

# The Existence of SMEs in Japan —Japanese Economic Growth and SMEs—

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## 1. Structures and Definition of SMEs

Generally, the number of small and medium enterprises increases with advancement of industrial structures<sup>1</sup>. Although efforts to improve the industrial structures have been promoted so far mainly by large enterprises through rapid developments of heavy and chemical industries, most small and medium enterprises or SMEs have survived and coexist with larger companies. When we look back on the history of development made by Japanese industries in the Post War Period, we can recognize the important roles played by SMEs.

Similar phenomenon can be seen not only among manufacturers but also in commercial and service industry. Competitiveness of Japanese SMEs has attracted the attention of many foreign countries in recent years. Their interests in analyzing the secret of Japanese industries' strength in international competitions are now directed at the fundamental industrial development and particular characteristics seen in Japanese style managements. Attention is also drawn to Japan's unique economic customs and social structure as well as structural adaptability of SMEs which fully supports change in the industrial structure. However, SMEs are not always found in all types of industry. Particularly in the manufacturing industry, SMEs are not seen everywhere, but rather concentrated in specific manufacturing. Large companies have more share in arterial industries like heavy and chemical industries (steel, chemicals and

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<sup>1</sup> Satake, T. (2008).

machinery) which play a leading role in this field. On the other hand, there are larger numbers of SMEs in the upstream (e.g. parts production) and downstream (e.g. product processing) in the production systems of large companies as well as daily life industries such as suppliers of daily necessities and service to individuals. Under the circumstances where politico-economy systems have been changing rapidly and direction to be taken for restructuring the economic structure has been actively searched in both capitalist and socialist countries worldwide, Japanese SMEs have contributed to stable development of the national economy and revitalization of the society which enjoys free competitions. This resulted in keen attentions from around the world<sup>2</sup>.

This report will first discuss what kind of economic entities the SMEs are. “SME” basically means enterprises which are smaller than large companies. As “SME” is a general term, there are diversified companies in this group. A mixture of diversified SMEs is, therefore, called “hetero-genuity”.

Let us study the grouping of “Medium-small Enterprises” according to their management styles. “Medium-small” of the “Medium-small Enterprises” means an enterprise of medium-small scale and not a “Large” one. It further means that they are the economic entities having nature of difficulty which large enterprises do not have. If we should explain about what a “Medium-small Enterprise” is, it is important for us to consider it from the point of its scale first. In The form of medium-small enterprises is classified further in the non-scale category after grouping the scale type and non-scale type from a viewpoint of the form the medium-small enterprises may take. The scale can be grouped in 4 types, “Micro Type”, “Medium-small type”, “Medium Type” and “Large Type”. If we should understand the “Medium-small” in the “Medium-small Enterprises” as those medium-small scale enterprises and not a “Large” one, the “Medium-small Enterprises” can be understood as a concept including “Micro Type” and “Medium-small Type” in a sense of scale<sup>3</sup>.

Now, what kinds of enterprises are defined as SME? Quantitative standards and qualitative standards are usually considered for this. The former classify

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<sup>2</sup> Fukushima, H. (2006).

<sup>3</sup> Yamashita, S. (2014b).

enterprises based on the number of employees and capital amount as well as such indices as asset amount, production amount, shipment amount, sales, number of business establishments, sum of wages, and profit amount. The latter relies on locality, independence, managerial organization, market share, managerial style, etc. However, none of these factors can precisely classify SMEs. Quantitative standards may also contain some arbitrariness because SMEs are understood based on comparison with large companies. With these taken into consideration, capital and number of employees are two indices usually employed. The SME Basic Law, enacted in 1963 also employs a definition based on quantitative standards such as capital and number of employees, and this has become a general definition of an SME in Japan<sup>4</sup>.

Let me now discuss the definition of an SME by showing specific cases in Japan. In this country, the definition of an SME, specified in the SME Basic Law enacted in 1963, is used for official statistics and measures taken for SMEs. As mentioned before, this definition employs quantitative standards such as capital amount and number of employees. This definition is not something to be fixed once determined but, instead, has been reviewed, with changes in numerical values and others over time. The SME Basic Law was revised twice in 1973 and 1999 since its enactment in 1963.

