



Policy Support for Japan to Become a Startup Powerhouse

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<Summary>

- ◆ In the Japanese government's 2022 Basic Policy for Economic and Fiscal Management and Reform, "startups" were selected as one of five priority investment areas. Various measures to support startups have already been implemented since the 1990s. With the added efforts of the private sector, startups are finally taking root in the society and economy of our country. Japan is currently entering a new phase of development, a phase in which it should aim to become a startup powerhouse by further increasing the number of startups and encouraging startups to scale up.
- ◆ Policies to promote startups are already in place to a certain extent in Japan, while we have seen major improvements in support from the private sector. However, the global business environment for startups has deteriorated sharply this year due to global monetary tightening and heightened geopolitical risks, and additional support from the policy side is deemed necessary. There are two tasks that are particularly important: 1) support startups that address local social issues as a way to increase the number of startups, and 2) strengthen support for deep-tech startups that have high potential to scale up.
- ◆ In addition, Japan needs to foster a climate that encourages the creation and growth of startups. Among the priorities should be a policy push to promote the flow of people within Japan, as well as between Japan and the rest of the world. Countries/regions with active startup creation and growth often exhibit openness in terms of human resources, high labor mobility, diverse work styles, and active exchanges between their own people and those of other countries. Full-fledged efforts must be made to tolerate side jobs and dual employment, to allow leaves of absence to be taken in a manner that does not disadvantage the employee concerned, to rehire those that have once left the company, to create

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opportunities for frequent communication between universities and the private sector, and to actively attract foreign nationals and support their launching of startups here in Japan.

- ◆ As the business environment for startups deteriorates, the social momentum to boost startups will wane, and policy support may recede as well. However, in order to stimulate the economy and resolve social issues through innovation, it will be extremely important to promote startups, which are the key players in innovation. Now is the time for the government to continue to demonstrate its unwavering support for startups, and to elicit greater involvement from the private sector by supporting their activities.

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1. Introduction

In the 2022 Basic Policy for Economic and Fiscal Management and Reform announced by the government, “startups” were selected as one of five priority areas for investment as part of the “new capitalism” implementation plan, and a five-year plan to promote startups is set to be launched shortly.

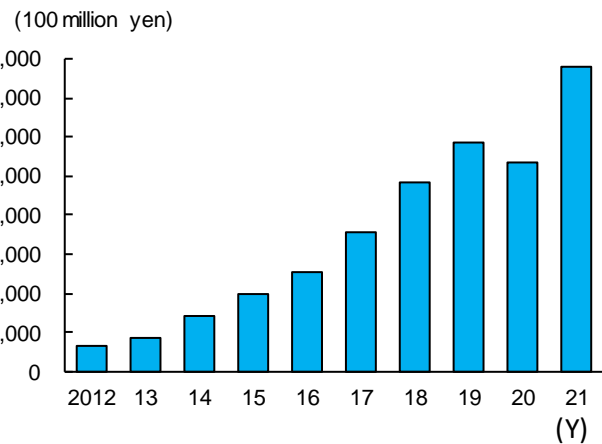
Support measures for startups are not new, having been implemented continuously since the 1990s. As a result of years of efforts, a certain lineup of policies is already in place, and with the addition of private-sector efforts, startups as a form of entrepreneurship have finally taken root in Japan's society and economy.

Japan is currently entering a new phase of development, a phase in which we must further increase the number of startups while encourage startups to scale up. If this phase proceeds smoothly, we can expect to see, as in the U.S. and other startup powerhouses around the world, a self-sustaining mechanism where many innovative startups are created, and while most of them fail, a small percentage of them grow to become large corporations.

This year, the favorable environment of startups has suddenly come to a halt globally. In addition to global monetary tightening, Russia's invasion of Ukraine has prompted investors' risk aversion, putting the brakes on the inflow of funds to startups.

Against this headwind, what kind of policy support should be provided to help startups move to a new stage of development? With this issue in mind, this paper examines policy support developments for startups.

