The Impact of Regulation on the Tech Sector

Informing a regulatory environment which leads to a stronger tech ecosystem in Europe

Full report

Truth.

Executive Summary

The tech ecosystem in Europe has developed fast in the last decade, and will play a pivotal role in the future as we move to a knowledge-based economy.

Tech ecosystems take time to develop, but the benefits to the economy are substantial as new companies are spun out of existing ones, and the sector as a whole creates jobs and wealth.

However, investors see some reasons to be wary, as current signals from regulators are that policy decisions are being made (or considered) which put the long term health of the sector at risk. A particular concern is that regulation and taxes designed to target the biggest companies will have unintended consequences, damage startups and lead to more unequal outcomes.

Investors seek more engagement with the sector, and more awareness from government that to nurture the tech leaders of tomorrow, the needs of today's small tech businesses need to be taken into account when developing policy.

Methodology

This report is based on a detailed consultation with tech investors in the UK, France, Germany and Ireland in August and September 2018. 25 tech investors were interviewed in-depth, with coverage across all four markets. Additionally, 160 investors were surveyed via an online questionnaire.

- **INVESTOR TELEPHONE INTERVIEWS**

- Interviews conducted by Truth, a UK based research consultancy
- Mix of local & international investment
- Mix of stage of investment: early seed through later stages
- 25 interviews in total
  - 7 in the UK
  - 11 in France
  - 6 in Germany
  - 1 in Ireland

INVESTOR ONLINE SURVEY

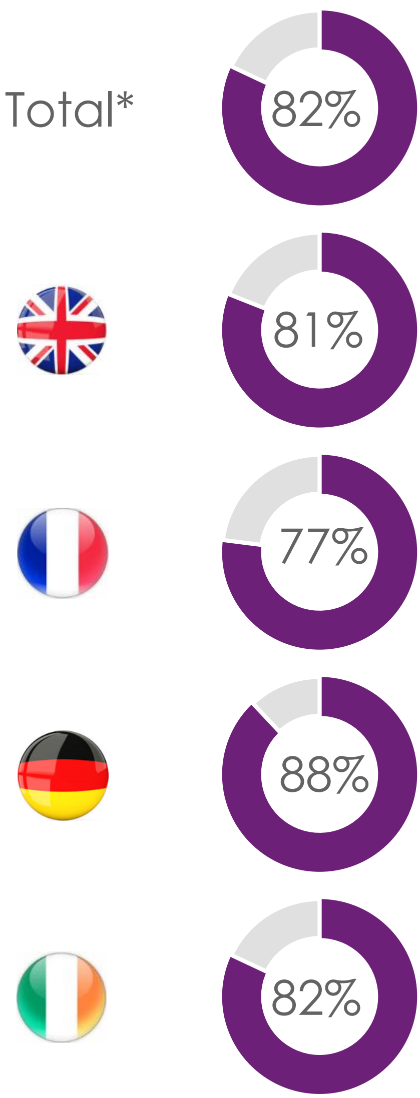
- Recruited from a specialist panel and then screened via telephone call
- Investors who qualify were sent a link to an online survey
- Criteria:
  - Invest in their local market
  - Mix of stage of investment: early seed through later stages
  - Average size of investment of over £1m, €1.2
- 160 interviews total
  - 78 in the UK
  - 31 in France
  - 34 in Germany
  - 17 in Ireland
- Please note data has not been weighted to account for differences in sample-size across markets

The EU tech ecosystem is significantly behind the US and China

The growth of the tech sector is of pivotal strategic importance, as we shift towards a knowledge-based economy. The Ecosystem in Europe is developing, but is significantly behind the US and China.

Agree with:

Government needs to demonstrate more innovative thinking to ensure the economy does not fall behind other tech centres



"At a broad European level it's clear that we have missed the last 20 years. It's almost a catastrophe. The US and China are tens of years ahead in developing their ecosystem."

