

Policy Brief

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Startup Agenda: From Creation to Growth to Internationalization

Startup-Politics: From Keyword to Strategy

Startups have recently taken the center-stage in German politics. Philip Rösler, former German economic minister, led a delegation of business founders to Silicon Valley. Both Chancellor Angela Merkel and her challenger Peer Steinbrück sought a connection to the startup scene during their electoral campaigns. While there is great political interest in entrepreneurship, a viable Startup Agenda consists of much more than support for the creation of new business ventures. If the German government wants to strengthen its information and communication technologies (ICT) sector, its strategy needs to focus on building a strong ecosystem for startups.

Berlin, Hamburg and Munich are known as popular locations for startups in the digital technology sector. The creation of new businesses in the ICT sector also generates a significant macroeconomic impact. A report by McKinsey has recently identified twelve technologies that will shape the eco-

nomics of the coming decade. Six of these twelve technologies are in the ICT sector. German businesses cannot afford to ignore technologies such as mobile, Internet of things, or cloud integration. A strong ICT sector will form the backbone for innovation and macroeconomic growth in Germany.

Startups play a critical role in the development and market integration of new technologies and business models. Many of the technologies and business models that shape our daily life were originally developed by entrepreneurs who were willing to take risks and broke with conventional thinking when they founded their own companies. The innovation introduced by startups creates a very dynamic environment in the ICT sector. Established businesses cannot afford to rest on their laurels, but must engage with new technologies and business models on a constant basis. Businesses react to this pressure by, either developing their own innovations, or purchasing innovations through acquisitions of promising

startups. The ones that don't take these steps risk falling behind.

How strong is the German startup sector? This question has been heavily discussed in recent months. Reports of success, especially in Berlin, Munich, or Hamburg, cannot hide the fact that so far German startups with international reputations and success have been few and far between. There is only one business in the DAX that was created post 1945 without any connection to previously existing firms: SAP founded in 1972. We have many small startups in the ICT sector. But we have no success stories even remotely as great as those of Google, Facebook, or Amazon. SAP aside, we are still waiting for the German example of a tech startup that develops into a truly global player.

There have been numerous calls for action. But identifying what role government must play in order to promote startups is easier said than done. How can ministries and parliaments advance the creation, and even more importantly, the international growth of businesses in a highly dynamic field without falling prey to the temptation of hubris? Understanding the limits of government interventions is just as important as the development of concrete policy proposals. We are convinced that government's role in startup advancement is a limited one. In the past, startup politics has been wrongfully sculpted around "what all could be done?" The correct question is "which measures promise long-term success?"

Three-Part Model for an effective Startup Agenda

The founding of new businesses alone is not enough. What we need are success stories built on growth and internationalization. Only they will attract lasting attention from investors, lead to job creation, and strengthen the high-tech location Germany in the long run. Therefore successful startup politics must be much more than "Founding Politics". So far young business's difficulty of generating growth has not received enough attention from policy makers. Especially the connection between growth and internationalization needs to become a focal point. Given the limitations of domestic markets, European startups must quickly expand into foreign markets. This is a real disadvantage in comparison to American startups. Language barriers and the adaptation to different regulatory regimes require additional investments. These problems even apply to the software industry whose products are generally more adaptable and scalable. Attracting foreign investors is another challenge but at the same time also a key to success.

Based on our emphasis on growth and internationalization our policy paper is divided into three parts: framework, startup phase, and growth & internationalization. The following info-graphic gives an overview of our agenda.

The Startup Agenda: Three Key Areas to Success

Part 1: Framework

- improve access to data through open data initiatives
- expand access to broadband Internet services

Part 2: Startup Phase

- corporate law: introduce Startup-Phase
- tax law: end discrimination of startups
- labor law: create flexible employment conditions
- evaluate public venture capital programs
- create spaces for collaboration and networking
- represent needs of the digital economy in government
- address education & training needs of startups

Part 3: Growth and Globalization

- attract international talent
- create international data protection standards
- strengthen european intigration and transatlantic economic development

Part 1: Framework

Data is the raw material of the digital economy. Many new and innovative services and business models depend on the collection and analysis of data. This is why in recent years the British government has released over 8,000 datasets free of charge. According to official estimates, the release of these datasets resulted in 16 billion Euros of economic growth in 2011.¹ The potential for new data-centered services is immense. Intelligent traffic control systems, efficient en-

ergy provision, and better healthcare services are just a few areas where the release of government data can spur the creation of new, innovative businesses. Not only does the government play a large role in the collection and provision of the data but also in defining the legal structure governing its use. Our access to and use of data does not only require open-data-policies, but also depends on an infrastructure that has the capacity to transport large quantities of data at high speeds.

