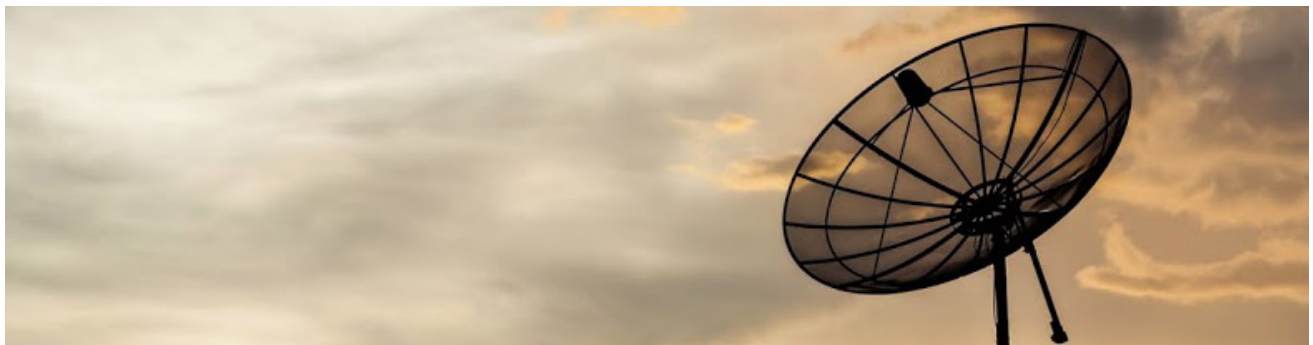




STRENGTHENING THE GLOBAL TRADE SYSTEM



Services SMEs in International Trade: Opportunities and Constraints

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ABSTRACT

Firms that engage in international trade are on average larger, more productive and more often foreign owned than firms that service the local economy only. Nevertheless, there are vast opportunities for services SMEs to engage in international trade.

It takes substantial scale to service international markets. But in the digital economy the additional cost of adding a new customer can be tiny and even start-up services firms can enter international markets – being born global. Music, films, computer software, computer games and the like are often produced for the global market by young SMEs. Most services markets rely on the physical world in addition to the digital economy, however. For these, services start-ups can leverage their reach through participation in international value chains.

An alternative way for services SMEs to participate in international trade is by franchises with multinational, often manufacturing firms. The franchisors provide a trade mark, know-how, and sometimes credit. SMEs may also engage in international trade by using foreign Internet platforms to connect with local customers to whom they deliver the service offline.

Although the opportunities are many, and it has been argued that the 21st century belongs to the micro multinational, the challenges and obstacles are also numerous. First, it is always more difficult for SMEs to absorb burdensome regulations and red-tape than larger firms. Second, staying power requires keeping abreast with rapidly changing technology and consumer tastes, which require significant human and financial resources.

Firms are born small, and a few are also born global. The vast majority of services firms that manage to survive in international markets grow rapidly to reach a sustainable scale. Some grow organically, some integrate into international networks and many are acquired by larger firms.

Policy should first and foremost remove unnecessary obstacles to entrepreneurship, and barriers to enter foreign markets. Reforms related to domestic regulation that would particularly benefit start-ups and SMEs are minimizing the burden of licensing requirements, and harmonizing with trading partners where possible; refrain from stigmatising going bankrupt; ensure competitive and well-functioning telecommunications and financial markets, including for venture capital; refrain from protecting incumbents against start-ups that use disruptive technologies; and protect intellectual property rights.

The most important trade policy measures would be to ease the flow of natural persons providing services across borders, remove barriers to establishing branches and representative offices; allow data to flow freely across borders; allow cross-border crowd funding; and make copyright and related rights suitable for the digital economy.

Government support for SMEs' services exports through explicit or implicit subsidies are not recommended. There is no evidence that such policies would improve welfare, stimulate employment generation or productivity, while there is some evidence that such policies would waste resources and become an obstacle to scaling up.

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LIST OF ABBREVIATIONS

CAD	computer-assisted design
CAM	computer-assisted manufacturing
EU	European Union
FDI	foreign direct investment
IT	information technology
R&D	research and development
SMEs	small and medium-sized enterprises
UK	United Kingdom
US	United States
USITC	United States International Trade Commission

A PORTRAIT OF SERVICES EXPORTERS

Services trading SMEs are few and far between ...

