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Resolving Structural Problems in the Japanese Economy: The Revitalization of Small- and Medium-Sized Enterprises

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Provincial cities in Japan have without exception fallen into a vicious cycle where population decline causes a reduction of public services, which further decreases the population and weakens local economies. This is explained by a failure to adapt to the forces of globalization, specifically price competitiveness with China and other developing economies in East Asia. About 100 years ago, the economist Alfred Weber used the term "agglomeration" to explain that reducing transportation costs was a fundamental principle in allocating resources and maximizing profits.[1] Japan's small- and medium-sized enterprises (SMEs), found primarily in rural areas, were once part of a national industrial structure that was based largely on that principle, but recent advances in transportation and information technology have rendered Weber's argument obsolete. As Japan's large firms continue to expand production networks throughout Asia, the SMEs have been left behind and are struggling to survive absent the traditional industrial model. This has created a structural problem in the economy, which the central government is trying to address with a revitalization strategy for depressed regions. Today, the key for Japan's SMEs is innovation, which will prove essential to reducing income disparity across regions and increasing the productivity of the Japanese economy as a whole.

Impact of Globalization

Globalization has caused a dramatic change in Japan's economic structure over the past 20 years. Traditionally, Japan has imported natural resources (coal, oil, steel, etc.) from foreign countries, which were then processed domestically and assembled into final products. Planning, marketing, and research and development were conducted by large firms, while smaller companies in various regions excelled at processing and assembly for quality-controlled mass manufacturing. Thus, even though Japan relied heavily on foreign countries for natural resources, it had a "full-set" industrial structure where goods and materials were procured domestically from the initial processing stage to the final processing stage.[2] In the 1990s, large Japanese firms began to relocate factories to China and other destinations to cut costs and improve efficiency. Smaller firms that once supported the full-set structure became uncompetitive and experienced the phenomenon known as the "hollowing out of industries." There are 4,326,000 SMEs in Japan and they account for 99.7 percent of all Japanese firms.[3] Given these numbers, it is quite clear that the SME sector must adapt to the changing structure of the economy and is in need of reform.

Japan's Recent Attempts at Regional Revitalization

The Junichiro Koizumi administration adopted a new economic growth strategy in 2006 to strengthen global competitiveness, improve productivity, and revitalize the rural economy. The Shinzo Abe administration followed suit in 2007 with the "Innovation 25" initiative based on the belief that technical improvement was indispensable to maintaining economic growth given the declining birthrate and growing elderly population.[4] The Ministry of Economy, Trade, and Industry (METI) submitted the "Law for the Usage of Regional Resources by Small- and

[1] Alfred Weber, *Kogyo Ricchi Ron [Uver den standort der Industrien, Verlang von J.C.B. Mohr]* (Tokyo: Daimeido Press, 1989).

[2] The full-set function cut excess costs on trade and evolved to produce high revenues. This was the structure that created the edifice of Japan as the world's second-largest economy.

[3] SMEs are defined as firms with less than 300 employees and capital of less than 300 million yen (approximately $2,795,000) for the manufacturing industry, and firms with less than 100 employees and capital of less than 100 million yen (approximately $932,000) for the wholesale and service industries.

[4] See Kentaro Yoshida, "Japan's Innovation Strategy," *Japan Chair Platform* (July 12, 2007).

Medium-Sized Enterprises" to the Diet in February 2007, and the bill became law in June of the same year.[5] This unique policy was designed to encourage managers of SMEs to search within their communities for "regional resources," or particular skills or strengths in areas such as agriculture, fisheries, or tourism, with which to revamp their businesses.[6] Support networks in areas such as marketing, investment capital, and the tax system have begun to assist SMEs as a result of the law.

Prime Minister Yasuo Fukuda discussed regional income disparities and the need for structural reform in his inaugural address on October 1, 2007. His cabinet created the "Regional Revitalization Integration Headquarters" on November 30, 2007, to close regional income gaps and improve productivity.[7] This strategy stresses government interaction with local businesses, nonprofit organizations, and residents to fully understand their needs and implement policies accordingly.

Innovation Strategies for SMEs

What can SMEs do to stay afloat in regional economies facing multiple challenges, including a declining birthrate, a reduction in fiscal resources, and an aging society? SMEs can differentiate themselves in three ways. First, they must aim to incorporate a metropolitan-type industrial model using technology stocks in their regions to produce various high-quality goods in quantities reflective of local demand. This will assist them in achieving a second form of differentiation, the development of businesses in niche markets to avoid competition with large firms.[8] Third, it is important for SMEs to move out of the subcontract and affiliate framework of large enterprises and manage their businesses with "originality." The continuum of innovation required to sustain SMEs begins with the identification of "regional resources" that will make them unique.

"Regionality" as Japan's Competitive Edge

It is likely that more attention will be paid to regional innovation strategy in the future. This is inevitable due to the effect of globalization on the Japanese economy. We should not forget that local economies are supported by SMEs and that their workers have the expertise to innovate and adapt flexibly to changes in the marketplace. The central government is expected to support them and abandon the *shitauke kaisha* (subsidiary company) mentality of old. Japan's long-term competitive advantage will stem from an emphasis on "regionality"—that is, measures that attach importance to the use of regional resources by SMEs. Unlike mass production and economies of scale, which can be imitated easily by other countries, innovation based on local resources will prove unique. SMEs can therefore play a central role in Japan's quest for sustainable growth.

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[5] This law attempts to provide tax and financial support to SMEs that utilize regional resources that are the strengths of each region and revitalize the rural economies. Regional resources are defined as follows: 1) fishery, agricultural, or manufacturing goods that are considered regional specialties; 2) skills and technologies to produce fishery, agricultural, or manufacturing goods that are considered regional specialties; and 3) resources for tourism.

[6] The basic stance of the federal government is to support projects from the planning stage to an exit strategy tied to sales. The government set a target of creating 1,000 new businesses in five years. The plan was incorporated into the policies of six ministries including METI.

[7] The "Regional Revitalization Integration Headquarters" consolidates four groups that were created during the Koizumi administration (Urban Rejuvenation, Promotion of Special Zones for Structural Reform, Regional Reproduction, and Downtown Vitalization). Prime Minister Fukuda is the general manager and all cabinet ministers belong to this group that is designed to centralize policymaking and implement regional revitalization policy more strategically.

[8] In large firms, projects that produce sales of 10 billion yen or less (about $100 million) would be rejected in the planning stage. However, SMEs should invest in those projects precisely because the absence of competition from large firms can increase their profit margins.