¹ <http://www.deloitte.com/assets/dcom-unitedkingdom/local%20assets/documents/market%20insights/deloitte%20analytics/uk-insights-deloitte-analytics-open-data-june-2012.pdf>

1.1 Improving Access to Data

Many startups build their business model around data. Open data initiatives in public and private sectors bear enormous potential for the development of new services. The public sector plays a particularly important role here. Unfortunately government bodies often lack the means and/or expertise to make full use of their datasets. Cases in the USA and Great Britain have shown that the publishing of these datasets opens great opportunities for the startup sector. The European commission estimates that open data initiatives could result in 40 billion Euros per year in growth and the creation of hundred thousands of job in the EU.² Germany still lacks a comprehensive open data strategy, leaving it trailing behind other countries in this important area.

Policy Recommendation: The German government should develop, promote, and execute a comprehensive open data policy with the goal of realizing its full economic and social potential. The EU open data strategy should be an important point of reference. By joining the Open Government Partnership, the German government could further underscore its commitment to open data and take advantage of international dialogue about best practices as it designs and implements its own policies.

1.2 Robust Broadband Infrastructure

Broadband communications networks are the central infrastructure of modern society. Today's digital data networks represent the convergence of three different information

systems that have long been separated. For example, mass media has been shaped by dominant technologies throughout the 20th century – shifting from newspapers to radio to television. Now the Internet is the paramount distribution channel for news and entertainment. Similarly, personal communications have transitioned from the postal service to the telegraph to the telephone, and now, to the Internet. And finally, the information system of markets—the means of exchanging information between buyers and sellers—has shifted largely to the Internet. These paradigm shifts demand that any nation committed to building a strong digital economy focus attention on the quality, affordability and universality of world-class information networks.

For start-up companies in any stage of development, access to high quality information networks is essential, no matter where they are located in the country. These new firms will also be supported (or not) by an ecosystem of Internet services ranging from data centers for storage and processing, local caching for quality of service, and a high density of interconnection points to ensure the lowest possible barriers to the flow of data between businesses and their customers.

Policy Recommendation: The government should conduct regular reviews of the broadband marketplace to promote competition and investment. The goal is to ensure the development and expansion of high-performance, national broadband infrastructure with universal, affordable access. Quality information networks catalyze the devel-

² <http://www.ddgi.de/positionspapiere/ogd>

opment of new products and services that generate innovation and job-creation in the digital economy. In addition to policies that promote competitive offerings of commercial services, broadband policy to promote startups should also ensure that public institutions – such as schools, universities and libraries – are also well connected. The teenagers with tomorrow's breakthrough innovations will not start out in high-tech corporate laboratories. And while they are still tinkering in their garages, they should have every opportunity to leverage public-sector networks to pursue their ideas.

Part 2: Startup Phase

The creation and development of a new business poses specific challenges that distinguish startups from established businesses. Liquidity is a key issue. In the early stages of a business investments must be often written off in order to create the possibility of profitability in the future. Startups must be very flexible. They constantly need to adapt their business plan to newly obtained information and experiences. Startups strongly depend on highly skilled and motivated employees. Especially in the developmental stage, the performance of every single employee is critical to the overall performance of the company. Effective startup policies must focus on the specific challenges related to the creation of new businesses. We therefore see the legal differentiation between startups and businesses which already have established themselves in the market as the critical cornerstone of our startup agenda.

2.1 Introduction of a Startup Phase in corporate law

The law makes no difference between a startup and a globally operating company. Many regulations that make sense for large corporations pose major problems for startups and can even threaten their survival. Therefore we propose to incorporate a startup phase into corporate law. The policies discussed further below would thus only apply during the startup phase. The biggest regulatory obstacles for startups would be removed, but only during the developmental phase during which these regulations are counterproductive for the establishment and growth of a new business. As soon as a business clears the startup phase, it will become subject to all the same regulations that apply to businesses already established in the market. This approach makes it possible to free startups from burdensome regulations that harm the development of new businesses without undermining effective regulatory policies designed for large businesses.