Firm-level studies consistently come up with the following stylised facts about exporters.¹

- Exporting firms are larger than non-exporting firms.
- Exporting firms are more productive than non-exporting firms.
- Exporting firms pay higher wages than non-exporting firms.
- Exporting firms are more often foreign owned than non-exporting firms.
- Smaller firms that engage in international trade are more likely to engage in cross-border trade than to establish a commercial presence abroad.
- Most exporting firms export only one product to one foreign market. The number of countries a firm exports to and the number of exported products increase with firm size.

These characteristics hold both for goods and services. Further, services have become an increasingly important source of revenue for manufacturing firms. For example, manufacturing firms account for about 35 percent of total services exports in Italy and 12 percent in the United Kingdom (UK). In France, 14 percent of exporters of business services are registered as manufacturing firms.

Firms that have their main business in services sectors, which include the majority, are more likely to export the larger they are. In Finland, in the mid-2000s, for example, the proportion of services firms that exported services was about 6 percent for firms with 1–9 employees, 18 percent in firms with 10–19 employees, 30 percent for firms with 50–249 employees, and almost 60 percent for firms with 250 and more employees.

Similar patterns are found in France, Ireland, and Slovenia, although the total share of exporters is much smaller in France, much larger in Slovenia, and slightly larger in Ireland. The share of exporting firms is nevertheless quite high in these examples compared to studies from the United States (US). The fact that intra-European Union (EU) trade is recorded as international trade is probably an important factor behind the difference. In France, for example, it is found that being located in a border area is an important

determinant of small and medium-sized enterprises (SMEs) exporting business services.

Unfortunately, similar information is not readily available from developing countries.

... but in absolute numbers there are many small and innovative services exporters

Hal Varian, the chief economist of Google, argued in an article in *Foreign Policy* in 2011 that the 21st century belongs to the micro multinational. And recent business literature abounds with stories about micro multinationals and firms born (or born again) global.²

Knowledge is a major source of competitiveness in the 21st century. Knowledge-intensive products can travel far and wide at negligible costs. Scale economies are less and less important at the production stage, and technology and demand patterns change rapidly. In this environment, small, flexible, and versatile organisations are the fittest, goes the argument.

How can the stylised facts about exporters be reconciled with the emergence of the micro multinational?

The explanation is that the stylised facts hold on average, but the average conceals an immense variety. A comprehensive database covering nearly all firms in New Zealand allows us to get a glimpse of the underlying variation (Table 1).³

Conforming to the stylised facts, only about 4 percent of all firms in New Zealand export, and less than 1 percent export services. Services exporters are indeed very much larger than non-exporting firms—firms that only export services are on average more than seven times larger than non-exporters. Nevertheless, at the time of the census, there were as many as 1,062 firms that exported services.

Moreover, the fact that the median of the 780 firms that only export services is 5.8 implies that there are 390 micro enterprises with less than six employees exporting services. A tiny portion, but they nevertheless constitute a significant number for interesting case studies. The size distribution of services exporters is likely to be similar in other countries.

1 The figures in this section are from different empirical studies based on firm-level data for individual countries: Breinlich and Criscuolo (2011); Federico and Tosti (2012); Haller et al. (2012); Crozet and Milet (2014). They are not necessarily comparable, but they do give an idea of the orders of magnitude.

2 Born global is often defined as reaching a share of foreign sales of at least 25 percent within no more than three years after the firm's foundation. The term born again global describes firms that have had their sales only in the local economy for many years, but then become global in a short period of time.

3 Most other firm-level databases exclude micro enterprises. Therefore, New Zealand is used as an illustration.

Further, a British study finds that the average size (and age) of firms in the digital economy is about the same as in the offline economy (Nathan et al. 2014).

Services exporters are on average large, productive, and foreign owned, but the average masks a large and diversified number of SME exporters, importers, and multinationals.

SMES TRADE SERVICES DIRECTLY AND INDIRECTLY

SMEs export services directly to foreign markets using digital platforms or other means; they export indirectly by providing services to local affiliates of multinational firms; or they sell to local exporters. SMEs also engage with foreign firms through franchise agreements and by using foreign platforms for conducting their business locally.

The direct route entails SMEs selling and delivering over the Internet ...

"It is harder to create a digital single market than a physical one."

