

# STI

SCIENCE TECHNOLOGY INDUSTRY

## REGULATORY REFORM FOR SMALLER FIRMS



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# **REGULATORY REFORM FOR SMALLER FIRMS**

**ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT**

## **ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT**

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## FOREWORD

Fostering a regulatory environment which is conducive to the establishment and performance of small and medium-sized enterprises (SMEs) is a high policy priority in OECD countries. Regulatory reform for smaller firms should seek to correct market failures and distortions in order to promote better market functioning (*e.g.* competition, financing), reduce regulatory burdens on enterprises, and achieve public policy goals (*e.g.* environment, safety and health) in the most efficient way possible. This report reviews the effects of selected types of regulations on SME performance in OECD countries and provides insights for regulatory reform and best practice regulatory policies for smaller firms.

The report summarises the results of the activity on “Regulatory Reform and SMEs” carried out by the OECD Industry Committee from 1997 to 1999. OECD countries which provided valuable information on their regulatory environments include the Czech Republic, Hungary, Japan, Korea, New Zealand, Spain, Turkey and the United Kingdom; the United States and the European Union also provided relevant information. Analytical work for this project was carried out by Helgard Wienert, Shigeaki Koga and Akira Masunaga of the OECD Secretariat.

While the report does not include the extensive country information collected and analysed in this activity, it reflects the basic findings; further, the more detailed material will be utilised in other activities of the Industry Committee. In particular, this work will contribute to the OECD horizontal programme on regulatory reform and to the work programme of the Industry Committee Working Party on Small and Medium-sized Enterprises.

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## INTRODUCTION

In most advanced countries, economic growth largely depends on growth in productivity of which a significant determinant is the competitive process in industry, *i.e.* the entry and exit of firms. As small and medium-sized enterprises (SMEs) account for a large share of entrants and exits, they are an integral part of the process that determines aggregate productivity growth and innovation.

The important role that SMEs play in OECD economies is illustrated by the fact that they constitute over 95% of enterprises and account for 60 to 70% of jobs in most OECD countries. They likewise account for a disproportionately large share of new jobs: in a number of countries, the highest net job creation rates are among very small firms. In addition, their contribution to innovation and to high-technology employment is significant.

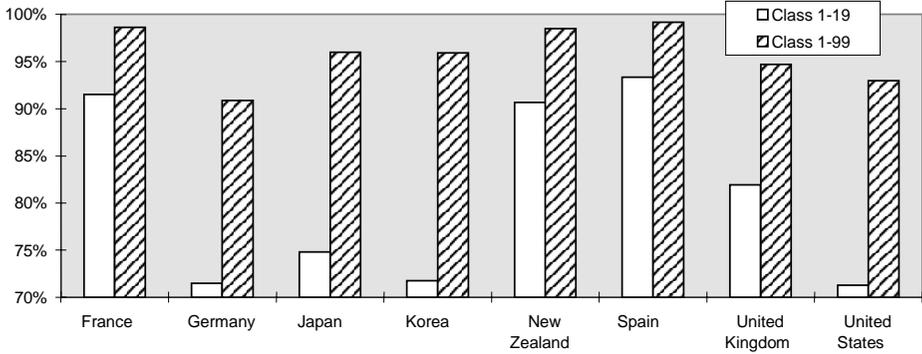
At the same time, less than one-half of SME start-ups survive for more than five years, and only a fraction develop into the high-growth firms that make important contributions to productivity growth and job creation. Furthermore, SMEs traditionally focus on domestic markets. As of the mid-1990s, it is estimated that SMEs contributed between 25 and 35% of world manufactured direct exports, with some 25% of manufacturing SMEs deemed internationally competitive.

In an increasingly integrated world, SMEs need to be more active in the global marketplace to maintain their job and wealth creation capability. To do so, not only must impediments to market access be removed, but the means should be available by which SMEs can upgrade output quality, cost competitiveness and management practices so that they can adapt to the pressures of globalisation.

Promoting a regulatory environment conducive to the development of smaller firms is a major consideration for growth policies. This should be a central feature of regulatory reform efforts, which must seek a balance in alleviating the regulatory burden on smaller firms while achieving valid policy objectives. Regulations which directly or indirectly discourage the creation and expansion of smaller enterprises and innovative start-ups that are important for growth and employment need to be modified and reformed.