Figure. Amount of Financing Procured by Japanese Domestic Startups



Source: INITIAL, 2021 Japan Startup Finance (base date: February 4, 2022)

2. Startups taking root in Japan

The first thing that can be pointed to as a basis for judging that startups have taken root in our country is the increase in capital inflows. The amount of startup financing has been rising fairly steadily over the past decade, reaching 780.1 billion yen in 2021 (INITIAL, “Japan Startup Finance in 2021,” as of February 4, 2022, Figure). If startups could obtain a certain level of evaluation, especially in the case of Internet-related startups, they had significantly less trouble obtaining funding, at least in the early and middle stages. Adding to the growing scale of domestic venture capital funds (VCs), foreign investors with large amounts of assets under management have been entering the Japanese market, and an increasing number of startups have succeeded in raising sizeable sums of money and accelerating their growth accordingly. Although the number of unicorns (unlisted companies with an estimated market capitalization of a billion dollars or more) in our country is not large (six, or ten if exits are included), the number of startups with an estimated market capitalization of 10 billion yen or more is steadily increasing.

Another reason for startups having taken root in Japan is an expansion in terms of people and organizations that support startups, especially in Tokyo. In addition to VCs, the number of angel investors and mentors has risen, and shared offices and co-working spaces that can be rented inexpensively by newly established startups can be found in many prime locations in central Tokyo. In such places, events are frequently held to boost startups and enable entrepreneurs to interact with each other. Universities and existing companies are also becoming actively involved with startups. Owing to these progresses, at least at Tokyo universities, we can now find students who have launched startups while still in school or have joined startups after graduation.

Furthermore, the recent increase in exits can be seen as an indication of not only the taking root of startups but also their future development. An exit is more than just an event for one company, as it also serves to expand the startup business environment in the region concerned. If the exit is an IPO, it is common for the founder to remain involved in the management of the company. However, when a founder relinquishes management control in the case of an M&A, he/she may become a serial entrepreneur, launching a new startup and trying again to achieve “0 → 1”. Alternatively, he/she may decide to nurture startups, and become an angel investor or incubator/accelerator program operator, thereby shifting to the startup support side. In Japan, IPOs are the most common method of startup exits, but recently M&As are also on the rise.

In the case of both IPOs and M&A deals, startup team members, too, often launch their own startups or provide support to startups, using money they have obtained from exercising stock options. Moreover, whether founders or team members establish a new startup or support a startup, they can use their accumulated experience to avoid failures and detours caused by lack of experience.

Exits also contribute to the accumulation of experience for venture capitalists. The recent increase in exits means that more and more VC investors have experienced the entire process from fund formation to exit. It is expected that they will apply their experience and knowhow to fund management and provide higher quality support to startups in the future.

3. Startup support measures largely in place

Looking back on Japan's measures to support startups, the initial focus was on improving the overall business environment, as seen in the introduction of the stock option system (1995), the establishment of the angel tax system (1997), and the opening of the Tokyo Stock Exchange Mothers market (1999). In recent years, the emphasis has shifted to providing more in-depth support to selected individual startups and regions. Prime examples of this are the J-Startup program (2018), which provides intensive support for startups with global potential through “ekohiiki” (a term used by then Minister of Economy, Trade and Industry Hiroshige Seko that means favoritism), and the World-Class Startup Ecosystem Center Formation Strategy (2019), which involves selecting cities as startup ecosystem centers and providing them with intensive support. As a result of these efforts, startup support measures are now in place to a certain extent in Japan, ranging from nurturing entrepreneurship to startup support and growth support.

While it is true that there are still many areas we need to work on to improve the startup business environment in our country, trying to address all of them through government policy would be an endless endeavor. Looking around the world, there are quite a few countries where numerous startups have been launched despite obstacles.

The French government, for example, has been running a startup support program, La French Tech, since 2013. On the other hand, France still faces several issues: IPOs in the country as exits are difficult due to the underdeveloped stock market for emerging companies, domestic investors have not been sufficiently nurtured, and regulations, including those related to labor, are generally strict. Nevertheless, more and more startups are launching, and the number of unicorns has increased from just one in 2015 to 24 today (CB Insights, as of May 25, 2022).