– Andrus Ansip, EU Commissioner

Entrepreneurs in the 21st century have access to information and communications channels with a global reach at very little cost. In the virtual world, digital products may require talent, skills, and imagination to develop, but they can be duplicated and sold at very low marginal costs, or they could generate revenue from targeted advertising. In this setting, small firms can produce a niche product for global

consumption. High-technology start-ups in engineering, design, computer games, software applications, and other computer services are frequently found among the born global SMEs.⁴

The Internet also provides unprecedented opportunities for independent artists to reach a global audience. Indie music labels account for about a third of the market in the US. However, earning revenues from foreign consumption of such products can be complicated by that systems and procedures for licensing of copyrighted material and related royalties were made before the Internet came into being and leave a lot to be desired.

With the proliferation of broadband and, not least, high-quality, affordable recording equipment, low-budget and independent movies are making it into niche markets and a few have even become blockbusters. One of the early low-budget independent box-office successes was *The Full Monty*, a British movie that was made on a budget of US\$3.5 million in 1997 and grossed more than US\$250 million.

A more recent example is *Paranormal Activity*, which was made on a budget of just US\$15,000. It made it to the Sundance Film Festival in 2007 and became an instant success. The rights for the movie were bought by Paramount Pictures in 2009, the film was remade and launched in theatres, on DVD, and through streaming, and went on to earn close to US\$200 million (and counting).

The Internet is sometimes portrayed as a global market place that knows no borders, where entrepreneurs can find customers globally. This is, however, pretty far from reality. Selling to a global niche market does not often happen by itself.

Some of the frictions found offline persist online as well. Once a product (or link to it) is uploaded on a platform, portal, or virtual social network and its existence tweeted,

4 | Note that the System of National Accounts (SNA) considers such digital products as knowledge capturing products and not services; see section 6.22 in the SNA manual at <http://unstats.un.org/unsd/nationalaccount/docs/SNA2008.pdf>.

TABLE 1:

Number of Firms by Exporter Status and Number of Employees, New Zealand, Late 2000s

Source: Saravanaperumal and Charteris (2010).

Type of firm	Number	Average employment	Median employment
Non-exporters	143,760	6	2.6
Goods exporters	5,037	45.5	9.5
Services exporters	780	45.9	5.8
Goods and services exporters	282	724.1	44.8
Total	149,859	8.9	2.7

it may take a substantial amount of additional marketing, broadly defined, to attract the attention of the targeted market and to entice a click on the buy button. Next, having succeeded at selling a new product, one needs to communicate with customers.

These are areas where SMEs tend to be weak. Technology start-ups, in particular, tend to be staffed by engineers and other tech-savvy types, while marketers and business strategists are not common at the entry stage of firms.

This is not to say that SMEs cannot make a hit on social networks without extensive marketing efforts, but they tend to be the lucky few. The movie *Paranormal Activity* nicely illustrates these points. Making the film was done on a low budget with a small talented team and it went viral on social networks. But revenue-generating distribution and marketing requires scale and experience, which in this case were provided by an established studio.

... selling over the Internet and delivering offline ...

A recent study by the United States International Trade Commission (USITC) finds that only a third of online sales of digitally intensive firms' sales were delivered digitally in the US. SMEs accounted for 24.3 percent of total online sales, and 22.8 percent of online delivery. The share of sales delivered digitally is substantially higher for exports at 40.6 percent of online sales. The trade figure does not distinguish between large and small enterprises, but it is clear that SMEs account for a very small share of international online sales from the US. It is also interesting to observe that US online imports are less than half of exports and only 6.2 percent of it is delivered digitally.⁵ Since these figures are based on a survey, there is no information about the absolute numbers of SMEs engaged in digital trade and in which sectors.

Buying services online takes a critical amount of trust. Secure payment systems and Internet platforms and portals with trusted brands have enhanced consumers' confidence in buying online. For instance, small hotels located off the main tourist tracks would probably not be able to obtain bookings from adventurous foreign tourists if they were not marketed through trusted portals. Trust and secure payment services are also crucial for online sales of products that are delivered online.

... or through combining online and offline activities in multimodal trade

With the possible exception of digital products such as music, films, computer games, and e-books, online delivery alone is seldom seen. Cross-border mobility of people complements online sales and delivery in markets for knowledge-intensive products, particularly in business-to-business trade, which accounts for nearly three-fourths of services trade.

A commercial presence close to customers may be needed. SMEs typically prefer to establish themselves through

representative offices or branches rather than subsidiaries, which are a more complex endeavour.

Professional services and a host of other business services constitute a large part of the business-to-business market. Many of the occupations providing such services are licensed, and the number of occupations subject to licensing is rising. In the US, for instance, the share of the labour force working in licensed occupations is about a third, and in the EU, there are more than 800 regulated professions. Obtaining a license in multiple countries with different requirements can be a huge barrier for SMEs.