**SMEs SHARE IN TOTAL NUMBER OF FIRMS (mid-1990s, manufacturing)**

Share of firms with less than 20 and less than 100 employees



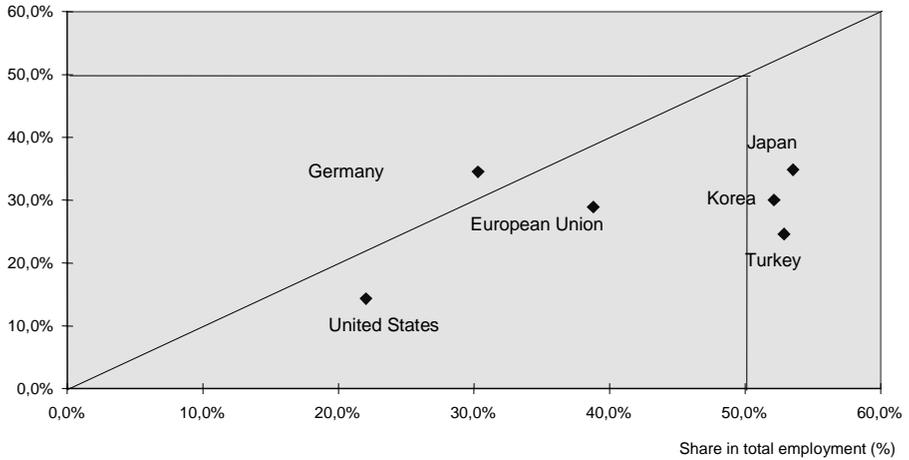
France and Spain refer to the total business sector

Source : OECD database on SME statistics 1998, Eurostat *Enterprises in Europe* 1996.

**SMEs Share in Total Employment & Output (mid-1990s, manu)**

Share of firms with less than 100 employees

Share in total output (%)



Source : OECD database on SME statistics 1998, Eurostat *Enterprises in Europe* 1996

## OVERVIEW OF REGULATORY REFORM

The regulatory regimes of OECD Member countries contain a number of instruments which have direct discriminatory effects on SMEs, as well as those which have indirect impacts. The latter often stem from regulatory systems developed in the image of large firms, rewarding economies of scale and stability rather than flexibility. More generally, SMEs often bear a disproportionate burden in complying with many types of regulations, and the cumulative pressure of regulatory requirements can lead to business failure, in part due to their limited ability to underwrite the fixed costs of compliance.

Since SMEs have a distinct role in economic growth, provide a large share of gross and net new jobs, make an important contribution to innovation and play a major economic role in rural areas, adverse impacts of regulation on smaller firms can be particularly harmful. SMEs identify high compliance costs, extensive and complicated paperwork, and economic regulations that prohibit certain activities as the most onerous burdens they face. Smaller firms have less capacity to absorb unproductive expenditures because they have less available capital than do larger companies. They also have fewer managerial resources to devote to paperwork.

Many countries have sought to lessen the regulatory burden on SMEs through the use of specific schemes and programmes. These have aimed to reduce paperwork and bureaucracy, minimise administrative burdens, streamline procedures and reduce compliance costs for SMEs. Some governments, when vetting new regulations, implement measures to ensure that they do not have disproportionate or unjustified effects on smaller enterprises. Centralised centres or *one-stop shops* have been set up, allowing small businesses to acquire information about all relevant administrative regulations and carry out many administrative formalities. To this end, a growing number of governments now disseminate regulatory information and forms for registration, taxation and other regulatory purposes to firms via electronic networks, including interactive Web sites.

