



Start-up Ecosystems on the Rise



Hauke Stars

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How an attractive framework and the acceptance of “failing fast” can foster innovation

Silicon Valley are the magic words in the ears of investors, start-ups, and incumbents. No other region in the world is better known for entrepreneurship and its very own spirit of innovation and scientific development. The San Francisco Bay Area has been the breeding ground for major tech companies such as Apple, Intel, and Google. Today, Silicon Valley is home to a large number of so-called unicorns – start-up companies with a value that has exceeded \$1 billion. Managers and employees of incumbents flock to California, hoping to share in the entrepreneurial spirit to trigger change within their companies.

New valleys around the globe

The vibrant flair created by a large number of fast-growing high-tech companies and innovative start-ups in one place is certainly inspiring. However, Silicon Valley also stands for economic growth and competitiveness. California’s rise has a long history that is due to different factors. Its proximity to the elite university Stanford plays a vital role as does a conducive economic, tax, and regulatory environment. The combination of these and other factors has contributed to the development of the world’s leading start-up ecosystem that attracts founders and investors alike. Therefore, it comes as no surprise that other locations are eager to create a similar environment to foster an entrepreneurial culture. Those international hubs are on their way to building healthy and growing start-up ecosystems, some of which are already quite advanced.

Comparing the ecosystems in Germany, Israel, the UK, and California

Within the European start-up scene, Germany is now playing an essential role and is attracting international attention. Its capital, Berlin, is always ranked among the top of the world's fastest-growing start-up ecosystems. If this pace continues, Berlin could soon easily become Europe's number one hub. The German start-up ecosystem is built on a stable infrastructure, comparatively affordable rent, governmental support, and a solid base of highly qualified workers. With some unicorns and a growing number of successful start-ups, Germany can compete with other international start-up locations such as Israel, the United Kingdom, and California.

However, a recent comparison of the economic, tax, and regulatory framework for founders and investors in those four locations, jointly undertaken by Deutsche Börse and EY, revealed that other ecosystems offer a more attractive environment for founders and investors. As an example, while 366 early-stage investments with a total volume of \$967 million U.S. dollars were made in Germany in 2016, during the same time 2,074 deals with a volume of \$13.2 billion U.S. dollars were executed in California as were 669 deals with a volume of \$2 billion U.S. dollars in the United Kingdom.

How can Germany's start-up ecosystem become even stronger? Together with EY, we have identified four recommendations for action that can help further develop Germany's start-up and investment culture:

1. More financing opportunities

Specialized funds, such as the Angel CoFund and the VC Catalyst Fund, are initiatives that have already been successfully implemented in the United Kingdom and encourage investments by business angels or venture capitalists in start-ups. This is also a way to strengthen the financing options in Germany. California has a strong investment landscape with a focus on Silicon Valley, which is supported, among other things, by the leading tech companies. In order to achieve a comparable attractiveness in Germany, a significant strengthening of the incentives for large tech companies is necessary to support investments in start-ups.

2. Attractive tax framework for start-ups and their investors

The comparatively high effective taxation rate in Germany as well as limited possibilities to deduct losses from failed investments are a considerable obstacle when potential investors decide on a location (especially in the case of capital gains taxation at the level of the investors). In contrast, the United Kingdom is regarded as a favorable tax location for founders and potential donors.

This is due, among other things, to the low income tax in the country and (especially at the level of the start-up itself) to the special tax arrangements for possible R&D costs. Israel also offers attractive tax conditions, such as the almost unlimited use of tax loss carryforward and tax relief for business angels. In addition, US-based investors are regularly able to collect capital gains tax efficiently after a successful investment.

Germany has to examine which of the tax measures in place in other countries it can implement in a similar form without violating (European) law. In recent years, Germany has made progress when it comes to a tax law that is conducive to the start-up climate by applying individual measures, measures which have to be maintained and expanded. The goal here is to make Germany more attractive from a fiscal perspective to company founders and potential investors.

3. Adjustment of capital requirements and reduction of bureaucracy

The high capital requirements for company foundings in Germany have a negative impact on the start-up ecosystem. In addition, the general start-up costs in Germany are the highest compared to the locations considered. A "one-stop shop" solution for company foundings is still missing in Germany. Complicated regulatory requirements and pre-costs for licensing in certain industries (such as the financial sector) often pose a serious obstacle to start-ups.

4. Stronger founding spirit

The start-up spirit in Germany is less pronounced than in California or Israel. The Californian founding spirit is based on the founder DNA of the population, which is closely linked to the roots of the IT evolution. Thomas Edison, who has been described as America's greatest inventor, is said to have once stated that he has not failed but has just found 10,000 ways that will not work. Compared to German culture, failure as well as the subsequent learning curve is an accepted part of the founding culture. "Fail fast" thereby becomes a winning formula.

In order to establish such a culture and promote the founding spirit in Germany, the focus in the education system has to be set properly. Above all, programs on innovation management and entrepreneurship at universities can have a very positive impact on the founder spirit. The seed for a distinctive start-up spirit is already laid at a young age. Preparing future generations of entrepreneurs through innovative education programs is one successful factor, which has already proved itself in some countries.

ENVIRONMENT	DIMENSION				
		GERMANY	ISRAEL	UNITED KINGDOM	CALIFORNIA
Commercial conditions	Funding and incentives	+	+	++	++
	Infrastructure	+	+	○	+
	Workforce	+	○	+	++
	Entrepreneurship	○	+	+	++
Tax environment	Treatment of losses	+	++	+	○
	Tax rates and special regimes	○	+	++	○
	Investor taxation	○	+	+	+
Regulatory landscape	Business incorporation	○	+	++	+
	Working environment	○	+	+	++
	Data protection	○	○	+	+

++ highly supportive + supportive ○ less supportive

Source: Deutsche Börse Group/EY:
 The economic, tax and regulatory attractiveness
 of start-up ecosystems. An analysis for Germany,
 Israel, the United Kingdom and California (USA).
 June 2017

Cooperation is key

Of course, there is no recipe for replicating Silicon Valley – and this should not be the aim. However, the points mentioned above can help to foster innovation within Germany and can be applicable to some extent in other countries and regions. A functioning start-up ecosystem creates jobs and generates wealth at an impressive pace, to say nothing of the rapid technological change. It is time for other places that have been lagging behind to catch up, as they will otherwise miss these tremendous opportunities. The reason why they are lagging behind is not because they lack the ideas or smart people to implement them. Rather, it is more the framework that is riddled with obstacles that block their path to success (or learning from failure). It is our call – companies, politicians, regulators, stock exchanges and the education system alike – to work closely together to prepare the foundation for an ecosystem for growth in Germany.■