4. Areas for support

(1) Increase the number of startups and scale-ups

As startups in our country enter a new phase of development, what kind of policy support will be needed? Support measures are already in place to a certain extent and support systems on the private-sector side are being expanded, while the national and local governments are under severe financial conditions. Given these aspects, it could be concluded that the focus should be on increasing the effectiveness of existing policies, and that any additional policies should be strictly focused and very limited. Such a decision would be reasonable if the favorable fundraising environment until last year still existed. However, given the current circumstances, in which the global deterioration of the startup financing environment is spreading to Japan and private-sector investors are likely to become more cautious, it is probably still necessary to strengthen support from the policy side.

Increasing the number of startups and helping them to scale up is vital for our country, and there could be two priority policy areas for this: 1) supporting startups that address local social issues, and 2) strengthening support for deep-tech startups. We will look at each of these in detail below.

A. Supporting startups that address local social issues

Supporting startups that tackle issues in their regions will naturally contribute to resolving social issues and at the same time increase the absolute number of startups.

In Japan, the various problems that have arisen as a result of declining birthrates and an aging population are particularly pronounced in provincial areas. In addition, deterioration in the functioning of local communities has resulted in difficulties in raising children, social isolation among the elderly, and vulnerability to natural disasters and crimes. On the other hand, local governments, which have traditionally been the main players in tackling social issues, are facing a difficult financial situation, and the increasing complexity of issues is resulting in a growing number of fields in which it is hard to apply the conventional method of uniformly providing a wide range of administrative services.

NPOs and volunteers are becoming more active in domains that are difficult for local governments to reach, and we can expect significant progress if startups join them. As for-profit companies, startups have an advantage over NPOs and volunteers in terms of the speed with which they can solve problems, their ability to raise funds and the resources they can thus secure, and the pressure to improve their business through exposure to market competition. Furthermore, being startups, they aim to grow through innovation, which sets them apart

from small businesses and local businesses. By addressing social issues in the community through a division of roles, with startups in fields where commercialization is possible and NPOs and volunteers in fields where that would be difficult, we can expect more progress toward solutions.

In recent years, an increasing number of large municipalities have begun to promote the creation of startups, but it is desirable that small and mid-size municipalities join this movement, focusing on startups that address social issues. In some regions, the existence of startups may itself not be well known, so it is necessary to begin by nurturing startup entrepreneurs and making people aware of startups as an entrepreneurial option as well as their role and significance.

Such startups, also called “zebras¹,” which pursue both earnings and social benefit at the same time, cannot grow as fast as a typical startup and the hurdles to scaling up are high. Because of these circumstances, VCs tend to be reluctant to invest in them, so policy support in terms of funding may be necessary. Even more important is for local governments to work together with startups. This is not only to secure earnings for the startup, but also because the fact that the startup has collaborated with the local government becomes an achievement in itself, making it easier for the startup to gain trust from potential customers. One of the keys to success will be for local governments to start with small projects and then gradually expand the scale and scope of their activities as they accumulate collaboration knowhow.

B. Strengthening support for deep-tech startups

One effective way for startups to scale up is to expand overseas. Deep tech, in which our country excels, could be a powerful weapon for startups to compete globally. Deep tech is innovative technology created as a result of long-term and costly R&D. Although there are many concerns about the future of R&D in Japan, such as the fact that corporate R&D expenditures have been flat since the late 2000s, the country still boasts world-class R&D capabilities.

Deep-tech startups cannot be supported by private-sector investment alone given the amounts of funding required and the time horizons involved. On the other hand, because they often take on social issues facing the world, their importance has come to be recognized in our country, and various support measures are available to them, including subsidies and grants, direct and indirect investment from public and private funds, and debt guarantees. Deep-tech startups such as Spiber (which is developing artificially synthesized structural protein materials) and TBM (which is developing new materials to replace paper and plastic) have continued to grow through leveraging such policy support and obtaining private-sector funding as well.

In 2021, the Small Business Innovation Research (SBIR) program was altered to include support for R&D by startups. 13 firms, including Astroscale (space debris removal), have been selected by the New Energy and Industrial Technology Development Organization (NEDO) for its SBIR Promotion Program for FY2021.

