European Commission

Startups and the Digital Single Market

FINAL REPORT

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Digital Agenda for Europe

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1. Introduction

This essay was commissioned by the Startup Europe team of the European Commission and produced by Nesta with the assistance of Tech.eu and The Lisbon Council. It is intended for discussion and does not constitute Commission policy.

The European Commission has indicated that it intends to create a 'Digital Single Market' in order to enable the 'borderless nature' of digital, internet-based technologies to flourish.[1] The Commission suggests that this will entail harmonizing various rules regarding telecommunications services, copyright, data protection, and management of the radio spectrum.[12] This document is intended to provide some guidance to the Commission in their deliberations over the Digital Single Market (DSM), specifically with regard to startups. It highlights some of the common issues that startups face across member states and explains why policy makers should pay special attention to them. The document draws in part on a survey of startups which was distributed in late February 2015, along with a subsequent workshop that was held at Berlaymont, Brussels, on 9th March 2015.

[1] http://ec.europa.eu/dgs/connect/en/content/digital-single-market-0

[2] http://ec.europa.eu/priorities/digital-single-market/index_en.htm; http://www.europarl.europa.eu/RegData/etudes/BRIE/2014/536384/IPOL_BRI%282014%29536384_EN.pdf

2. Why Startups Matter

Innovation is by far the most important driver of prosperity and productivity in advanced economies.[3] Within Europe, over 60% of the economic growth between 1995-2007 is calculated to have been due to innovation.[4] Disruptive innovation, in particular, is disproportionately driven by young, technology-intensive companies.[5]

Young companies also power job creation, with enterprises five years or younger generating almost 50% of all new jobs.[6] Nesta's own research supports this finding, showing that growth is very unevenly distributed, with just 6% of firms contributing 50% of growth.[7] Clearly, policies which support such high-growth firms have significant potential for economic impact.

Despite possessing a wealth of intellectual and cultural resources, however, Europe has largely failed to build sizable, global companies that are younger than 25 years old.[8] Whilst 60% of current software 'unicorns' (companies with billion dollar valuations) in the world were built outside of Silicon Valley, only 16% (including Skype, Spotify and Zalando) came from Europe.[9] Addressing this should be a priority for entrepreneurs and policy makers alike.

Unfortunately, when it comes to startups, many policy makers fail to distinguish between startups and other small or medium enterprises (SMEs). This is understandable, since many startup definitions relate to their growth ambition or other attributes which are difficult to observe, but it may also be unhelpful: the challenges faced by a young, innovative, high-growth startup are often quite different to those of an established SME or a small firm with no growth ambitions. The essential point is that startups are not

[3] Albert Bravo-Biosca, Louise Marston, Ann Mettler, Geoff Mulgan and Stian Westlake, Plan I(nnovation) for Europe. Delivering Innovation-Led and Digitally-Powered Growth (Brussels and London: The Lisbon Council and Nesta, 2013).

[4] Ibid. Nesta calculation using data from INTAN-Invest.

[5] Clayton M. Christensen, The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail (Boston, MA: Harvard Business School Press, 1997); Paola Criscuolo, Nicos Nicolaou and Ammon Salter, "The Elixir (or Burden) of Youth? Exploring Differences in Innovation between Startups and Established Firms," Research Policy, Vol. 41, No. 2 (2012), pages 319-333.

