore face a societal, legal, and economic environment that creates incentives to work hard for a venture firm.

In Japan, however, legal barriers in effect until very recently posed serious hurdles in attracting good employees to venture businesses. Although those barriers have for the most part been removed, potential employees still face many rapid growth era disincentives.

Due to legal restrictions, non-salary financial incentives for employees were almost impossible until very recently. Until 1997, the number of firms allowed to issue stock options was severely limited, and until 1998 stock options could be taxed as capital gains even if they were not exer-

cised.¹¹ Thus most venture firm employees are on orthodox salary structures without the potential for rapidly amassing massive wealth through options.¹² With orthodox pay scales, even if employees feel their individual effect on the firm they do not feel the sense of partnership or sharing that Silicon Valley employees can feel. Thus for people who could be working at large firms, the comparatively long and strenuous work hours, yet orthodox wage scales, do not balance out against the socially inferior “feel” of a normal medium or small firm, only with a higher risk of failure. However, with the recent changes business practices should start to evolve, and firms utilizing stock options, simultaneously cultivating a sense of sharing and “feeling” of a new type of venture firm, should add incentives for working at a venture firm.

Lack of job security is another disincentive that will decrease as long-term employment fades. While labor markets for small- and medium-sized firms has been liquid even during the rapid growth era, people in those labor markets were usually not top-level, highly skilled workers. People who had a choice mostly chose the job security of large firms, but as labor markets for the highly skilled become more liquid and accepting of workers from failed firms, top-level employees will have more incentive to join venture firms.

HUMAN RESOURCES

Human Resource Pool Differences between United States and Japan

The United States and Japan face significant differences in the human resource pool of potential for entrepreneurship, suggesting the need for serious changes to Japan’s legal, societal, and economic structural factors for Japan to best utilize its human resources.

In the United States, favorable immigration laws allow immigrants and newly naturalized citizens from places such as India and Asia to play a large role in the high tech industry which is central to U.S. entrepreneurship. Immigration and the U.S. economic system have also created a polarity in level of skills for workers, with a large proportion of highly skilled labor and a large proportion of unskilled labor. Venture firms make use of this large pool of highly skilled workers.¹³ In U.S. society, a predominant proportion of college educated women have their own careers, whether married or not, with liquid labor markets allowing interruptions for childbirth and infant rearing. In Japan, however, the demography combined with societal values and entrenched business practices from the rapid-growth era will continue to result in a serious underutilization of potential human resources unless changes occur.

Japan faces a seriously aging and shrinking population.

The birth rate has been declining rapidly and is now under 1.4 children per family, while the elderly are living longer than ever before. Complex and forbidding immigration laws severely restrict immigration, depriving Japan of the benefit of highly skilled labor and youth pouring in from abroad.

As an outgrowth of the rapid post-war era practices, Japan also seriously underutilizes women in the labor force. A growing number of young women have been pursuing careers after higher education, but a large proportion drop out of the labor force following marriage. With this behavior as a societal norm and expectation, job markets for young women are seriously limited, and re-entry is almost impossible. Women drop out of the labor force largely because of their socially designated responsibility to be actively involved in their children’s education. Young women have increasingly been trying to prolong their working years in careers, creating a destructive cycle where the average marriage age has been pushed higher and higher, decreasing potential for Japanese population growth. Thus, women who pursued careers but are unable to reenter the skilled job market, combined with women who never pursued careers due to early marriages or because they grew up when women didn’t pursue careers, constitute an extremely large, underutilized labor force.

In terms of skills of workers, largely due to the educational system and lack of immigration, Japanese society is not as polarized as that of the United States. Instead, Japan faces a larger proportion of skilled workers in-between highly skilled and unskilled labor.

Thus the evolving Japanese economic system with entrepreneurship as a major factor must utilize a large population of people over 65, a small population of youth, a large underutilized population of women (especially married women), and a predominant pool of skilled (but not highly skilled) workers. Legal changes can extend working legal retirement ages and provide tax incentives for senior citizen labor, but social values and entrenched business practices from the rapid-growth era need to evolve to maximize utilization of Japan’s current and future demography.