French investor

"We need to invest heavily now to have winners. The FANGS and BATS invest more in R&D now than most countries, and not only are they building a huge competitive lead but building a moat around themselves. If we don't act now we will be beholden to the Americans and Chinese"

UK investor

"The future is shifting to a knowledge based economy so we have no choice but to tilt the economy this way"

UK investor

**FANG: Facebook, Amazon, Netflix, Google. BAT: Baidu, Alibaba Group, Tencent Holdings

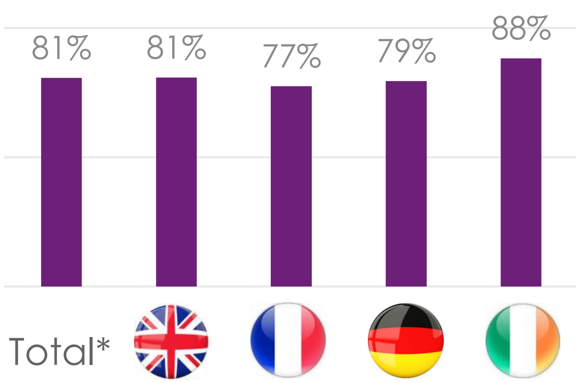
*Total (investors in all markets, no weighting) 160, UK 78, France 31, Germany 34, Ireland 17

Government can do more to support the long-term development of the sector

Currently, the tech sector in Europe is expanding fast, and investors in each market see reasons to be confident in the future. However, it's essential that regulators make decisions that encourage long-term growth and consider the development of the ecosystem as a whole.

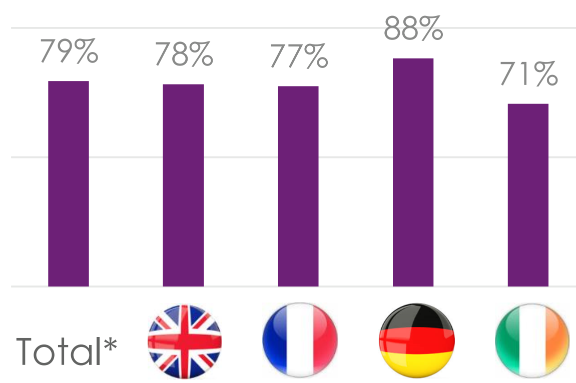
Agree with:

More could be done by government to create an environment where tech startups and scaleups can thrive



Agree with:

Government should adopt policy that creates a positive environment for all and incentivises investment in local startups/scaleups



Specifically, there are three main areas in which investors would like to see more support from policy makers.

1. Creating a proportionate and predictable regulatory environment
2. Helping tech businesses & investors access capital
3. Ensuring tech businesses have access to the talent they need

*Total (investors in all markets, no weighting) 160, UK 78, France 31, Germany 34, Ireland 17

There are concerns that the increased appetite for regulation will disadvantage EU markets vs. the US and China

Historically, the UK has a more liberal business environment, while France and Germany are more heavily regulated. However, recent signs that this is changing in the UK and a legacy of tighter regulation in France and Germany mean there are worries about the tone and direction of the current conversation around tech matters.

In particular, investors seek stability and consistency, and proportionate and predictable regulation which is built around a long-term strategy.

"I don't think it's well communicated what the ultimate strategic goal of policy is. I don't feel there's an integrated strategy that says how do we keep up as a modern economy that feels fair and is right for the modern age"

UK investor

"When it comes to tax and labour laws, you have a position that the next government thinks they can change over-night, and that generates a lot of uncertainty"

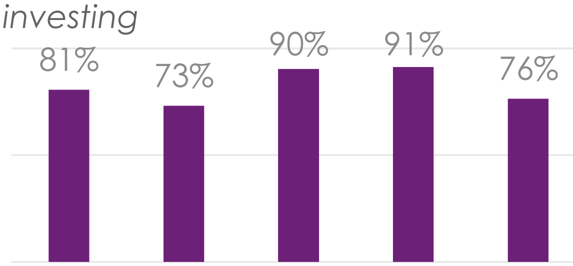
French investor

"Germany has always been a bit slower in their openness to tech and innovation, and policies reflect that by being deeply entrenched in the legal system, things are slow to change"