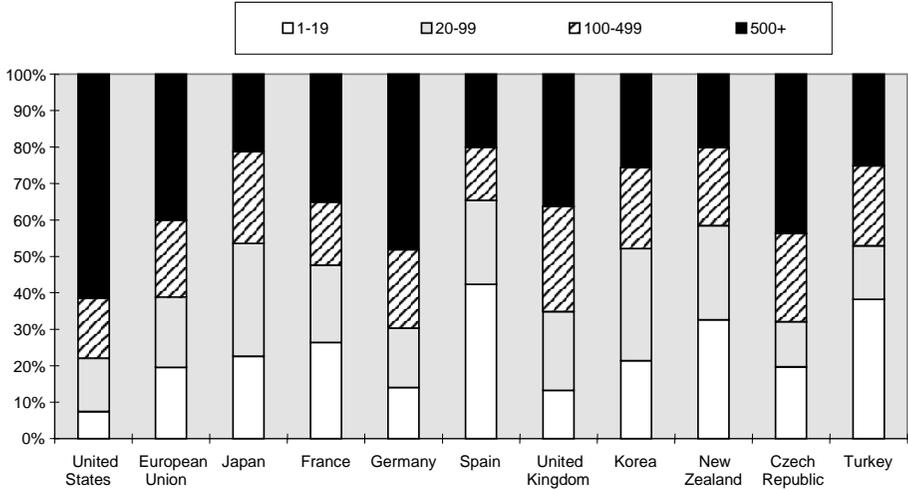
For example, the European Union has taken a number of steps – both direct (in the areas defined by the EU Treaty) and indirect (aiming at a convergence of practice in regulation affecting the competitiveness of the European economies) – to improve the regulatory environment for small firms. Within the framework of the Single Market, a strong accent is placed on removing, simplifying and standardising legislation in many areas of regulation, which has led to a number of instruments for promoting reform in accordance with SME requirements.

In addition, the EU Programme for SMEs has simplified and improved the business environment for small firms and facilitated start-ups. This was reinforced by the adoption in April 1999 of the Business Environment Simplification Task Force (BEST) Action Plan. It is likely that, in the framework of the next EU Multiannual Programme for Enterprise and Entrepreneurship, which will cover the period 2001-2006, further reforms will be made in the regulatory conditions for smaller firms. Such programmes have implications not only for EU member countries, but also for candidate countries in Central and Eastern Europe.

Broad reforms in regulatory regimes have an important effect on the ability of the SME sector to be competitive. The general regulatory reform programmes now being implemented in many OECD countries should be a boost to smaller firms. However, it is difficult to formulate cross-cutting recommendations concerning reforms of most value to SMEs due to differences in the economic and social climate affecting smaller firms in OECD countries. The regulatory environment for SMEs, and responses to regulations, tend to differ according to the level of economic development (*e.g.* some transition economies may need re-regulation after steps to deregulate) and differences in industrial structure (*e.g.* different regulatory approaches may be needed for service *vs.* manufacturing sector SMEs). Nevertheless, there is a need for greater efforts by governments to alleviate the cumulative regulatory burden on small firms and to enact reforms in specific areas that impede small firms from realising their economic potential.

### SMEs SHARE IN MANUFACTURING EMPLOYMENT (mid-1990s)

Percentage of each size class in total employment

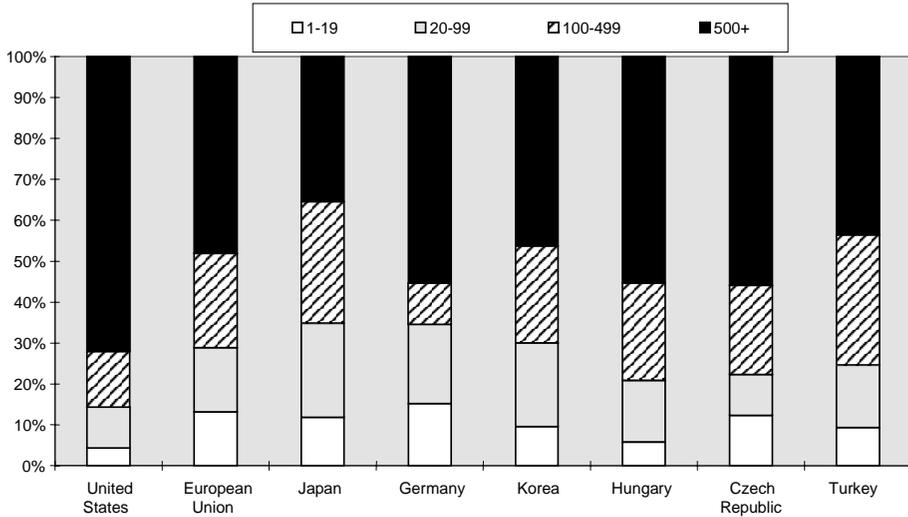


Number engaged except for France where data relates to employees.

Source : OECD database on SME statistics 1998, Eurostat *Enterprises in Europe* 1996.