This is our proposal how a startup phase could be legally defined:

- 1 A startup can be defined as every lawful business, that
 - 1.1 is funded at least 80% by its own capital or similar matters
 - 1.2 (i) does not have more than [30] employees and was not founded more than five years ago; or (ii) shows a significant growth in employees, volume of sales, or profit within a period of 24 months
 - 1.3 has increased its volume of sales or profit by a minimum of x%

The following recommendations should be tied to the startup phase in order to foster the creation and growth of startups:

2.2 Adaptations in tax law

Employee Stock Options

Taxation of employee profit sharing: Nearly all startups want to share the business's success with their employees. This allows startups to compete for talent and makes employees stakeholders in the success of the venture. Stock options are particularly important to startups because they often lack liquidity to offer their employees the high salaries they might be able to get in large companies. However, currently employee stock option programs are made very difficult in Germany. Once employees receive shares, they are subjected to income tax at current trade value, even if these shares are not liquid assets the owner may immediately benefit from. This places an unnecessary financial strain on employees and makes stock option programs unattractive for startups.

Policy Recommendation: Stock options hold no liquid value to the owner other than potential dividends or sale. Therefore the shares should not be taxed as a liquid asset. Tax law should be adjusted so that liquidation and tax coincide.

Loss of Tax Write Off

Generally speaking a tax paying business can partially write off losses created by business investment from their taxes in future profitable quarters. This write off has a limited effect after 25%, and ceases at 50%, of the companies share value. This law found in §8c KStG was created due to the misuse

of companies that were being kept economically weak for the sake of tax abuse, hence the law is a necessary one. However, with startups this tax situation is not abuse but the general rule of thumb. During the building phase of many startups more than 50% of share value is written off, resulting in lost write offs. This loss of write offs leads to unfair financial damage.

Policy Recommendation: Startups should be excluded from §8c KStG and write offs made during funding rounds or exits (the exit of investors) should be maintained.

Taxing of Debt Waivers

Occasionally startups are financed through loans. More times than not, these loans have options. This means that when the loan period runs out, the loan giver has the option of obtaining company shares and henceforth waiving the claims. However, if the startup is not able to pay its debts at the time of the option, the value of the loan is added to outstanding debts of the business and is therefore subject to taxation. If the investor had made the loan amount available as immediate capital, there would have been no tax. Even though this is a financially comparable situation, one event is taxable and the other is not. This can lead to insolvency due to tax burdens, even though an investor may have waived the claims.

Policy Recommendation: The law should be adjusted in such a way that the waiving of loan claims, when the loan giver receives company shares, is not subject to tax on the company.

2.3 More flexible employment models

Startups differ from established businesses by operating in an environment of extreme risk and volatility. Financial troubles can arise quickly when the search for investors proves difficult or the monetization strategy is not fully developed. Product development and business models need to be constantly adjusted to outside influences. As with all other aspects of the startup business, the human resources department must be flexible. Many startups attempt to solve this problem with subcontracting and voluntary labor. In our eyes, this is neither desirable for the workers nor for the startups. Thus it should be made easier for startups to hire employees without losing the necessary flexibility. This would lead to the creation of more regular employment opportunities. The loss in job security would be offset by the chances for high financial awards (stock options) and greater opportunities for personal advancement in a business that employees are helping to create.

Policy Recommendation: During the startup phase a three-month long protection from dismissal should apply to permanent employees.

2.4 Evaluation of public funded venture capital programs

Entrepreneurs and startups often struggle to raise venture capital for their businesses. This is a widespread problem that the government is seeking to address with its own funding programs. The German ministry for economics and technology will support the creation of innovative businesses with 83 million Euros in 2013. There is an additional

500 million Euros available via the central innovation program for mid-sized companies “Zentralen Innovationsprogramm Mittelstand” (ZIM). These are considerable sums. Yet we don’t know how efficient and effective these state run programs are. In particular, it is important to ask whether or not these programs help startups with mid-term growth, market capitalization, and job creation, especially through the eventual generation of a second round of private investment financing.