German investor

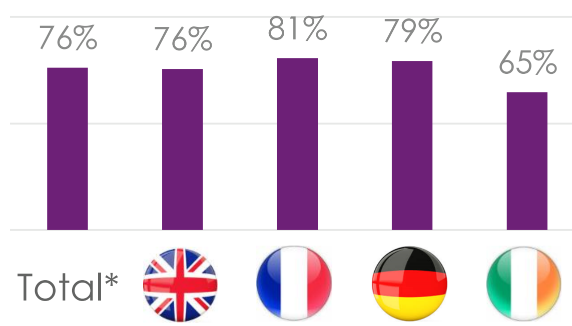
Agree with:

More stability in policy and regulation would create a better environment for investing



Agree with:

The overall direction of regulation affecting tech companies can be more reactive than strategic



 *Total (investors in all markets, no weighting) 160, UK 78, France 31, Germany 34, Ireland 17

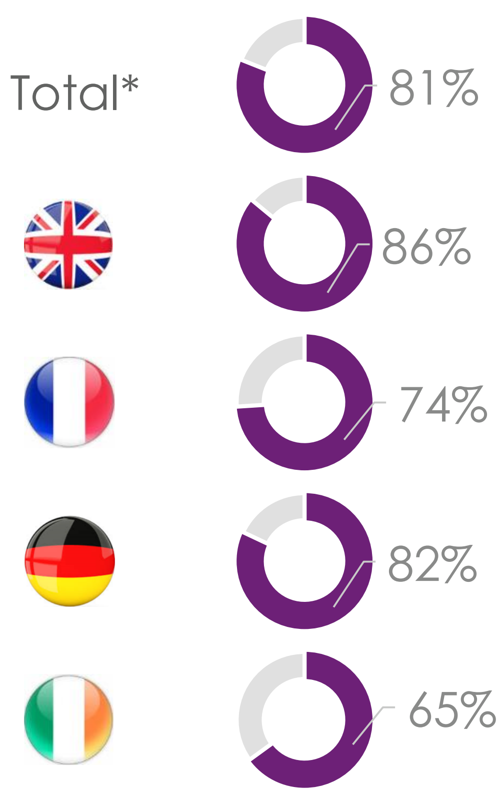
Specifically, there is concern that regulation designed to target big companies will affect the whole sector

This is thought to lead to poor outcomes and be damaging for startups.

"There is pattern in France which has always failed; they try to tax GAFA to prevent them from being more powerful. But the new regulation always has the same effect – it hits GAFA but much more it hits the smaller guys. It seriously damages the smaller guys and GAFA are broadly untouched, so it has the opposite effect of what we wanted. GAFA are now stronger, have less competition and can compete harder"
French investor

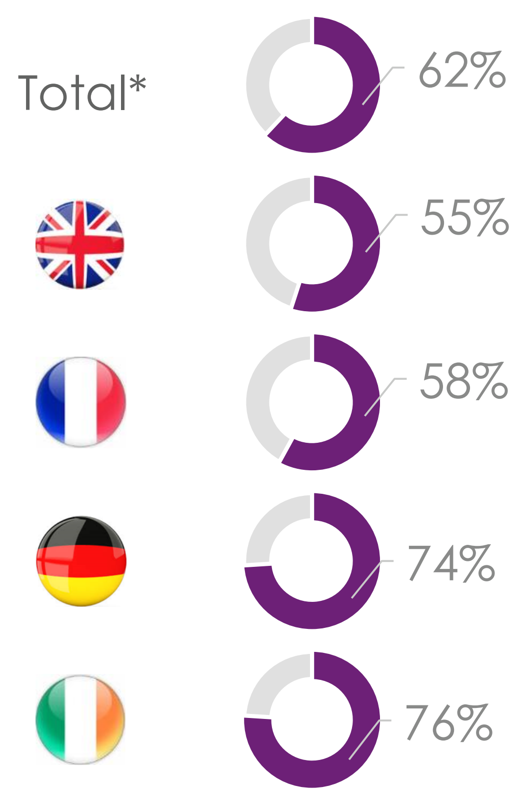
Agree with:

The principle of designing policy and/or legislation in order to target specific companies (i.e. global giants) could lead to poor outcomes that inadvertently hurt or hinder tech startups



Agree with:

Regulation can feel more arbitrary for tech businesses than traditional businesses



*Total (investors in all markets, no weighting) 160, UK 78, France 31, Germany 34, Ireland 17

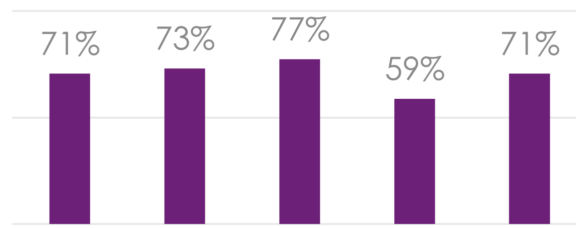
The proposed digital tax would have damaging consequences for the sector as a whole

The tax is seen as likely to be a significant burden on small businesses. Businesses on a growth trajectory seek to invest ahead of the curve and plough profits back into the business, so if money is diverted to taxation it would act as a brake on growth. Investors see four major impacts from a digital tax based on revenue:

1. It would affect the ability of companies to scale, as cash is taken in taxation that could be used for growth
2. It would affect the ability to hire talent
3. It would destroy the ability of smaller companies to compete, while the tech giants will easily be able to pay
4. It would need to force transparency from all companies, and it's hard to see how this might be achieved with the big multinationals

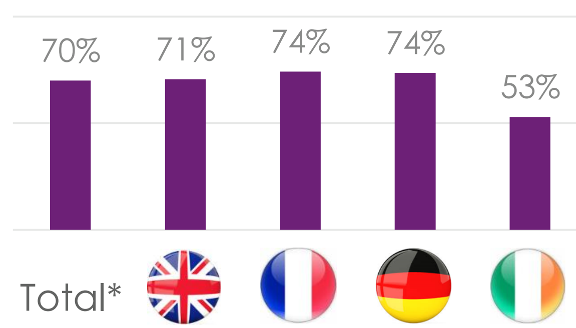
Agree with:

A digital tax on turnover could make it harder for startups and scaleups to succeed in [the UK/ France/ Germany/ Ireland] compared to other regions



Agree with:

A digital tax on turnover would drive tech entrepreneurs to set-up in other regions



*Total (investors in all markets, no weighting) 160, UK 78, France 31, Germany 34, Ireland 17

The proposed digital tax would have a particularly serious impact on smaller businesses

"If you do it to attack Amazon and it has an impact on small firms you're going to kill all the small firms and the tax will be insignificant for the large ones, so small firms will never emerge to challenge them"

French investor

"Tax systems need to be kept competitive because capital can easily move. So in the end this proposal could mean less innovation from European companies"

German investor

"You add this on revenues without any considerations for the cost for producing the good, its incomprehensible"

French investor

"This tax feels like it's written and designed in such a way that you're being penalised as a small enterprise because a large enterprise has large loopholes – and they'll probably be able to circumvent it in 6 months anyway"

UK investor

"This would be a poor attempt to harmonise tax systems in Europe, and in real European style – we would crush innovation for the sake of a "fairer" businesses environment, which in fact would not be fairer"

German investor

"The issue is that we need a consistent way to tax people at the European level. There are different tax systems in different countries, so we have ideas like this to compensate, but it's not the answer"