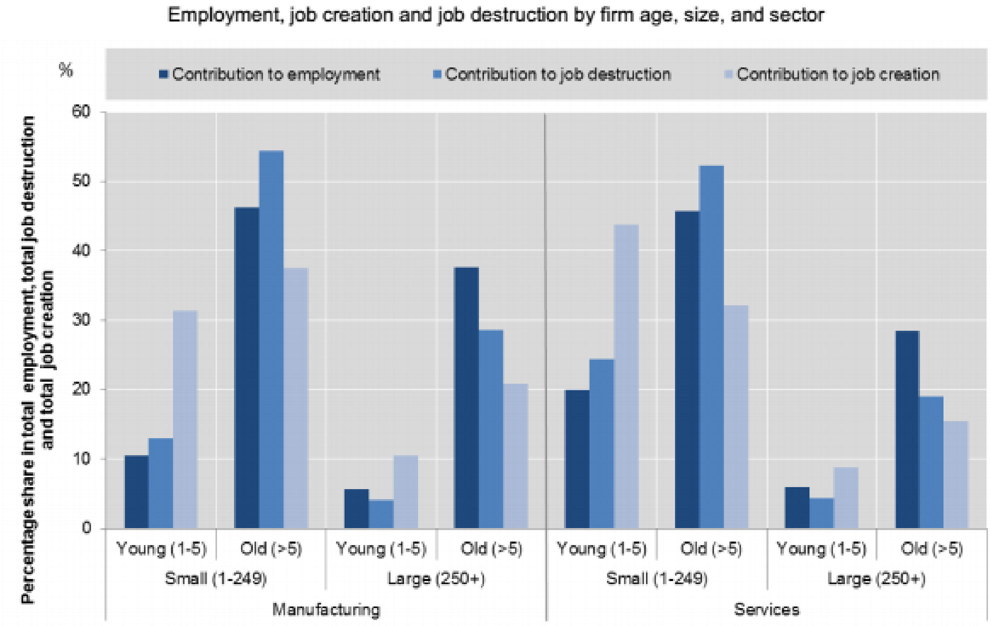
[6] Chiara Criscuolo, Peter N. Gal and Carlo Menon, The Dynamics of Employment Growth: New Evidence from 18 Countries (Paris: OECD, 2014); http://www.oecd.org/sti/young-SME-growth-and-job-creation.pdf

[7] http://www.nesta.org.uk/publications/vital-6

[8] Thomas Philippon and Nicolas Véron, "Financing Europe's Fast Movers," Bruegel Policy Brief Issue 2008/01 (Brussels: Bruegel, 2008); Nicolas Véron, "The Demographics of Global Corporate Champions," Bruegel Working Paper Issue 2008/03 (Brussels: Bruegel, 2008).

[9] Data from Atomico; available online at: http://www.atomico.com/explore-d3

(just) SMEs, and hence that policies aimed at promoting innovative startups are likely to be somewhat different than policies designed to assist established small firms.[10]



Young firms contribute disproportionately to job creation[11]

Young firms are more dynamic[12]

[10] William Gale and Samuel Brown, Small Business, Innovation, and Tax Policy: A Review, (Brookings, Brookings 2013); available online at: http://mpra.ub.uni-muenchen.de/57384/1/1001675-Small-Business-Innovation-and-Tax-Policy-A-Review.pdf

[11] Chart taken from Criscuolo, C., P. N. Gal and C. Menon (2014), "The Dynamics of Employment Growth: New Evidence from 18 Countries", OECD Science, Technology and Industry Policy Papers, No. 14, OECD Publishing, Paris. DOI: http://dx.doi.org/10.1787/5jz417hj6hg6-en

[12] *ibid*.

3. Summary of Issues from the online survey

So how might the DSM help startups? Nesta surveyed some startups about existing barriers that they faced when operating across borders, and what they thought the DSM could mean for them.[13] This survey should *not* be considered as representative of European startups for various methodological reasons (e.g. it was distributed only in English due to time constraints, and the responses showed significant geographical bias). Nevertheless, the respondents reported some consistent themes, which must be taken into consideration. In particular, around 75-80% of respondents mentioned the change in VAT regulations which came into effect in January 2015 as being a significant (or indeed *the* most significant) inhibitor to cross-border activities.

Other recurrent themes included language, culture, availability of finance, availability of talent, general uncertainties surrounding company law in other jurisdictions, consumer law and e-commerce; differences in data protection and privacy rules, proposed taxes on cryptocurrency transactions; and digital signatures.