There is ample evidence that people's behaviour as consumers is still largely determined by their physical world. Friends, colleagues, and family shape which new products people are aware of and interested in trying. Simply put, people learn from each other and copy each other in the real world, which shapes their behaviour in the virtual world.⁶ Consumption of digital content, for instance, is largely a social activity where people like to share their experiences.

The Internet creates a channel for start-ups to reach global niche markets instantly. At the same time, consumers everywhere have access to the same content.

The digital market is characterised by superstars, alongside a tail of niche products.

SMES ALSO ENGAGE IN TRADE INDIRECTLY

By selling to local customers through franchises with foreign companies ...

Much of the services trade undertaken by manufacturers are services between affiliates, royalties, franchises, and advertising. SMEs are involved in this market largely through franchising of sales and after-sales services.

⁵ The shares are calculated by the USITC for 2012 on the basis of a comprehensive survey where 80 percent of the respondents were SMEs, defined as having more than ten but less than 500 employees. Digitally intensive industries are defined as publishing, motion pictures and sound recording, broadcasting, news syndicates, software publishing, data processing, hosting, web search portals, finance and insurance, machinery and equipment manufacturing, distribution, and selected business services.

⁶ See Bell (2014) for an interesting popular analysis of the relationship between the virtual and the physical world.

Franchisors typically enter into contracts with local services SMEs for marketing, distributing, selling, and repairing products. Examples are car dealerships operating under franchise arrangements with automobile manufacturers; gas/petrol stations featuring convenience stores and contracts with oil companies and retailers; pubs operating under franchise with breweries, and hairdressers and beauty salons working under franchises operated by manufacturers of skin- and hair-care products. Franchises are also common in services sectors such as fast food restaurants, management consulting, and real estate.

It should not be forgotten that franchising has triggered anti-trust concerns related to exclusive dealing, exclusive territories, product tying, and retail price maintenance to mention but a few. In other instances, there have been concerns about the rights of franchisees. Nevertheless, franchises are an important channel through which services SMEs can participate in international markets. It is a market-based solution to many of the entry barriers that services SMEs face, including access to supplier networks, marketing, finance, and know-how.

Data on employment and sales of franchises are not readily available, but franchises employed more than 8.5 million people in the US in 2014.

... selling to local customers using a foreign Internet platform ...

We have already seen that Internet platforms are an important channel for direct exports by SMEs. In addition, imports of services from such platforms are a new way for micro enterprises or self-employed services providers to connect with customers in their local market. Examples that have attracted a lot of media (and regulator) attention are passenger transport (for example, Uber and Lyft), accommodation (for example, Airbnb), and temporary or project work (for example, TaskRabbit). Internet platforms create market places where services are marketed, sold, and paid for online, but delivered offline by local services providers to local customers.

In principle, such platforms reduce search and transaction costs for both services suppliers and customers. However, the platforms are also gate-keepers in their own right, which may generate competition policy concerns.

... and trading through production networks

The most common way of internationalizing services SMEs is probably through international networks or value chains. SMEs follow their main customers abroad, as in the Vik-Sandvik case (see below). They also supply subsidiaries of multinational companies in their home country, which, in turn, either embody the services in their exports of goods, or make them suppliers to the regional or global operations of multinationals. Having succeeded in entering a global value chain, erstwhile small firms typically grow rapidly.

Services SMEs engage in cross-border trade over the Internet, often in combination with visits to customers and/or establishing a branch or a representative office close to major customers.

Networks of self-employed are growing rapidly in knowledge-intensive services.

International distribution and marketing require scale. SMEs attain scale through organic growth, using Internet platforms, or becoming part of an international production network.

THE MICRO MULTINATIONAL IS NOT LIKE OTHER MULTINATIONALS

As already noted, exporting firms are on an average larger than non-exporting firms, but firms engaging in foreign direct investment (FDI) are even bigger. Little systematic information is available on the patterns and determinants of FDI by services SMEs, possibly because of a paucity of examples. We therefore rely on anecdotal evidence.