French investor

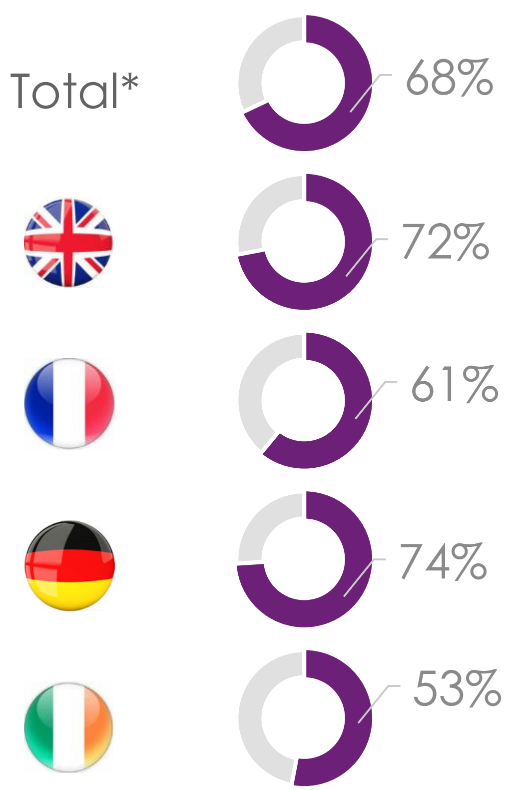
Self-regulation is seen to lead to increased innovation and better outcomes

Investors believe it's impossible for regulators to keep up with the pace of change in the tech sector, as innovators create new markets and business models.

Self-regulation is seen to offer flexibility to startups and enables innovation and growth.

Agree with:

Broadly, tech businesses of all sizes should be given the opportunity to self-regulate, rather than being subject to official regulation from the outset



"There is a feeling that the government is several years behind and doesn't have the expertise about how it all works. For people like us trying to invest in innovative companies we want things open to change and not fixed in place. We want to make it easier for new companies to come in"

UK investor

"Self-regulation and de-regulation offer flexibility, which is crucial. Young startups need flexibility to grow and thrive"

German investor

"The government should stay out of the free economy more, over-regulation – which is something we see in Germany – can kill the potential of a startup because it involves people in lengthy processes and legal structures that no one understands"

German investor

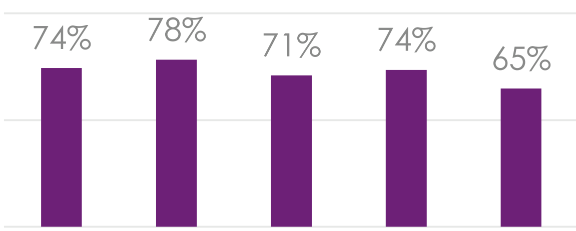
*Total (investors in all markets, no weighting) 160, UK 78, France 31, Germany 34, Ireland 17

Sudden changes in regulation must take into account the impact on the ecosystem as a whole

A particular concern is ending limitations to liability for online platforms. Making all businesses, regardless of their size, responsible for third party content would be extremely burdensome and create a material risk of failure for small platforms.

Agree with:

Making tech companies liable for specific online activity could be damaging for tech businesses of all sizes, but particularly so for startups and smaller companies

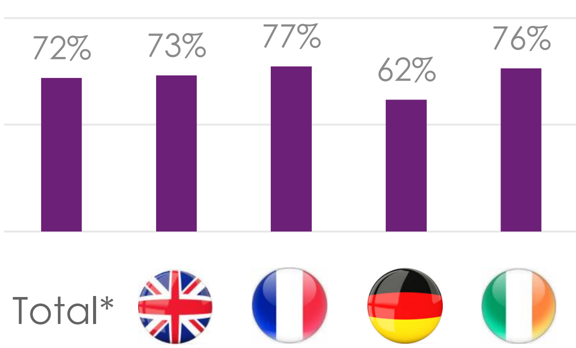


"My companies as of today don't prepare for liability. If they should there is a problem, if something comes up from the government saying you should set apart cash in order to stay within liabilities – for my companies this would be a big issue"