INCENTIVES OF ENTREPRENEURS ALONG THE LIFE OF A VENTURE BUSINESS

Starting Up - Incorporating

The first step for entrepreneurs after gathering a core of people to start a company is incorporation. Due to legal factors stemming from societal factors and entrenched business practices, incorporation is extremely easy in the United States while in Japan, significant effort is required by the entrepreneur.

In the United States, once seven or eight people are as-

sembled becoming a company is as easy as filing documents.¹⁴ Furthermore, legal and accounting firms provide future networking opportunities, as legal firms often provide powerful connections and possible networking to venture capitalists and others supporting actors.¹⁵

Incorporation in Japan, on the other hand, requires an initial minimum capitalization of 10 million yen. The idea behind regulations requiring initial capitalization stems from social and economic structural factors. Since a company's credibility is a large factor in determining its status, large companies with high capitalization have more credibility than firms with low capitalization.¹⁶ Following this logic, incorporated companies are expected to have a certain level of credibility to protect investors, shown by the minimum initial capitalization.¹⁷ Therefore, an entrepreneur must somehow gather at least 10 million yen through friends, family, and / or mortgages and high interest loans. Initial capitalization requirements act as deterrents to potential entrepreneurs because failure will incur personal costs if loans cannot be repaid. Deregulation removing initial capitalization requirements would solve this incentive problem, but social and entrenched business ideas behind the regulations need to change first.

Starting up - Funding

Collateral-free funding is usually necessary to operate venture businesses in their early stages of development. With legal, social, and structural incentives aligned in Silicon Valley, obtaining funding through venture capitalists or angel investors is not difficult. In Japan, with increasing recognition of the importance of venture firms, funding has become easier to find. The main incentive differences facing entrepreneurs is the potential networking capabilities of venture capitalists and angels.

Due to Japanese rapid-growth era practices of long-term employment, few people are well connected horizontally across many firms or across industries. The few well connected people that exist are usually attached to their own company and cannot act as independent angel investors or come together with others and form venture capital partnerships. While U.S. venture capitalists play large roles in a venture firm's networking with business partners, other investors, and provide support for entrepreneurs, most Japanese venture capital firms provide only money. Thus although both U.S. and Japanese entrepreneurs have little choice for non-collateral funding besides venture capitalists and angel investors, the evolution of these investors, to be discussed later, allow U.S. entrepreneurs to benefit much more than their Japanese counterparts.

Going Public

The financial incentive of equity holders of start-ups is their realization of value upon the start-ups' going public. Until very recently, Japan lagged far behind the United States in the ease and effectiveness of going public, due to regulations and the rapid-growth era economic structure. However, opportunities are increasing as the Japanese economic structure is adapting U.S. elements.

U.S. companies can value their stock at a fraction of a cent when distributed to founders, employees, venture capitalists, law firms, accounting firms, etc., and NASDAQ provides an active, liquid market supported by a developed over-the-counter market for start-up stocks to be traded. In Japan, on the other hand, until the advent of Mothers and NASDAQ Japan and recent developments in over-the-counter markets, Japanese venture firms had only a slight chance to become a traded company. In major stock markets, the minimum stock price for Japanese firms going public was 50,000 yen. Thus, prospects of massive capital gains were slim, and founders and employees had no advantage over first round investors.¹⁸ Mothers and NASDAQ Japan are still in their embryonic stages, but an IPO-driven value realization incentive structure is now realistic, bringing incentives for all actors involved in venture firms in closer line to the United States.

Failure

Venture businesses are high-risk, high-return enterprises. It is said that in Silicon Valley, almost seven out of 10 start-ups go under within their first five years. Cushioning from punishment is needed for potential entrepreneurs to decide to engage in such high risk enterprises. While in Silicon Valley, legal, social, and economic structural factors no longer make failure a serious disincentive for potential entrepreneurs, those same factors form the most significant deterrent for potential Japanese entrepreneurs.