Case 1: Vik-Sandvik; naval architecture

Vik-Sandvik was established as a naval architecture firm in 1975 in a small community in Norway. The region has a strong maritime tradition, featuring shipbuilding, shipping, fishing, and offshore oil and gas drilling and production. Vik-Sandvik began by servicing Norwegian ship owners with an international fleet built in shipyards all over the world. Over time it became a leading global ship design company with a commercial presence in nine countries, servicing the global shipping and shipbuilding market. Employment doubled from 200 in 2000 to 400 in 2008, when the firm was acquired by Wärtsilä, a large multinational energy and maritime company with a turnover of €4.8 billion and 17,700 employees in 70 countries in 2014. The former Vik-Sandvik has continued to expand in global markets under the Wärtsilä brand.

Case 2: Local Motors

Local Motors is a car manufacturer in the US that was established in 2007, specializing in custom-made offroad vehicles. According to its website, it is an international

community of enthusiasts, designers, engineers, fabricators, and experts. The company has 81 employees (up from 15 in 2010) and 49,900 community members who collaborate on 6,500 designs across 51 projects.⁷ It combines online and physical workspaces where people can share ideas about designs, develop the designs into projects, and have the cars built. The most recent projects use 3D printing for fabricating cars.

These two cases illustrate that scale is needed in servicing international markets, but there are several ways of attaining scale.

Vik-Sandvik started as an SME, internationalized through its main customers, entered foreign markets through a combination of cross-border trade (using computer-assisted design/computer-assisted manufacturing [CAD/CAM] technology), movement of people, and establishment of branches. Over time, the company grew organically and was eventually acquired by a large company. The same pattern has been observed in a number of industries. A Swedish success story in video games, Mojang, for instance, was established in 2009 by two founders, grew spectacularly, and was acquired by Microsoft in 2014.

Local Motors is an example of a new way of organizing production directly through the market rather than through firms. Production is organized around projects drawing on a network of freelancers and self-employed. These typically involve custom-made physical products where the design is the main output and fabrication may be outsourced—or automated, as with 3D printers.⁸

IS THERE A RATIONALE FOR POLICY INTERVENTION?

Is small beautiful or is it rather young and beautiful?

Firms are born small. Over time they grow organically, are acquired by bigger firms, or go out of business after a few years. However, some firms stay small and do not have ambitions to grow. These can be self-employed people and small family businesses that are content with providing a livelihood for the family. Another reason for staying small is that a firm gets by through servicing a loyal customer base, or a customer base that has few alternative suppliers. In this category, we find mom-and-pop retailers, particularly in developing countries, restaurants, hairdressers, construction firms, transport firms, and a host of other personal services

providers. These firms are unlikely to engage in international trade.

It is well known that SMEs account for a very large share of employment—in the range of 60 percent to more than 80 percent in the countries for which data are available. It is, however, a myth that SMEs are the most important net job creators. There is no evidence of a systematic relationship between firm size and growth after controlling for firm age. Young firms are the major job creators and innovators, while old SMEs almost by definition do not create a lot of jobs.

Are firms more productive because they export—or do they export because they are more productive?

Entering foreign markets is costly and entry costs are often independent of subsequent sales revenue. The larger the sales volume, therefore, the lower the average cost of entering and doing business in a foreign market. This explains why SMEs are much less likely to export or establish a commercial presence in foreign markets, and why exporting firms are more productive than non-exporters.

Supporting SMEs' exports may result in welfare losses if entry costs are duplicated by firms that cannot recover the costs through sales revenue. A justification for such support is that firms learn and become more productive through exporting, and that the support will pay off in the long run.

The evidence of a learning effect from exporting is mixed, however. Given that there is little evidence that supporting SMEs to enter export markets have positive employment and welfare effects, a better idea would be to reduce the policy-induced costs of entering markets, thereby making life easier for entrepreneurs.

For example, costly and onerous processes to register, obtain the necessary permits, and comply with regulation curb entrepreneurship. Such regulations may also be a disincentive for self-employed and small family businesses to enter the formal economy.

Likewise, some taxes and labour market regulations may kick in at certain size thresholds. In France, for instance, there is a threshold of 50 employees for a number of labour market regulations. It is probably no coincidence that there are 2.4 times more companies with 49 than 50 employees. India also famously has a host of labour market regulations and thresholds for taxation that are widely believed to have kept formal employment at no more than 10 percent of the total labour force. Most enterprises have fewer than 100 employees,

7 See <https://localmotors.com/>, and Mettler and Williams (2011).

8 The Makers' Movement is a loose network built on similar ideas. Designs are developed and shared on the Internet and the product is made by individuals or micro enterprises either for their own use or as a basis for an artisan business. In the latter case, the project is typically crowd-funded.

a critical threshold, and take other legal forms than heavily regulated companies.