Policy Recommendation: Public funded venture capital programs for startups should be evaluated in regard to their record of helping startups grow into viable, sustainable businesses. A committee of experts consisting of investors, government officials, and founders should be entrusted with this task. Public venture capital programs should be adjusted and potentially expanded based on the findings.

2.5 Spaces for collaboration and networking

Space plays an important roll in the creation of startups. Founders require cheap, flexible office space in attractive locations. Flexibility is a must since startups can quickly grow or fail. Attractive business locations are also an important factor in regard to attracting top talent. Startups especially benefit from close proximity to each other during the developmental phase of the business. It allows them to share limited resources and expertise. On the open market startups must pay large fees and sign long term contracts in order to receive attractive office space. Even though collaborative offices spaces specifically designed for the

needs of startups have been created, demand far outweighs supply.

Policy Recommendation: German cities can improve their local startup ecosystem by enhancing the supply of startup friendly office space. This can be either done directly through specific programs such as the building of a so-called “founders campus” or indirectly through tax incentives for companies looking to build office space specifically designed for the needs of startups.

2.6 Advocates for the Digital Economy

Our law and regulatory framework were created, for the most part, during a time when the Internet did not yet exist or had little economic relevance. Modern digital business models often do not fit into these dated regulatory frameworks. This can lead to unnecessary conflicts with regulatory agencies and oversight bodies. Traditional industries often use these frameworks to defend their market position against disruptive, innovative competitors. This is problematic when the main purpose of these dated regulations is to protect out-dated business models against innovative competitors rather than to protect the public interest. In these cases, regulations harm innovation without serving a greater public good. Rather than letting dated regulations undermine innovation, there should be a thorough examination of the goals and purposes of these legal framework and whether they can be made compatible with digital business models.

Policy Recommendation: We need a government official designated to represent the

interests of the digital economy within government. Startups should reach out to this official when they experience that regulatory frameworks are being used to deny market entry rather than to serve public interests. The official and his staff will be responsible for investigating such cases and, if necessary, bring them to the attention of the relevant government bodies so that they can be resolved. The official will also generally represent the perspective of digital businesses in intra-government bodies and discussions. The representative for Mittlestand und Handwerk in the state government of Baden Württemberg could serve as a model for the creation of such a position within government.

2.7 Professional Education Opportunities

Rapid expansion often leads to personnel problems for startups. Developers and product designers quickly become team leaders and managers. The greater management responsibilities require skills that professionals with technical backgrounds often lack. There is a great need for the appropriate educational programs to prepare developers for the new management responsibilities. The standard management classes offered at business schools do not address the specific challenges faced by the technical development team. Here a look at Silicon Valley might be useful. Stanford University offers management courses, specifically designed for the needs of developers and product designers who work for rapidly growing tech-companies. These programs should be part of a life-long learning strategy that helps German startups to prepare their personnel for growth and internationalization.

Policy Recommendation: The ministries of education should promote the creation of programs similar to those found at Stanford. It is critical that the courses are specifically designed for the needs of a young technology based companies. Due to the international workforces typical for startups, the courses should be offered in English.

Part 3: Growth and Internationalization

We believe that startup politics has so far been too narrowly preoccupied with the creation of a business. Government policies should not only concentrate on the creation of new business but also on the creation of conditions that focus on long-term success. Especially for startups, growth and internationalization are strongly connected. Long-term, sustainable growth can only be achieved through international expansion. Therefore our policies need to emphasize the promotion of international growth potential.

3.1 Attracting international talent

Especially during the growth phase, German startups struggle to find enough qualified employees in the German job market. This leads to increased international recruiting efforts by German startups throughout Europe and the USA. However, language, cultural, and bureaucratic barriers make the move to Germany difficult. This is especially true for potential leaders who already have a family. They still see Germany as an unattractive country to emigrate to. Often this view is based on misperceptions. Nonetheless, this makes it more difficult for German

startups to compete against those based in Britain or the USA for top talent internationally.

Policy Recommendation: The German Government should make more efforts to advertise Germany as an attractive location for ICT startups. A strong presence at international conferences and trade shows would add to the utilization of already available resources such as make-it-in-germany.com. On the local level, cities and communities must offer better services for the families of top leadership personnel. This includes language courses, bilingual kindergarten and schools as well as English language government services. Additionally, offers made by startups such as the covering the cost of moving for the family should not count towards the employee's income tax.