U.S. bankruptcy laws afford such extensive protection to the firm that there is even an incentive to misuse them.¹⁹ The U.S. Chapter 11 bankruptcy law protects the firm from creditors as it re-organizes itself to become competitive,²⁰ and the incumbent management is not forcibly replaced.²¹ In terms of societal and business practices, in Silicon Valley it is often said that entrepreneurs who have failed on their first, or even first few, attempts have gained valuable experience.²² Liquid skilled labor markets allow them to easily find employment elsewhere, and they do not risk personal bankruptcy from a firm's failure. Thus potential entrepreneurs in Silicon Valley have little to lose in taking the final step to embark on a venture business.

In Japan, on the other hand, under the Corporate Reorganization Law, specific guidelines need to be met for a firm to declare bankruptcy.²³ Creditors have more rights than the firm and are allowed to attempt to collect their debts

while the incumbent management is forcibly replaced.²⁴ Thus, financially ravaged and with experienced management replaced, small or medium firms declaring bankruptcy often face liquidation.²⁵ Due to factors from the rapid-growth era economic system, entrepreneurs whose venture firms fail can face personal bankruptcy as well. For the initial capitalization to incorporate or for very early stage funding, founders often have to take out loans with personal guarantees and collateral. If the business cannot repay debt, the founder is personally held accountable, easily leading to personal bankruptcy. Compared to the United States, social convention in the Japanese business world seems to attribute success or failure of a firm to entrepreneurs themselves.²⁶ The community ostracizes those who fail, and their careers are permanently tainted. With relatively inflexible skilled labor markets, finding reemployment at a high-level firm is nearly impossible, and since many VCs are branches of large firms, many of their views on failure are in line with the mainstream, making future funding difficult to secure.²⁷ Thus, failure is probably the most serious disincentive for potential Japanese entrepreneurs.

Revision of the bankruptcy laws is probably the easiest and most effective government action to remove the overriding disincentive of potential entrepreneurs. Minimum initial capitalization regulations could be eased, and bankruptcy laws could be changed to be more firm-friendly instead of their current investor-friendly nature. Since entrenched economic structural factors such as inflexible skilled labor markets are beginning to change, the burden on founders can be eased significantly, especially as the investing structure develops, allowing more collateral-free investment in early stages. The societal tendency of the business world to focus on the entrepreneur for success or failure also needs to change, and fortunately, people who have studied the Silicon Valley model seem to understand this need.²⁸

Attaining Success

The potential for attaining success, meaning the relative openness of the economy in allowing new venture firms to become significant players, varies greatly between the United States and Japan due to entrenched business practices. The Japanese rapid-growth era business relationships and values such as “credibility,” along with the continuing dominance of large firms, pose barriers to entry for Japanese venture firms. Such barriers are becoming less severe as the Japanese economic system evolves, but Silicon Valley start-ups seem to have an easier time attaining success if their idea is good and their implementation into business plan effective.

In the United States, merger and acquisition markets are well developed, and large existing firms often acquire or

enter into partnerships with start-ups. Silicon Valley does not have a culture of long-term business relationships, and large companies know that engineers and personnel in start-ups are highly skilled and talented workers. In acquiring start-ups, the main challenge for large firms is keeping the people from leaving once they become acquired.²⁹ There are also visible success stories of start-ups attaining tremendous stature, for example AOL’s buyout of Time Warner. Thus in the Silicon Valley business structure, it seems unlikely that factors beyond product quality affect a firm’s choice between products made by a large firm and a start-up, as long as the start-up looks healthy. For entrepreneurs in Silicon Valley, there is incentive to compete against large firms if they think they can make a better product. Competition aside, entrepreneurs know that as long as their product is high quality and is marketed and supported well, and if they have sufficient networking capabilities, they are on an even playing field with existing firms. Thus, combined with previously mentioned factors, they have little to lose in starting an enterprise if they see a business chance.

In Japan, merger and acquisition markets are not well established, and one of the largest hurdles for venture businesses is to get their product or service accepted by large firms. Due to the rapid-growth era economic system, large firms dominate most high value-added business, and business structure comes from a background of long-term relationships through keiretsu organizations of reciprocal shareholding, and the main bank system. In doing business with a large firm, credibility is the key issue. Large, established companies have clear track records and existing long-term relationships that become the basis for judging credibility. Credibility of medium- and small-sized companies are judged by with what large companies they hold, and have held, business relationships. Thus start-ups with no track record, even if offering a superior product or service, are not chosen by large companies if other established, more credible companies offer something similar.