### SMEs SHARE IN MANUFACTURING OUTPUT (mid-1990s)

Percentage of each size class in total output



Size classes are different for Hungary (0-9, 10-99, 100-499, 500 & more) and the Czech Republic (0-24, 25-99, 100-499, 500 & more).

Source : OECD database on SME statistics 1998, Eurostat *Enterprises in Europe* 1996.

## **Regulatory reform for smaller firms**

Despite important variations across countries, the following are general recommendations for regulatory reform to improve the environment for SMEs:

- ◆ *The regulatory reform process should be based on an explicit understanding of the overall economic importance of the SME sector.*
- ◆ *Regulatory policy should be forward-looking, part of a broader strategy to foster a large and healthy community of SMEs, and needs to be considered in the context of structural reforms which include other factors such as taxation.*
- ◆ *Regulatory reform for SMEs should not take a “good or bad” regulation approach but a “better” regulation approach in all policy areas.*
- ◆ *Regulations should ensure an economic structure within which SMEs, and in particular micro-enterprises, are given a fair opportunity to compete.*
- ◆ *Mechanisms should be established to ensure that SME concerns are considered and debated in the regulatory process.*
- ◆ *Attention should be given to the cumulative effects of regulations on SMEs, particularly micro-enterprises, for both regulatory and economic reasons.*
- ◆ *Special attention should be given to regulations that affect flexibility for entrepreneurial activities, which is a major SME advantage.*
- ◆ *All types of SMEs, including those which are not technology-based, innovative or high-growth, should be considered when vetting regulations and reviewing regulatory effects.*

## SPECIFIC POLICY AREAS

### Finance and access to capital

Regulations affecting the availability of capital may significantly affect the performance of SMEs. Smaller firms tend to rely primarily on self-financing from profits or from the personal resources of owners, and thus face severe capital constraints. Regulations can affect the attractiveness of starting and operating an entrepreneurial venture as well as influence the amount of investment available for financing. Regulations may determine the types of financial instruments developed to finance new enterprises. There are also important non-regulatory aspects of finance, particularly taxation, which may need to be taken into account. In many OECD countries, regulations may unnecessarily hamper the ability of SMEs to finance start-up or expansion as well as operating costs or to undertake short- and long-term investments.

The provision of *venture capital* is crucial to small start-ups, particularly to technology-based SMEs which may lack the collateral necessary to obtain bank loans. The most important regulations affecting the development of venture capital or private equity markets are government rules concerning the type of investor eligible to fund venture capital funds and firms. Some countries block or discourage pension funds, insurance companies and other institutions from venture capital investments. The logic behind these restrictions is that investing in venture capital is too risky for certain classes of investors. Some countries also have rules regarding the liabilities of parties to investment partnerships which can discourage institutional investing in venture capital funds. While intended as a safeguard against default, these restrictions limit the supply of venture capital funding for SMEs.

Many countries are currently reviewing the regulations that govern the types of investors permitted to invest in private equity and are considering a loosening of restrictions. Some are taking steps to differentiate between the reporting and disclosure obligations of investment companies by type of investor. In general, accounting and disclosure requirements for obtaining finance can be

problematic. They are burdensome for small firms, while financial institutions are often hindered by the lack of standardisation of accounting practices and the lack of transparency in the financial situation of SMEs. Governments should seek an appropriate balance between the interests of investors and those of smaller firms seeking finance.

### **Venture capital regulations and SMEs**

In the *Czech Republic*, lack of trust in SMEs on the part of institutional investors is the reason given as to why they receive limited investments, while venture capital businesses also prefer to avoid the risks associated with investing in smaller firms.

In *Hungary*, almost no capital is available from institutional or individual investors, and equity investment from venture capital firms is supplied primarily to medium-sized enterprises.

In *Japan*, strict regulations governing portfolio investment of pension funds are now being lifted, and rules regarding liabilities of partners in investment partnerships, that discourage institutional investors from seeking opportunities in venture and/or smaller businesses, are being modified.

In *Korea*, venture capital firms, while having limited capital, must meet strict requirements for registration, reporting yearly statements of accounts and achieving a specified level of investment.

In *Spain*, a new regulation concerning risk capital which came into force in April 1999 has given the venture capital sector a stable legal framework that is expected to enhance SME investing.