French investor

Agree with:

Placing liability on tech companies would be more burdensome for startups/ scaleups than the global giants, potentially allowing the giants to strengthen their dominance



"The big platforms have huge armies of people checking for compliance, so it would be a significant overhead if our companies need a lot of resource to focus on it"

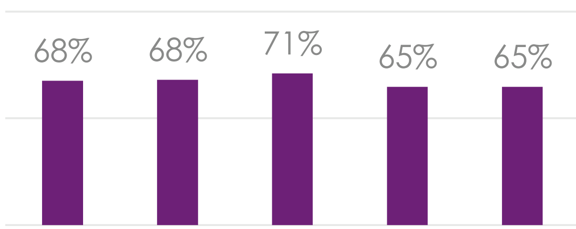
UK investor

*Total (investors in all markets, no weighting) 160, UK 78, France 31, Germany 34, Ireland 17

Government should consider the impact of legal changes to limitations to liability in more detail

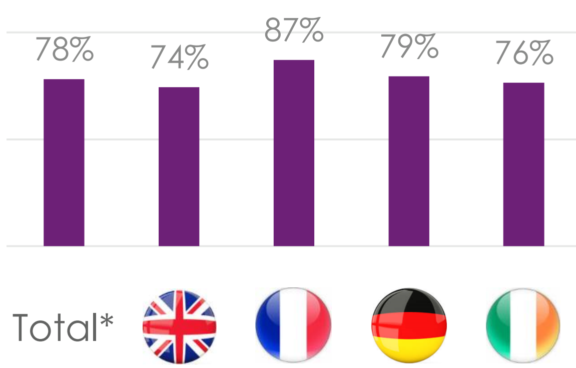
Agree with:

This change to liability could make us reassess whether to invest in local platform businesses



Agree with:

Government should consider in more detail how this legal change to liability could impact smaller tech businesses



"The risk to create a startup are extremely high in the beginning: founders often don't know all the risks and if you add high liabilities they will fail"

German investor

"The big companies we see now emerged because they reinvented communication. But the more you put in rules, the more limiting it becomes. In the end it will reinforce monopolies as it will create a new barrier of entry for any newcomer"

French investor

*Total (investors in all markets, no weighting) 160, UK 78, France 31, Germany 34, Ireland 17

As well as considering the regulatory environment, government should consider how to help investors and entrepreneurs access capital

For European scaleups to compete with their counterparts in the US and China, there is a need for easier access to funding. This is particularly the case in later series funding for ambitious companies, when significant capital is needed.

"There's not enough institutional money in risky businesses. There's a rise in PE and VC money, but it's but hard to raise institutional money even for the big businesses of the future"

UK investor

"Smaller businesses often struggle to scale up because the funding and the support system is not there, while they have built top notch technology. This is where we see a flawed eco-system: If there are barriers in the market that don't allow smart, talented people with a product that has lots of potential to scale up, then something is wrong."

German investor

"The EIF (European Investment Fund) are calling the shots as they're so important; but they put restrictions on general partners which is not positive for returns and doesn't make funds look good from a performance standpoint. We should be helping more large institutional investors to come in"

French investor

"The point where we drop the ball is scaleups – we need to find another solution rather than selling. This is the only option at the moment and it creates an element of frustration over the long term. Financing power is the issue. There's is already a lot of money available for early funding, but it's at saturation level and it's not always healthy as it's competing with the markets. What's needed is finance for later stages."

French investor

"One aim at the European level is to build more of an exit market – a good exit now is a float on the Nasdaq or an acquisition, but we should aim to do more in Europe, liquidity is poor"

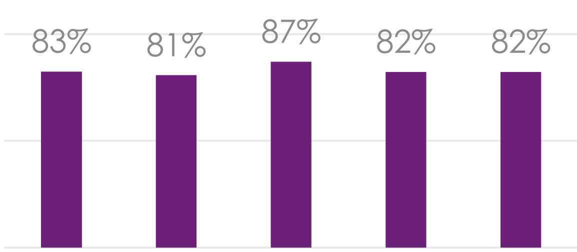
French investor

The labour market also plays an essential role in a developing ecosystem

Tech businesses need talent to thrive; and so seek a dynamic labour market where the best talent is free to enter, universities attract and educate the leaders of tomorrow and where they have labour flexibility.