In General, the “Old Basic Law” referred to here is the SME Basic Law revised in 1973 while the “Revised Basic Law” is the one revised in 1999. Revision of the Law in 1999 saw a change in the quantitative definition of SMEs first time in 36 years since the law was enacted. The latest revised SME Basic Law specifies SMEs to be an enterprise with its capital ¥300 million and less or 300 employees and fewer for manufacturers, with capital of ¥100 million and less or 100 employees and less for wholesalers, with capital of ¥50 million and less or 100 employees and fewer for retailers, and with capital of ¥50 million and less or 50 employees and fewer for service industry.

However, as previously noted, it is clear that the styles of SMEs are also “heterogeneous and diversified”. For example, as to in what points the sub-contracting enterprise and venture are different from each other, you will

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<sup>4</sup> Yamashita, S. (2014b).

not be able to capture exactly the existence and established form of a medium-small enterprise if you use the quantitative definition only we studied above. As such, it is required to use the qualitative definition of a medium-small enterprise.

## 2. An important Role of SMEs in the Japanese Economy

A medium-small enterprise has an apparent disadvantage in a field where it must compete with large enterprises and has a difficulty to survive therein. Namely, as long as the competition exists among enterprises in the course of growth of capitalistic economy, weak enterprises will be in principle culled out and disappear from the market, whereas those enterprises survived from the competition will become stronger and larger and repeat severer competitions to build up ultimately a completely monopolized market where no competitor exists. However, a field not suitable for a large enterprise, namely, a niche sector is left open to the medium-small enterprises, where many medium-small enterprises get together to succeed. If we consider its grounds, we will find a background in the theoretical implications based on such economical and rational grounds that an adequate scale for a business sector to exist can be found in the medium-small enterprises.

Amazing growth of the Japanese economy after the Second World War raised the country to the status of large economy, allowing it to accomplish its objective of catching-up with the economies of advanced countries after its defeat in the war. Large companies led this success, but SMEs also maintained their share at a quite high level by increasing their number, instead of becoming extinct. We will take here an example of manufacturing, industry other than agriculture, forestry and fishery, which particularly drove high economic growth<sup>5</sup>. According to the “Industrial Statistics Table” prepared by the Ministry of Economy, Trade and Industry, the medium-small enterprises with employees below 300 represent 99% or more weight of the total business offices, around 70% weight of the total number of employees and around 50% weight in the total manufacturing/shipment

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<sup>5</sup> Ministry of Economy, (2010).

amount. (Although the number of employees of a medium-small enterprise is set forth at 300 or less according to the Medium-small Enterprise Basic Law, the enterprise with employees below 300 is defined in this paper as a medium-small enterprise because the numerical figures in the “Industrial Statistics Table” are used herein for edition.) The weight of medium-small enterprises has become lighter to some extent during 1955 and 1970 during which period the high economic growth continued. After this period, the weight of medium-small enterprises was kept almost constant until 2008<sup>6</sup>. In the Japanese economy after the World War II also during which period the business activities of large enterprises showed up greatly, the medium-small enterprises did not diminish by the pressure from large enterprises. On the contrary, they kept very large weight in the economy until 1985 by increasing their number. SMEs maintained quite a high share until prolonged recession of Heisei Era in recent years, by increasing their number. This history was far from being overwhelmed by large companies and eradicated even in the Japanese economy after the Second World War through which large companies have manifested their activities.

For example, if we study the position of medium-small enterprises held in the number of business offices, that number has been decreasing since the peak year of 1985, but the weight held by the medium-small enterprises is very large. The number of business offices of medium-small enterprises was 442,562 in the recent 2008, representing 99.2% of the total number. As far as the proportion of the medium-small enterprises in the number of employees/amount of shipment is concerned, the number of employees of medium-small manufacturing sectors represents 70.5%. With respect to the total amount of shipment per year attained by enterprises with employees between 1 and 299, it represents 47.8% of total number of business offices in 2008. When we view the situation based on the number of business offices, those factories or stores owned in fact by large enterprises will be taken as medium-small enterprises when such factories or stores are kept in a medium-small scale. Therefore, the role of medium-small enterprises is often overestimated. Even if we should deduct such an overestimated point from our consideration, it can be said that the medium-small enterprises hold an important

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<sup>6</sup> Ministry of Economy, (2009).

position. It is beyond doubt that SMEs have contributed much to the Japanese economy in the Post War Period, which shows the importance of the SMEs in the national economy.