The government can play an important role in helping deep-tech startups survive the difficult period of getting their businesses off the ground. The same is true in the U.S., where private-sector investment funding is more readily available. In many cases, government subsidies and grants, along with funding from philanthropic organizations, support startups in the early stages when commercial potential is difficult to ascertain, and then private-sector investment funding takes over when commercialization looks feasible. Since deep-tech startups

¹ This name was inspired by the stripes on a zebra, and reflects the simultaneous pursuit of both earnings (black) and social benefit (white).

are a promising field with the potential to scale up through overseas expansion, further expansion of policy support is required.

(2) Facilitate the flow of people in and out of the country

In the previous section, we looked at the importance of policy support for startups addressing local social issues which also leads to increasing the number of startups, and policy support for startups addressing global social issues which also encourage the startups to scale up. In addition, Japan needs to foster a climate that encourages the creation and growth of startups. This could include reviewing regulations and vested interests, strengthening entrepreneurship education, and raising the spirit of challenge and self-esteem. Among the priorities should be a policy push to promote the flow of people within Japan as well as between Japan and the rest of the world.

There are several patterns for countries/regions with active startup creation and growth, but they often exhibit openness in terms of human resources, with high labor mobility, diverse work styles, and active exchanges between their own people and those of other countries. In such countries, for example, it is not uncommon for a person to launch a startup as a side business, have acquaintances also involved as a sideline until the business gets off the ground, make it his/her main business if it goes well, but then liquidate the company if the business stalls and go to work for a large corporation.

It is well known that many successful startup entrepreneurs in the U.S., such as South African-born Elon Musk, are of foreign origin, and this is also common in other countries. Looking around Japan, Russell Cumber, one of the co-founders of Paidy (buy now pay later (BNPL) services), which was acquired by PayPal in 2021 for about 300 billion yen and became a big story, is from the U.S. And in the case of Playco (mobile game development), which became a unicorn as soon as it announced its foundation and funding in 2020, three of the four co-founders are from the U.S.

However, it must be said that these two companies are exceptions among startups in our country. Japan needs to make such exceptions the norm.

Toleration of side jobs and dual employment, acceptance of leaves of absence such that the employee is not disadvantaged, and the rehiring of those that have once left the company will not only reduce startup risks but also contribute to supplying the human resources needed by startups. For example, if a startup needs specialized personnel for a particular project on a temporary basis, an employee from a large company could take a leave of absence to get involved and then return to their former workplace after the project is completed. This will have the added benefit of exposing the employee to an open and challenging startup culture, which they can then bring back to their own companies, thereby bringing a breath of fresh air into large corporations.

On the other hand, for a deep-tech startup to succeed, it must transform its research results to businesses with high economic value. To this end, it would be effective to increase human interaction between universities and other research institutions on the one hand and the private sector on the other. One of the solutions will be to increase the number of places where both these sides can meet and where they can come into contact and consult with each other on a daily basis.

Human exchange between Japan and the rest of the world, with the exception of specific fields such as foreign

tourists visiting Japan, has always been weak, and stopped altogether with the COVID-19 pandemic, but it must be revived and enhanced. Actively attracting foreigners, collaborating with them remotely, and supporting their launching of startups here in Japan are all beneficial for enabling startups to build a global team, travel abroad, and raise funds from foreign investors. It also certainly contributes to building diverse and innovative organizations. Developing human resources with a global perspective through such measures as promoting students to study abroad will also help build global teams.

5. Conclusion

The global startup business environment is expected to become more selective about startup investments for some time to come, leading to a rapid weeding out of startups and raising the hurdles for new launches. A phase like this also tends to see scandals involving startups and their founders coming to light, in which case startups in general become confronted with stronger headwinds. In the face of this, social momentum to boost startups will wane, and policy support may recede as well.

However, in order to stimulate the economy and resolve social issues through innovation, it will be extremely important to promote startups, which are the key players in innovation. For Japan's startups to enter a new phase of development, and to push the country forward to becoming a startup powerhouse, now is the time for the government to continue to demonstrate its unwavering support for the creation and growth of startups, and to elicit greater involvement from the private sector by supporting their activities.

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