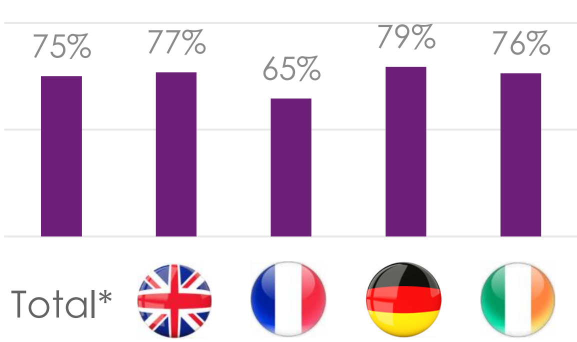
Agree with:

It's vital that the government invests in tech-related education and research & development to avoid negatively impacting the startup environment in [the UK/France/Germany/Ireland]



Agree with:

It's vital that immigration policies are designed to help the best talent set-up and join tech companies in [the UK/France/Germany/Ireland]



"We need to attract entrepreneurs and engineering talent and allow them to move frictionlessly – we need to be more creative than we are now"

UK investor

"There are not enough technical founders. It's a generalisation but most really great tech people have largely taught themselves. Its about the building blocks of coding – how you think about logic, not about teaching specific languages which will be out of date in a few years"

UK investor

"We still have work to do on labour law in France. It needs to be simpler to hire and fire. Also the tax costs of hiring senior people in France are so high that we think twice about putting them in France. We need to create a situation where for the first couple of years startups get reduced social taxes as it's very detrimental"

French investor

*Total (investors in all markets, no weighting) 160, UK 78, France 31, Germany 34, Ireland 17

Market overview: UK

This summary is based on a detailed consultation with tech investors in the UK. 7 investors were interviewed in-depth by telephone, and 78 answered an online survey sent to senior investors.

- Tech investors in the UK are facing a number of significant long-term challenges. Brexit threatens London's position as the EU tech hub, and recent signals from government that they're increasingly prepared to intervene through regulation risks damaging long-term growth.
- Investors would benefit from a more strategic approach to regulation; **81%** want to see more innovative thinking from government to ensure the UK does not fall behind other tech centres, and **81%** think more could be done by government to create an environment where tech startups and scaleups can thrive.
- Historically, the UK has offered a liberal business environment. However, investors are concerned by signs that this is changing in response to political pressures. **76%** agree that the overall direction of regulation affecting tech companies can be more reactive than strategic and **73%** believe that more stability in policy and regulation would create a better environment for investing,
- In particular, the appetite for government to regulate to target specific companies is seen as potentially damaging; **86%** agree that the principle of designing policy this way could lead to poor outcomes that inadvertently hurt tech startups.
- Investors see potential for unintended consequences from two proposals; first a digital tax based on revenue, second, making tech companies liable for content on their platforms.
- The proposed digital tax is seen as likely to be a significant burden on small businesses, and would be harmful for the long-term prospects of the local market. **73%** agree that a digital tax on turnover could make it harder for a startup / scaleup to succeed in the UK vs. other regions and **71%** agree that a digital tax on turnover would drive tech entrepreneurs to set-up in other regions
- Ending limitations to liability for online platforms is seen to have potential to lead to a more unequal market and less competition. **78%** agree that making tech companies liable for specific online activity could be damaging for tech businesses of all sizes, but particularly so for startups and smaller companies. **73%** agree that placing liability on tech companies would be more burdensome for startups / scal-ups than the global giants, potentially allowing the giants to strengthen their dominance. **74%** agree that government should consider in more detail how this legal change could impact smaller tech businesses

Market overview: France

This summary is based on a detailed consultation with tech investors in France. 11 investors were interviewed in-depth by telephone, and 31 answered an online survey sent to senior investors.