However, the fields where the production is absorbed by large enterprises are mainly the raw materials production division and/or parts assembling division. Many of raw materials processing processes and parts production processes are the fields the medium-small enterprises are in charge. Those roles are assumed by medium-small enterprises as sub-contractors. According to the “Industrial Statistics Table”, the concentration by large enterprises in such sectors of production is very high as the industries of spinning, chemicals, petroleum, coal products, steel, non-ferrous metals, rubber products, electric machinery, transport machinery, etc. In addition, as seen in the manufacturing sectors also, the related production is absorbed by small number of large enterprises at their raw materials production division or parts assembling division. Due to the limited competition which may be caused by such absorption by large enterprises, there could be such a case that the market is controlled monopolistically. Many sub-contracting medium-small enterprises having technical relationship with such divisions are forced to accept disadvantageous price conditions from the principal large enterprises. There are many cases the medium-small enterprises are facing with undue competition through mutual competition as called a primitive competition.

Nevertheless, in recent years, it has become recognized that the SMEs are important in the national economies of both developed and developing countries. It is considered that the SME ① functions as a subcontractor or keiretsu (affiliate of group companies) in relation with large company for production and sales, ② stabilizes life of the nation (supply of multiple consumable goods produced in small lot and services, absorption and creation of employment and contribution to local economy and society), and ③ contributes to industrial development and revitalization of the market economy (seedbed for new industries, leader in technological innovation and demonstration of entrepreneurship), among

others<sup>7</sup>.

### 3. Problems of SMEs<sup>8</sup> viewed from the dual Structure<sup>9</sup>

When we look at individual SMEs, there are enterprises of diverse styles. In general, the scale of medium-small enterprises is smaller than that of large enterprises in term of the number of employees and amount of capital. In addition, they are treated as entities having several issues arising from the gap in the scale. Those issues which have arisen in such a manner are the issues inherent to medium-small enterprises. Namely, the medium-small enterprises are not only the entities simply in medium-small scales but also the entities maintaining their very poor establishment under the pressure from and subordinate to large enterprises, having issues arising from such a recognition that they are the entities facing with problems different in the nature from large enterprises. These have been pointed out as issues relating to medium-small enterprises.

In the progress of the high economic growth in Japan, large companies solidified their foundations. SMEs, particularly in the manufacturing industry, where they had organic relations with large companies in manufacturing processes, have been under strong pressure from large companies and forced into intensified relationships between governor and subordinate through affiliation. These problems drew attention as a result of manifestation of a gap between large companies and SMEs, which were seen as dual-structure economy. This was taken as one of the major issues faced by SMEs, leading to implementation of SME policies.

The dual structure phenomenon is composed of two different layered structures, namely modern sector and feudalistic sector, because Japanese economic structure is not the same as that of the advanced countries in Europe and USA. Weights of micro enterprises owned by small enterprises and/or managed by the family exist

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<sup>7</sup> Satake, T. (2008).

<sup>8</sup> The origin of SME research in Japan is the discussions about problem of SME in subcontracting system. This discussion is widely known as Fujita-Komiyama Controversy. Theory for Problem of SME basically developed about the problem and existence of SMEs industries under the national economic structure. This aspect of theory for SME problem was rarely seen in other countries.