Whilst there was general optimism that the *principle* of the DSM would be beneficial for business, this was coupled with widespread pessimism that ***execution* of the DSM would entail additional bureaucracy or compliance costs for small firms, particularly if further efforts were not made to consult with startups and small businesses**. Furthermore, many sole traders and micro-businesses felt policy makers did not consider them at all. It is significant that numerous startups and SMEs felt that changes such as the VAT rules were implemented without consultation of the community at large, suggesting that policy makers should make greater effort to listen to concerns raised, and gather more intelligence directly, from European startups regarding future regulation that could affect them.

In addition to the themes above, attendees at a workshop on 9th March 2015 raised further points, such as:

- Company status – preference of US VCs for US incorporation, given (perceived) variation and complexity of European legal entities;
- Open data – more openness around datasets (inc. EC data) will promote innovative uses of this data and spur entrepreneurship;
- Labour law – especially the complexity of multiple laws for a distributed workforce;

[13] Survey ran online 20/2/2015–09/3/2015; 262 responses were received, with around 40% describing themselves as startups; 20% SMEs, and 25% sole traders or microbusinesses. The remaining 15% included VCs, IP advisors and other service providers, plus a few large firms.

- Data roaming – cheaper data tariffs will inevitably improve the market for many digital startups;
- Dynamic equity splits – unclear tax treatment for founders and investors;
- Consumer rights law – uncertainty whether foreign sales generated additional risk and responsibilities; variations in e-commerce & consumer protection rules;
- Bank accounts – the 'catch 22' situation of anti-money-laundering regulation requiring historical records in order to open a new account;
- Claiming VAT – significant difficulty in claiming back VAT across borders;
- Dispute resolution – some firms seeking refuge in language or national laws when cross-border problems arise, rather than openly trying to resolve the issues;

4. Principles to Consider

We urge that, in designing the Digital Single Market, the Commission should bear in mind some core principles:

- Recognise the importance of startups and entrepreneurship in driving innovation and economic growth.
- Understand that most startups will fail, and so the policy environment must accommodate failures. Fear of failure is reported as a barrier more frequently by entrepreneurs and potential entrepreneurs in Europe than elsewhere, especially among younger people.[14]
- Consider the potential impact of all new regulation and legislation on innovation, and be especially mindful of the compliance costs for small firms and entrepreneurs.[15]
- Think of digital technologies as impacting all sectors, not (just) as a sector in its own right.
- Ensure that harmonization does not preclude future experiments in government; in other words, wherever possible governments should still be able to use experiment and creativity to find out what could work better, and be able to test new ideas - preferably on a relatively small scale - before spreading them.
- Consult further with startups before specific plans are implemented, and be mindful that the Commission may need to use multiple, creative, communication channels to reach them.

[14] http://www.youthbusiness.org/europes-youth-fear-business-failure-and-a-lack-of-start-up-skills/

[15] See, e.g., http://www.riskforum.eu/innovation-principle.html

With the above in mind, we suggest the following three specific actions:

Firstly, the Commission should seek to identify and remove bureaucratic obstacles for startups. In particular, it should re-double efforts **to resolve the current issues relating to VAT**, since it is clear that this poses a real – and quite possibly fatal – obstacle for many startups and other SMEs. Indeed, many startups commented that, in their view, the DSM would achieve nothing unless the VAT issue were resolved. One possibility may be an agreed *threshold on turnover for VAT exemption*.

Secondly, the Commission should **develop a light-weight corporate structure** which would follow the harmonised requirements in all EU Member States, be straightforward to establish, and have a common name to attract foreign investors. It should also allow for all formalities to be conducted online; permit information to be submitted to the authorities only once (instead of resending the same information many times to different authorities); and include startup-friendly insolvency rules which would not punish innovation, but rather would facilitate 'rescue restructurings' and give a second chance for honest, bankrupt entrepreneurs.