The *United Kingdom* reports that investment from institutional investors is constrained due to lack of access to pension fund capital in the European Union. The government is working to increase the flow of SME investment capital by improving co-ordination and co-operation through *business angel networks*.

In the case of the *United States*, the greatest problem is obtaining equity capital in the range of USD 250 000 to USD 3 million. Most venture capital firms prefer to make investments larger than USD 3 million, while most entrepreneurs are unable to obtain more than USD 250 000 from self-financing, friends and family.

Undeveloped *stock markets* in many countries, particularly secondary markets for smaller firms, prevent these from being a major source of SME financing. Often, the regulations governing registration and listing on stock markets are too costly and complicated or simply inappropriate for smaller firms. The rules and standards for stock market listing may specify a minimum firm size or age, a certain level of profits or other enterprise characteristics which are impossible for most SMEs to comply with.

The major reason why relatively few new or established businesses go public to finance their growth is that securities laws make the process complex, time consuming and expensive. For example, in Korea, an SME must have a minimum of: *a*) three years' business experience; *b*) 300 million won in capital stock and 5 billion won in equity (USD 212 000 and USD 3.5 million, respectively); *c*) average sales of 15 billion won over the past three years (USD 10.6 million); and *d*) a three-year record of net profits. Since the financial crisis, considerable steps have been taken in Korea to facilitate access for smaller firms to the stock market, in particular the KOSDAQ, which like NASDAQ in the United States, is directed to technology-based firms.

In general, to enhance financing for smaller firms, reforms to stock market regulations are needed in the way of relaxation of qualification standards for registration, simplification of registration procedures as well as new methods for pricing stocks.

## **Stock market regulations and SMEs**

In *Korea*, it takes on average ten years before an SME “makes it” to the KOSDAQ, the Korean version of the NASDAQ, due to arduous registration and listing procedures.

In *Japan*, reforms with respect to capital suppliers (*e.g.* pension funds and partnerships), stock market regulations and qualification rules/standards, and procedures of the Security Dealers Association for listing/registration in stock markets are being implemented. These include relaxation of qualification standards for registration in the over-the-counter (OTC) market, simplification of registration procedures, and the introduction of new methods of pricing OTC stocks.

In *Turkey*, only medium-sized and large companies can benefit from the stock market since the registration and listing procedures are said to be too costly and complicated for small firms.

In the *United Kingdom*, the procedures for securing a listing on the stock market are demanding and costly, making official listing prohibitively expensive for smaller firms; for unlisted SMEs, access to equity finance is restricted. For example, the production of a prospectus is characterised by unnecessary and overly burdensome requirements.

In the *United States*, recent changes in US law are advantageous to small firms. For instance, under federal securities law, companies that seek to raise less than USD 1 million within 12 months are excused from registration requirements. Most states also offer various exemptions for offerings of USD 1 million or less. In addition, a method known as SCOR (small company offering registration) can be used by entrepreneurs seeking capital of less than USD 1 million through public sale of stock.

The *banking sector* is a major source of financing for SMEs. In many countries, SMEs are made overly dependent on bank financing due to inadequate venture capital resources and inaccessible stock markets. The nature and degree of regulation in the financial sector as a whole can influence the lending practices of banks. Lack of competition between banks and other investment sources may lead to a failure of banks to adequately fulfil the financial requirements of small firms or to address SME needs. Banks may lack the capacity to evaluate the longer-term potential of small businesses or to assess the value of their intangible assets. They may require traditional collateral as the basis for loans, such as real estate or other tangible assets which SMEs frequently do not possess. Banks may also demand longer-term track records or a minimum level of profits or turnover as a basis for receiving credit.

Appropriate regulation can improve the functioning of the credit market, *e.g.* by raising the probability that relevant information is provided to all key players involved. For instance, the United States has introduced new types of regulations that oblige banks to report their lending to SMEs. Such lending practices are ranked and publicised by the government. Late payments have also been the target of reforms in some countries. The European Union has taken steps to enable smaller firms to charge interest to their clients in the event of late payment. Loan guarantee systems, often underwritten by governments and public institutions, do not always function well for SMEs. A number of regulatory reforms could potentially improve transparency and functioning in the banking sector for smaller firms.

## **Banking regulations and SMEs**

*Japan* reports that heavily regulated financial markets, stock markets and the banking sector have had negative effects on SME financing. After deregulation, competition between banks and stock markets and among banks has intensified, increasing loans to SMEs.