- The current administration is making the right signals in driving perceptions of France as a business-friendly environment. However, it's vital that these signals are translated into policy decisions which support long-term growth, as the regulatory environment is seen as challenging for startups and investors. **90%** agree that more stability in policy and regulation would create a better environment for investing.
- French investors seek a more strategic approach to regulation which considers long term growth rather than short term political goals; **77%** of investors want to see more innovative thinking from government to ensure France does not fall behind other tech centres, **77%** think more could be done by government to create an environment where tech startups and scaleups can thrive and **81%** agree that the overall direction of regulation affecting tech companies can be more reactive than strategic.
- In particular, the appetite for government to regulate to target specific companies is potentially damaging; **74%** agree that the principle of designing policy this way could lead to poor outcomes that inadvertently hurt tech startups.
- Investors see potential for unintended consequences from two proposals; first a digital tax based on revenue, second, making tech companies liable for content on their platforms.
- The proposed digital tax is seen as likely to be a significant burden on small businesses, and would be harmful for the long-term prospects of the local market. **77%** agree that a digital tax on turnover could make it harder for a startup / scaleup to succeed in France vs. other regions and **74%** agree that a digital tax on turnover would drive tech entrepreneurs to set-up in other regions
- Ending limitations to liability for online platforms is seen to have potential to lead to a more unequal market and less competition. **71%** agree that making tech companies liable for specific online activity could be damaging for tech businesses of all sizes, but particularly so for startups and smaller companies. **77%** agree that placing liability on tech companies would be more burdensome for startups / scal-ups than the global giants, potentially allowing the giants to strengthen their dominance. **87%** agree that government should consider in more detail how this legal change could impact smaller tech businesses

Market overview: Germany

This summary is based on a detailed consultation with tech investors in Germany. 6 investors were interviewed in-depth by telephone, and 34 answered an online survey sent to senior investors.

- The tech sector in Germany is in a growth phase and seen to have high potential, but it's critical that the government consider long-term growth when designing policy as the regulatory environment is seen as inflexible and overly interventionist. **79%** think more could be done by government to create an environment where tech startups and scaleups can thrive, **88%** want to see more innovative thinking from government to ensure Germany does not fall behind other tech centres, and **88%** think government should adopt policy that creates a positive environment for all and incentivises investment in local startups/scaleups.
- The regulatory environment is currently a barrier to the development of a local ecosystem, and investors would like a fairer and more stable regulatory environment. **91%** agree that more stability in policy and regulation would create a better environment for investing, and **79%** agree that the overall direction of regulation affecting tech companies can be more reactive than strategic.
- In particular, the appetite for government to regulate to target specific companies is potentially damaging; **82%** agree that the principle of designing policy this way could lead to poor outcomes that inadvertently hurt tech startups.
- Investors see potential for unintended consequences from two proposals; first a digital tax based on revenue, second, making tech companies liable for content on their platforms.
- The proposed digital tax is seen as likely to be a significant burden on small businesses, and would be harmful for the long-term prospects of the local market. **74%** agree that If regulation is designed to target tech giants from the US, China and elsewhere, smaller tech businesses could be damaged if they have to follow the same rules, and **74%** think that a digital tax on turnover would drive tech entrepreneurs to set-up in other regions
- Ending limitations to liability for online platforms is seen to have potential to lead to a more unequal market and less competition. **74%** agree that making tech companies liable for specific online activity could be damaging for tech businesses of all sizes, but particularly so for startups and smaller companies. **71%** think tech companies should have some responsibility for tackling illegal activity when they become aware of it but should not become legally liable for it and **79%** agree that government should consider in more detail how this legal change could impact smaller tech businesses