Thus many Japanese venture firms often aim not to compete with larger firms but to add value to operations or products and services of large firms.³⁰ Many venture firms also target low-tech sectors such as goods transportation services. With a long and difficult road to business with large firms, and the road to success still largely determined by relationships to large firms, entrenched business practices cause Japanese entrepreneurs to encounter much more difficulty than Silicon Valley entrepreneurs in getting their products accepted.

Investors

In the Silicon Valley entrepreneurial funding structure, laws, society, and business practices align incentives for investors to maximize and monitor the start-up’s progress.

In Japan, however, although recent changes in laws have helped align incentives somewhat, evolution of investing from the rapid growth era has not aligned incentives for investors to maximize the venture business' progress.

Angel Investors

In Silicon Valley, angel investing is an attractive option for very early funding. Due to a supportive legal structure, U.S. angel investors receive tax exemptions on long-term personal investing in small companies, with deferrals on capital gains. Furthermore, capital losses can reduce taxable income and can be applied toward the future.³¹

Recently, Japanese angel investing has become more attractive due to regulatory changes in 1997, but incentives of angels are still not as strong as in the United States. For angel tax laws to apply, the company must apply for and be categorized as a "venture." Tax-applicable capital gains provisions apply only if the company goes public, and tax deduction on losses can only be deducted from the same category of investments - in this case, "ventures."³² Therefore, although the legal structure has been improved somewhat, angel investing laws cannot be taken advantage of effectively unless angels invest on a large scale with investments in many ventures.

INCENTIVES OF VENTURE CAPITALISTS/VENTURE CAPITAL FIRMS

The most important type of investing for enterprises in both countries is undoubtedly venture capital - loans with no collateral except equity. Mainly due to evolution of the investing structure from the rapid-growth era Japanese economic system, the predominant structure of Japanese venture capital firms prevents them from facing Silicon Valley style incentives to maximize start-up performance.

In Silicon Valley, the majority of venture capital firms are partnerships or limited partnership investment funds. Aside from managing funds, partners running the firm are investors with their own money, having a personal stake in the fortunes of start-ups they fund.³³ Therefore, monitoring of start-ups is close and intensive, with VCs often offering or demanding major changes, such as appointing a new CEO to the company.³⁴ Thus VCs provide money - but more importantly - networks to other start-ups, partners, and law firms, and they add credibility to the start-up.³⁵

Competition for promising start-ups among VCs is intense, and start-ups with multiple offers can get information from "gatekeeper" consultant firms that monitor and publicize information about VC performance.³⁶ Thus the partners of Silicon Valley venture firms have large personal stakes in the welfare of firms they invest in, which gives

them incentive to monitor and nurture these companies, while at the same time they are under pressure to make good investments because they are being monitored themselves.

Japanese venture capital firms are predominantly branches of financial sector firms, trading companies and other large companies. Since they are branches, many VC firms are not financially independent, and their employees are salaried company employees who do not gain directly from good venture business performance. Furthermore, there are no monitors for VC performance. Without as much at stake as a firm or as individuals, and without performance being monitored, Japanese VC investments tend to be risk averse, looking for stability rather than intensive selection and monitoring to realize potentially high returns.³⁷

Japanese venture capital is evolving from branches of large companies largely due to human resources issues mentioned earlier due to the evolution of Japanese corporate structure.³⁸ Large companies have a greater ability to connect start-ups to networks and provide support compared to Silicon Valley-style independent VCs in Japan. Since people connected horizontally across multiple firms are extremely scarce, it is difficult for groups of talented, well connected people to leave large corporations and form venture firms.