Thirdly, the Commission should **bridge the information gap**, in terms of better explaining the processes and obligations of cross-border employment law, consumer law and taxation law to SMEs. Uncertainty about the risks and requirements of selling across borders is a barrier in itself. Possible channels might include (i) an **online portal**; (ii) **dissemination** via national / regional small-business federations, chambers of commerce, associations of startups, tech blogs, etc.; (iii) **connecting European hubs of startup** activity in order to promote knowledge exchange. We recommend that the Commission undertakes research to find out which channels are most effective.

With regard to the second recommendation, one way to achieve this could be through a **'29th regime'**. However, as EU law stands at the moment, this would seem to require unanimity within the Council of the EU and the involvement of the European Parliament is very limited. We note that previous initiatives designed as a 29th regime (European Private Company, European Foundation) failed for that reason. The most realistic option may therefore be to build on the EU initiative concerning single-member companies (*Societas Unius Personae*, SUP) and expand its scope to multiple shareholders, so that startups could quickly incorporate new investors in the company. The SUP Directive includes many innovations which would be beneficial for startups, if the SUP can be made applicable to multi-shareholder entities, such as full online registration, harmonised online templates for articles of association & registration, and low minimum capital. Ideally, the SUP (and its extension to multi-shareholder companies) would contain clear, concise and user-friendly information about laws governing SUP and its future expanded model. This information should be prepared by Member States and available at national level, but should be linked to one EU central portal, for example E-Justice. It should be available in the languages used in international business.

In addition to the above, there are a number of further actions which would benefit not only startups, but a range of businesses:

- Examine differences in consumer protection legislation and simplify and standardise where possible, so that startups are not confused by varying obligations. Consideration should be given to the question of refusal to sell - i.e. whether a start-up must accept an order from anywhere in the EU, or whether it is permitted to reject orders from areas where compliance with local laws may be difficult or uncertain.
- Simplify cross-border VAT refunds. At present, when a firm attends a trade fair in another member state it must pay local VAT and then reclaim it back. This can be expensive as firms normally need to engage a provider to do this for them. This issue should be soluble on a governmental level without any adverse impact on startups.
- Conclude the current data protection discussions and standardise legislation so that it does not matter where within Europe a firm's servers, customers or staff are located.
- Expedite changes to employment law to make it easier to hire & fire employees. Young companies are a major source of new jobs, and need to recruit talent to succeed, but many hesitate to take on new employees for fear or being unable to shed these staff if the firm does not grow as fast as expected (or if its strategy shifts, which is often the case as startups may 'pivot' multiple times in search of a sustainable model).
- Proceed with (and expedite) proposed EU roaming regulations to abolish all roaming tariffs for mobile data.
- Examine why electronic signatures are still not being adopted uniformly by member states; if necessary, consider promoting a European standard for this to improve trust in transactions and online contracts.
- Avoid closed, proprietary standards where possible (instead using open standards for data interchange, mobile payment, etc. ensuring that open standards do not become a way to prevent innovation and protect incumbents) since such standards often present a barrier to new startups.
- Promote more open, online, public procurement (including within the EC itself). This would be of benefit to all SMEs, not just startups, but would assist many startups in finding their first customer.
- Promote legal clarity of Bitcoin and other cryptocurrencies across member states. Blockchain-based innovations have several potential applications, but in the EU,

the absence of legal clarity is causing great uncertainty for blockchain entrepreneurs. Most pressing is the pending question of whether the activity of trading Bitcoin can be exempt from VAT or not; an unfavourable ruling could disincentivise cryptocurrency use, stifle innovation in the blockchain technology sphere, and force blockchain entrepreneurs to move abroad.

- Leave space for crowd-funding: this is increasingly important to new company formation, and Nesta's own research found that it was crucial for funding many startups which were unable to secure finance from other sources.[16] Excessive regulation of this nascent industry would likely be detrimental to startups.

[16] Peter Baeck, Liam Collins and Bryan Zhang (2014) *Understanding Alternative Finance*, available online at: http://www.nesta.org.uk/sites/default/files/understanding-alternative-finance-2014.pdf

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