<sup>9</sup> Hiromi Arisawa raised the theory of dual structure. It was further discussed by Miyoei Shinohara.

on both ends. These micro enterprises are held in a feudalistic employer–employee relationship with modern large enterprises. This phenomenon has pointed out that the number of middle scale enterprises is very small. As a gap structure representing such dual structure, there existed between modern and feudalistic enterprises a wage gap based on their scale<sup>10</sup>. Namely, the lifetime employment/seniority payment system employed by large enterprises is a system prepared to make it possible to select laborers with excellent quality and settle them at their enterprises for life, which is a closed system in such a sense. It is considered that such a labor market of large enterprises as above has been caused by an excessive supply of labor. Those laborers who could not gain job from large enterprises and have weakened the demand power for wages are forced to start working at medium–small enterprises whose ability to pay wages is relatively low<sup>11</sup>.

In addition, such a technology innovative investment being concentrated on large enterprises can be the cause to improve the value–added productivity of labor at large enterprises, and at the same time, the factor which invites further excessive work force will be intensified because of labor saving nature. On the other hand, the capital weakness found in medium–small enterprises becomes a factor which will result in a low profit gain. Resolution will become more difficult in a dynamic course. The wage gap and labor value–added productivity gap between large and medium–small enterprises are used indicator which explains the dual structure concretely.

Value–added productivity of labor shows economic efficiency of an enterprise. It significantly affects the survival of an enterprise. Therefore, by comparing the labor value–added productivity according to each scale of enterprises, it will become possible to make clear of the weakness in existence of medium–small enterprises when compared with large enterprises. During the period of high economic growth, we noticed above gaps tended to scale down to some extent. The gaps which expanded from around 1980 scaled down a bit in 2008.

If we should seek after the cause which invites labor value–added productivity

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<sup>10</sup> Yamanaka, T. (1948b).

<sup>11</sup> Suzuki, T. (1995).

gap in both physical aspect and value aspect, we can point out from the physical aspect a gap in the capital reserve ratio (amount of tangible fixed asset per employee). This will indicate that, when compared with large enterprises, the capital equipment owned by medium-small enterprises is often found not efficient enough in a quantitative and qualitative sense which declines their physical production power. Namely, we can point out that those medium-small enterprises whose capital situation is weak and their financing power is also weak have to face with an obvious disadvantage in promoting rapid mechanization through technology innovation like large enterprises are doing. In addition, in view of value aspect, we can mention the control-subordination relationship of medium-small enterprises with large enterprises. Because large enterprises are exercising their monopoly power or medium-small enterprises depend on large enterprises, medium-small enterprises are forced to accept disadvantageous payment conditions or acceptance conditions. In addition, medium-small enterprises are not stable enough in their management because their capital is not strong enough. Every time economic depression attacks, they fall into serious management crisis. In order to avoid bankruptcy, many of medium-small enterprises are forced to become depend on large enterprises in a sound capital situation.

For a company, wages constitute another expense to be deducted from the added value produced. The amount of wages a company pays to its employees (employed laborers) significantly affects corporate earnings, and thus the survival of the company. The gap in wages became dramatically smaller in the period of high economic growth from the 1960s to the early 1970s. It again widened during the period of low economic growth after the 1st Oil Crisis, and started to be narrowed in the years of the bubble economy after 1985.

The labor value-added productivity is the enterprise's economic efficiency, which level will have a substantial impact on the viability of an enterprise. Therefore, by comparing the labor value-added productivity according to the scale of enterprises, it will become possible to make clear of the weakness in viability of medium-small enterprises compared with large enterprises. Although the gap tended to scale down to some extent during the period of high economic growth, the gap which expanded from around 1980 was fixed firmly until 2000. The gap

maintained its constant level. However, the gap temporarily scaled down in 2008. As explained above, the value-added productivity of medium-small enterprises is very poor when compared with that of large enterprises<sup>12</sup>. However, the reason why medium-small enterprises can relentlessly exist will be that their dependency on a cheap labor power has become their basis for existence, redeeming their weakness in existence. Therefore, in line with the scaling down of wage gap caused by rise in wages, it is required to level up to some extent the labor value-added productivity which represents the ability to pay wage. If medium-small enterprises cannot raise their wage, they will lose their basis of existence.