Changes are occurring, however, and newly formed venture capital firms independent of large corporations, which live off of venture fund management - with employees having individual stakes in venture businesses - have been increasing. However, such venture capital firms are still small in size and few in number.³⁹ Furthermore, they lack the expertise to make investment decisions based on business plans, relying instead on how well the venture firm is already established and its prospects for immediate growth.⁴⁰ In other words, independent venture capital funding comes at a later stage than in Silicon Valley - after the venture firm already seems to be destined for success,⁴¹ making them "piggyback investments."⁴²

VCs that are branches of companies engaged in lines of business outside finance, such as software - for instance, Softbank - usually invest strategically in their own field of expertise, with future acquisitions or benefits in mind.

Since legal barriers do not seem to be significant in forming independent VC firms, if social prestige and attracting and keeping talent in large firms keeps declining, if the economic structure keeps changing in the direction to allow more horizontally connected people to float in a more liquid labor market, and if existing VC firms become more independent with the advent of VC performance monitoring, then investor incentives will be more aligned to maximize enterprise performance. In sum, social and business structural factors already seem to be evolving in the right direction, although there is still a ways to go.

Networking - Possibly the most major issue for evolution

Networking is a crucial factor in Silicon Valley in connecting entrepreneurs with investors, business partners, and sources of advice. Legal, social, and economic structural factors in the United States create an environment enabling dense networking, while the Japanese economic system needs to evolve significantly before a similar level of networking can be attained.

In Silicon Valley, due to the human resource issues mentioned earlier, well-connected people exist in a variety of places. The networking role of venture capitalists has already been mentioned, and in addition, law firms, accounting firms, and investment banks - all of which are firms providing services that start-ups need to rely on - all interact in a dense network of information. Law firms can contact venture capitalists that may be interested, accounting firms may introduce firms to potential partners, and venture capitalists can enter the start-up and use their extensive knowledge and connections to the start-up's advantage. Consulting firms specializing in aiding start-ups also provide networking and advice. Furthermore, outpatient incubators, such as garage.com, are businesses whose main purpose is to facilitate networking and provide support.

The rapid-growth era Japanese economic system has not facilitated the development of large law firms, and accounting firms are divided into tax firms and accounting oversight firms, making them weak in terms of networking capability. Because of human resource issues mentioned earlier, venture capital firms and other large firms are also not

well equipped to set up extensive communication networks. The future role of consulting firms as well as outpatient incubator style firms seems crucial in the evolution of networking in Japan if they can capitalize on changes in the Japanese economic system and attract talented, well-connected human resources.

Evolving from a different economic system, Japan's networking channels are likely to diverge from the Silicon Valley model to some extent. Yet networking is critical, and support organizations such as the Kansai Silicon Valley Venture Forum are actively trying to create networking channels.

CONCLUSION

In this paper, we have seen that social factors, legal factors, and entrenched business practices from Japan's high-growth era act as impediments to the development of a Silicon Valley style economic model based on entrepreneurship. Incentives faced by Japanese potential entrepreneurs and investors are not conducive to maximizing the potential of entrepreneurship. However, we have also seen that changes in the Japanese economic system have been steadily aligning the incentives of these actors, and although serious gaps still exist, changes are moving in the right direction. Convergence is unlikely to occur, though, because of the Japanese economic system's evolution from the rapid-growth system. The manner in which Japan's demography and human resources are utilized and the type of networking relationships that develop will determine the character of Japan's new economic system.

¹ Imai, Ken'ichi, Akiyama Yoshihisa, et al, *Ventures' Infra – the Infrastructure of Venture Companies* (Tokyo: NTT shuppan, 1998), 225

² Imai, *Ventures*, 225

³ "Teaching Note: Venture Business in Japan." Graduate School of Business, Stanford University. 1/99. 14

⁴ Imai, *Ventures*, 228-229

⁵ Horiba, Masao. Chairman, Horiba Seisakusho Ltd. Lecture, Kyoto University, 6/6/2000.

⁶ Examples of lecture series include "Venture firm theory" at Kyoto University and similar classes at Osaka University, Doshisha University, etc.

⁷ "At the height of ... high growth, as many as forty-three individuals competed for every one who was successful [in attaining a senior civil service position]. By the early 1990s, this was down to fewer than fifteen candidates for each opening." (Pempel, T.J. *Regime Shift – Comparative Dynamics of the Japanese Political Economy* (Ithaca, NY.: Columbia Press, 1998), 160)

⁸ Sanyo Electric AV Systems, for example, now hires external professionals on yearly contracts and welcomes mid-career employees (Komamiya Takeo, President and CEO, SANYO Electric AV Systems Co., Ltd. Round Table Talk, KDD Osaka, 5/19/2000).