Scaling up involves uncertainties and risks. Investment in machinery, equipment, and research and development (R&D) may or may not pay off. Sales revenue may or may not cover the salaries of new employees. Entry to foreign markets may or may not succeed. Inflexible labour markets, therefore, discourage risk taking, particularly in R&D-intensive sectors. By the same token, bankruptcy regimes that severely punish entrepreneurs that fail discourage risk taking and, by implication, exports. Finally, poorly developed financial markets can create difficulties for SMEs to finance risky activities such as entering export markets.⁹

Entering export markets is costly. Policies should aim at lowering entry barriers and removing obstacles to scaling up and cross-border networking.

POLICY RECOMMENDATIONS

Policy intervention improves welfare when markets fail to deliver the best social outcome, the market failure is well defined, the policy measures are well targeted, and the gains from the intervention are higher than the costs of funding and administering it.

Support for enhancing the participation of services SMEs in international trade typically relies on the argument that they are important for employment, that exports are good for productivity, and therefore SMEs should be encouraged to export, often without a clear idea of the market failure that governments seek to correct.

What the policy recommendations below have in common is that they mitigate entry barriers for entrepreneurs in local and foreign markets. Such reforms are likely to enhance efficiency throughout the economy and enable firms to adjust to changing markets and technology. Further, burdensome regulations affect SMEs more than large firms, and they would be the main beneficiaries of regulatory reforms.

Policies that directly target SMEs and their entry to foreign markets, on the other hand, should be limited to providing information about foreign markets through, for instance, embassies, export promotion agencies, and dedicated websites. Procedures related to export credits, when available, should not be more burdensome than necessary to ensure that the recipients comply with the conditions for obtaining credit.

- Restrictions on establishing foreign branches and representative offices should be minimized. Establishing a subsidiary abroad involves committing substantial resources to that country over a considerable period of time. Establishing a branch or a representative office is a lower threshold entry point for SMEs. However, many countries do not allow foreign branches or impose discriminatory conditions on them.
- Governments should ensure open and competitive markets in financial services and telecommunications. SMEs rely on the Internet for cross-border export of services and they need financing to enter new markets. Importantly, regulation of international financial transactions, including crowd-funding, should not effectively cut off transfers to entrepreneurs in developing countries.
- Lengthy and costly visa procedures and restrictions on residency and work permits for medium-term stays should be minimized. Knowledge is one of the most important assets of successful international SMEs. Further, a distributed network of collaborating high-skilled entrepreneurs often forms the business model in the digital economy. However, face-to-face interactions over shorter or longer periods to share tacit knowledge are also needed.
- Governments should not protect incumbents against innovative newcomers. The proliferation of Internet-based platforms linking micro enterprises to customers has disrupted existing business models. Government should address genuine safety and anti-trust concerns through enforcing general laws and regulations.
- Data should be allowed to flow across international borders. The Internet is essential for the internationalization of SMEs. Their information technology (IT) costs can be reduced substantially by using cloud services. Protecting privacy is a genuine concern, but the definition of privacy and the means of protecting it should be carefully considered.
- Intellectual property rights should be adequately protected. The asset in a franchising arrangement is the brand of the franchisor. Lack of adequate intellectual property protection significantly reduces the attractiveness of a market for franchise agreements. Nevertheless, intellectual property rights should be defined sensibly, and strike the right balance that rewards innovation rather than rent-seeking.
- Better ways of enforcing copyrights in the digital economy are needed. For media, music, film, computer games, software, and other digital content the transactions involved are the right to use/listen to/view a copyrighted

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See Bravo-Biosca et al. (2013) for a firm-level analysis of the dynamics of business growth.

product, and not a transfer of ownership. Licensing and the collection and distribution of royalties and license fees are often not adapted to a borderless digital economy. The need for licensing should be revisited and the licensing requirements and procedures should be reassessed. Obtaining a license in multiple countries with different requirements can be a huge barrier for SMEs.

- Going bankrupt is not a crime. Entrepreneurship as well as internationalization is a risky endeavour, with a considerable probability of failure. Severe punishment for going bankrupt discourages entrepreneurship and internationalization of SMEs.

Finally, it is always more difficult for SMEs to absorb burdensome regulations and administrative procedures than for large companies. But easing the burden through exemptions and financial incentives targeting SMES may discourage scaling up. Therefore, governments should keep it as simple as possible for all.

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