For the foregoing reasons, elimination of a dual structure was taken as policy objective. Along with the progress of the high economic growth, natural disappearance of a gap in wages accompanied by shortage of labor was one of the issues to be tackled. Besides, to eliminate a gap in value-added productivity of labor had the highest priority in policy. When the labor shortage occurred amid the high economic growth, it was necessary to narrow gap in wages. Measures to improve value-added productivity of labor which shows the capacity to pay wages were then required to reinforce the foundation so that SMEs would survive. In the period of high growth of Japanese economy, the existence of gap in wages or value-added productivity of labor between large companies and SMEs was labeled as a dual structure and was considered to be at the core of problems related to SMEs<sup>13</sup>. However, as labor shortage in the period generated the necessity of narrowing gap in wages, measures were needed for improved value-added productivity of labor which shows capacity to pay wages in order to strengthen the foundation of survival for SMEs. The SME Basic Law passed for this purpose states the necessity of modernizing SMEs. The SME Modernization Promotion Law, which follows the Basic Law, specifies the methods of modernization, and improvement in value-added productivity of labor was placed as a mainstream of SME policy. This created a scheme - "Modernization of SMEs = Improved value-added productivity of labor". A fear of retarding the growth of Japanese economy generated the necessity of SME measures, leading to enactment of the SME Basic

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<sup>12</sup> It is said that it is important to promote the so-called modernization of SMEs. See Satake, T. (2008) for details.

<sup>13</sup> Kurose, N. (2006).

Law in 1963.

The “SME Basic Law” in 1963 mainly focuses on “Modernization” and “Correction of disadvantages” as SME policy. There was a transit of SME policy as social measures in the past to the economic policy based on the SME Basic Law. The economic SME policy referred to here was set up as part of the industrial policy (industrial structure policy), which was not entitled to anti-monopoly policy (industrial organization policy). The SME modernization policy presented in this way is the one based on the SME Modernization Promotion Law enacted to bring about “Modernization”. Although the “Modernization of SMEs” in the past concentrated in modernizing equipment based on the “Capital intensification” policy which modeled on mass production system of large company, it was later changed to the “Knowledge intensification” policy

#### 4. SME Policy and SMEs.

SME modernization policy is the one made based on the SME Modernization Promotion Law enacted to achieve “Modernization”. There was an objective of shifting a relationship between large companies and SMEs from the governor-subordinate to the interdependent. In order for SMEs to throw off their subordinate condition, it was necessary to work out a relationship of technological differentiation. Also, the technology of small and medium enterprises had to exceed the level that large companies can make themselves. It is to establish social differentiation as technology differentiation. A relationship of technological differentiation referred to here is considered an organic technological relation between large companies and SMEs. We will see next the SME policy in Japan in relation to the process to enact the SME Basic Law. This is based on demands for modernization of SMEs in terms of industrial structure. In terms of industrial organization, establishment of environmental conditions for competition along economic democratization will be touched on<sup>14</sup>.

By discussing the above, we will make it clear that the SME policy, as an economic policy, is rational for economy and appropriate for public benefit.

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<sup>14</sup> Tsuruta, T. and Ito, M. (2001).

Referring the industrial structure, “Modernization of SMEs” was a prerequisite to catch up with the economies of advanced countries. It was indispensable for the growth of the Japanese economy and to prevent SMEs from becoming a bottle-neck for the production of large companies. In the aspect of industrial organization, a governor-subordinate relationship accompanied by exploitation from inferior capital under the dominance by financial cliques and monopolistic capital existed before the Second World War. It was changed by the post-war economic democratization policy based on USA’s anti-monopoly policy. This allowed SMEs with smaller capital to keep their growth potential through “Modernization” such as technological innovation. As a result, dual isolation of pre-modern and subordinate conditions partially disappeared. In this way, it is considered that development of a competitive environment through economic democratization was a prerequisite for catching up with the economies of advanced countries<sup>15</sup>.