⁹ Imai, Ventures, 229

¹⁰ Nihon Dentsu's CEO, Mr. Nagamori, never intended to work for a large business, even since he was young. Softbank's Son Masayoshi is of Korean descent and went to an American university. Ed-contrive's founder, Mr. Kawai, was a "chimpira," and Igaku seibutsukagu kenkyuujo (Medical Biology Lab)'s founder was a female secretary of a doctor (Tsunoda, Ryutaro. Professor, Ritsumeikan University Economics Department. Lecture, Kyoto University. 5/9/2000.).

¹¹ Stanford 8

¹² Oota, Hajime. "Hataraku ba to shitenno venture kigyo." (Venture firms as a place to work) Chuo Koron, March 2000, 174

¹³ Imai, Ken'ichi. Director, Stanford Japan Center. Personal conversation, May 2000.

¹⁴ Yang

¹⁵ Kawasaki, Guy. CEO, Garage.com. Lecture, Stanford University, May 2000.

¹⁶ It is not uncommon for companies to increase their capitalization amounts to increase their credibility (Kawabe, Yoji. CEO, Futures Venture Capital Ltd. Lecture, Kyoto University, 6/27/2000).

¹⁷ Nagano

¹⁸ Stanford 7

¹⁹ Imai, Ventures, 305

²⁰ Stanford 8

²¹ Imai, Ventures, 304

²² Fong, Kevin. CEO Mayfield Fund. Lecture, Stanford University, May 2000.

²³ Imai, Ventures, 304

²⁴ Stanford 8

²⁵ Stanford 8

²⁶ Kawabe, Yoji. CEO, Futures Venture Capital Ltd. Lecture, Kyoto University, 6/27/2000.

²⁷ Kawabe

²⁸ As mentioned earlier, almost everybody involved with the Japanese entrepreneurial scene points out that acceptance of failure is a large key to success of the economic model.

²⁹ Andresson, Mark. Founder, Netscape Communications. Lecture, Stanford, April 2000.

³⁰ "Tsuyoi venture no omowanu sugao," Nihon Keizai Shinbun June 11, 2000.

³¹ Stanford 10

³² Stanford 10

³³ Ventures 14

³⁴ Fong

³⁵ Kawasaki

³⁶ Imai, Ventures, 25

³⁷ Kawabe

³⁸ Imai, Ventures, 44-45

³⁹ Kawabe

⁴⁰ Kawabe

⁴¹ Terauchi, Isshu. CEO, Nissho corporation. Round Table Talk, KDD Osaka. 5/19/2000.

⁴² Other problems of Japanese venture capital firms, whether independent or branches of firms, mainly stem from inexperience and lack of expertise. Listed here are several opinions of major problems. First, many Japanese VCs lack strategic understanding, investing little by little until the venture firm gets media attention, after which the firm is flooded with funding. The venture firm, lacking management experience, uses up most of the money, causing investors to retreat rapidly, leading to the demise of the business (Imai, Ken'ichi, Akiyama Yoshihisa, et al, Ventures' Infra – the Infrastructure of Venture Companies (Tokyo: NTT shuppan, 1998), 74). Second, Japanese VCs rely mostly on technical specialists for evaluation, causing venture firms to be evaluated on the basis of technology rather than business models, marketing, or implementation (Imai, Ken'ichi, Akiyama Yoshihisa, et al, Ventures' Infra – the Infrastructure of Venture Companies (Tokyo: NTT shuppan, 1998), 74). Third, many venture businesses end up receiving more money than they know what to do with. Combined with the strange high tech market phenomenon that if companies like amazon.com actually invest in real infrastructure such as warehouses, rather than new business models or web pages, their stock goes down (Andresson), venture firms that end up with capital end up becoming VCs themselves, engaging in overseas as well as domestic investments themselves, losing their entrepreneurial spirit (Nagano).