3.2 European Data Protection Directive

For the data centric business models of many startups, the collection, processing, and transfer of data across international borders is essential. International standards for data protection would reduce costs and promote internationalization. The currently discussed data protection directive has the potential to achieve this, streamlining divergent national laws into a single European regulation. However, startups must also consider markets outside the EU. Thus ultimately we need international, if not global standards for data protection, processing, and transfer. Yet while streamlining data protection regulations within the EU is difficult enough, prospects to negotiate international or even global agreements are much slimmer. Thus we need the expansion

of “bridge-mechanisms” between the different data protection systems such as Binding Corporate Rules, Standard contract terms, and Safe Harbor. Additionally, in the wake of the current NSA debate, it is important that commercial data usage is not being held responsible for excessive government surveillance programs. It is important that this is seen not as a commercial but a political problem since governments force Internet service providers and other digital companies to cooperate with law enforcement and intelligence agencies. Limitations on international, commercial data processing is neither a productive nor an adequate political response to the NSA scandal.

Policy Recommendation: Government officials and politicians should promote the adoption of a EU data protection directive. A legal framework will also be required to regulate the exchange of data between the EU and third party nations. Bridge-mechanisms such as Safe Harbour, standard contract terms, and Binding Corporate Rules need to be strengthened and, in the long run, converted into international agreements.

3.3 European Integration & Transatlantic Trade and Investment

Language barriers and divergent regulatory standards make it difficult for German startups to expand into other European markets. The unitary European telecommunications market proposed by EU commissioner Neelie Kroes would, through the introduction of a uniform regulatory and legal framework, open up tremendous growth opportunities for German startups. There is

also need for reforms beyond the ICT market. The different legal systems make expansion of German startups into other EU markets difficult and costly. A uniform legal system across the EU for the creation of new businesses would be a great step forward. The scaling opportunities of a more uniform marketplace within the EU would also greatly increase the attractiveness of German startups for investors from outside of the EU. Finally, improved growth opportunities within the EU would better prepare German startups for entry into the US market. After all, the key to a strong international presence still lies in the American market and access to its consumers, capital, and technologies.

Policy Recommendation: The German government should promote the creation of a unified telecommunications market within the EU and push for further harmonization of regulatory standards and frameworks. Additionally, the negotiations on the transatlantic trade and investment pact (TTIP) should be seen as an opportunity for startups. It will be particularly important to reduce the barriers for American investment in the European technology sector and to increase European access to the American market.

Conclusion

Startups have become an important topic in discussions on economic policy. The potential for startups to drive innovation and growth is undeniable. Nonetheless there is a great divide between the current state of startup politics and the innovative ideas on how the German startup ecosystem can be

improved and what role government can play. We see this agenda as an opportunity to raise the level of debate on startup policies. It is particularly important to us that the success of startup politics is not simply measured by the number of new businesses created. The promotion of growth and inter-

nationalization need to become the focus in this debate. Our startup agenda should be seen as an invitation for a discussion among all relevant stakeholders about how we create a thriving ecosystem for startups and thus innovation and opportunities for the economy overall.

| About “Forum Digitale Agenda”

The Forum Digitale Agenda is a cross-sectoral coalition of thought-leaders from NGOs, companies, and academia based in Berlin that share a common interest in raising the quality of the debate in technology policy. Through original research, expert workshops, round-tables and public events, the FDA seeks to expand the scope of policy discussions at the intersection of technology, society, and economics. The unusual constellation of members unites a wide variety of experts into a forum of exchange and collaboration. The FDA includes German as well as international companies and organizations with operations in Germany. The Forum is governed by its members, and it is hosted and managed by the stiftung neue verantwortung. It brings together a combination of social enterprises, NGOs, IT start-ups, network owners, equipment makers, content and service providers. The mission of this group is to offer provocative ideas for change and to work with the German government throughout the process of deliberation, decision-making, and implementation.

Papers published by the FDA are the result of elaborate discussions and analyses of all members. The FDA might also consult external experts from various backgrounds. The group is committed to a multi-stakeholder approach. This leads to the inclusion of many different perspectives, which is also characteristic of political decision-making processes in government. Our goal is the development of policy ideas that are realistic and driven by the need for practical implementation.

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