“Dual isolation”<sup>16</sup> is a phenomenon in which, in the days before Japan’s high economic growth, SMEs could not afford technological progress by themselves. They were stuck in a pre-modernized condition in which they were desperately isolated and retarded technologically compared with large companies. Of course large companies themselves were far from developed compared with advanced industrial countries. In addition, SMEs were under the control of capital of large companies. “Modernization” was witnessed while dual isolation partially disappeared during the period of high economic growth although a dual structure remained. There were then demands for policy for public benefits of catching up with advanced countries. Based on such social demands, the SME Basic Law was enacted in 1963 to promote “Modernization of SMEs” for correction of the disadvantage compared with large companies. The SMEs modernization policy formulated in 1963 promoted, at its early stage, capital integration by modernizing equipment of each SME and managerial rationalization. Later in 1969, the structural improvement system was

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<sup>15</sup> Tsuruta, T. and Ito, M. (2001).

<sup>16</sup> The viewpoint is that, it is far from Japan’s big manufactures, which is significantly behind industrialized nations, and there is still isolation that small and medium-sized manufactures are lagging behind. And it is a phenomenon that technological progress by voluntary efforts cannot be found due to the viewpoint of dominance that it is under capital control from the large manufactures. Refer to Komiyama, T. (1941).

introduced with the purpose of modernizing whole businesses or industries. Then in 1973, the 1st Oil Crisis resulted in demands for change in industrial structures. Promotion of projects relating to intensified intelligence, including market cultivation and product development was focused. 1975 witnessed a transition such as promotion of joint projects for structural improvement with related business and plans to launch into new fields. It can be said that the “organic technological relationship” between large companies and SMEs is the foundation in the policy<sup>17</sup>.

Regarding the gap in value-added productivity of labor which embodies a dual structure phenomenon, many bad capital equipment with lower efficiency in quantity, and quality are found among SMEs, leading to their lower production capacity compared with large companies. SMEs for which capital is scarce and financing capability is weak suffer a disadvantage in trying to modernize through technology innovation in the same way as at large companies. From the 1960s through the 1970s in Japan, a relationship among enterprises entered into a transitional period. A new relationship was established between large companies and SMEs while market mechanisms were functioning only partially. This relationship is considered a social labor differentiation system bearing a mutual dependency with a governor-subordinate relation partially moderated. It is no longer a governor-subordinate relation although a subcontracting production relationship remains. It is a change in corporate system and at the same time, a phenomenon occurred during a transition of industrial structure<sup>18</sup>.

As seen above, the SME modernization policy, a central pillar of the SME policy, largely helped raise the industrial structure to a higher level and accomplish high economic growth. A new subcontracting production system such as business in keiretsu and long-term continuous business between subcontracting SMEs and large contractors was constructed through moderated market dominance by monopolistic capital along with the progress of economic democratization. Managerial resources of SMEs, particularly technological and developmental capacities generated by human resources were actively used. Financial resources

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<sup>17</sup> Satake, T. (2008).

<sup>18</sup> Fukushima, H. (2006).

were added through industrial policy for advanced industrial structure and economic growth. It was not to creating businesses relationship with SMEs, a weak economic entity explored through a governor-subordinate relation. It was rather to build a business relation with large companies based on mutual dependency which would allow SMEs to emerge themselves from fragility. In other words, it was to diversify products by forming quasi inter-organization businesses different from market business for the whole or part of industrial products. It was also to diversify products by transferring some specialized production assets of large contractors to subcontractor SMEs. Accomplishment of modernization of SMEs in terms of capital equipment and value creation was also required. Use of managerial resources of SMEs needed to be considered in order to maintain quality, stabilize operations, reduce production cost, strengthen compatibility with the external managerial environment and continue technological progress. Thus managerial problems faced by SMEs were solved.

As seen above, modernization of SMEs based on the SME policy formulated and implemented following the enactment of the SME Basic Law was promoted and accomplished through the recessions after the Oil Crisis in 1970s as well as recession caused by high evaluation of yen and the collapse of bubble economy in 1990. It was an economically rational policy because it helped large contractor companies, manufacturers of final products, raise their industrial structure, and improve competitiveness of their products in international market, leading to their growth. It also helped the Japanese economy to enjoy its high growth and stable growth and pull itself out from recession at an early stage.

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