In *Korea*, the financial sector prefers to provide loans to larger firms and the government is operating a Credit Guarantee Fund for SMEs which have limited ability to provide collateral for loans.

In *Spain*, the Bill of Civil Law Procedures being debated in the Parliament is expected to confer legal protection that would expedite the claiming of small debts (under ESP 5 million) and increase bank and other SME lending.

In the *United Kingdom*, procedures for debt recovery are being put into effect in 1999 to modernise the civil justice system by making litigation speedier, simpler and more affordable.

In the *United States*, reforms to reduce paperwork, speed up loan approval and reduce costs have led a number of commercial banks to create departments specialising in the origination and sale of SBA and other guaranteed loans. Some 60% of small firms now rely on some form of bank credit.

*New Zealand* reports that the government funds the Business Development Programme (currently under review) which aims to increase the management capability of SMEs and their ability to access bank and other financing.

In the *European Union*, the Commission's Recommendation on late payment (issued in 1994) is being reinforced with a proposal for a Directive which contains the provision that interest be charged on late payments, thus discouraging such practices.

## **Technology and know-how**

SMEs are a major source of innovation in knowledge-based economies, and government regulations can influence the overall climate for innovation and technology diffusion. Governments can create favourable framework conditions, such as for intellectual property rights, and enhance co-operation between government researchers and industry in order to stimulate innovation and the adoption of advanced technology in SMEs.

Technology-based and high-growth SMEs have a strong interest in *research co-operation* with public universities and research institutes. Such SMEs may not have sufficient equipment, institutional infrastructure and personnel for in-house research activities. However, regulations may impede or discourage co-operative links between small firms and publicly-financed research. There may be no institutional structures to promote collaboration with the private sector, and regulations may limit the means by which an enterprise can access the know-how originating in publicly financed institutions.

Regulations may discourage or prohibit public researchers or university professors from working in the private sector even for short periods of time and from conducting joint research or technical projects with enterprises. Taking leave of absence to work with enterprises may have adverse effects on public pensions and tenure. Business activities, such as technology consulting by university professors, may be prohibited. Government researchers may not be entitled to the patents and income from their own research and/or may be barred from starting spin-off enterprises. Conversely, it may be difficult for industry researchers to become university faculty members or to work for the government.

Certain aspects of the regulatory environment limit SME access to know-how and technology as well as the creation of new technology-based firms; countries from Japan to Turkey are now implementing widespread reforms in this area. The United States introduced regulations to oblige public research agencies to allocate a certain share of their R&D budgets to SMEs. Another approach involves reforms to the educational system, which can aid in creating an entrepreneurial culture. Competition among universities and government funding rules can induce universities to provide greater research support and technology transfer to smaller firms.

## Research co-operation regulations and SMEs

In *Korea*, joint R&D activities and co-operation (e.g. pooling of human resources) are limited because it is difficult for private sector researchers to become university faculty members, just as university professors find it difficult to enter business.

In *Japan*, detailed regulations and practices, as well as some administrative procedures, were amended in 1997 to promote and not impede co-operation between universities and businesses.

In *Spain*, it is only recently that SMEs, universities, public/private research centres and technology consultants have begun to carry out joint research and development activities. Initiatives such as the *Fundación Universidad-Empresa* (University-Enterprise Foundation), geared to promoting research collaboration between the two spheres, are beginning to bear results.

In the case of *Turkey*, KOSGEB has established six Technology Development Centres which provide support to SME projects related to research and development of new products and production methods. As a type of soft loan, KOSGEB pays 85% of the total cost of the equipment or material needed for prototype production as well as 85% of the costs incurred for technical consulting provided to an SME by universities.

In the *United States*, the Bayh-Dole Act of 1980 allows universities to profit from the results of government-sponsored research; it is typical for a university to have a technology licensing office that administers the marketing of discoveries. Public/private co-operation is also encouraged by the Small Business Technology Transfer Program (STTR) of 1994 which taps research institutions for ideas that have not yet been effectively deployed. For SMEs that have a relationship with a university, a share of the cost of carrying out R&D is borne by the university.

In the *United Kingdom* as regards co-operation between public research centres and SMEs, government accounting regulations affect the ability of the Research Councils to provide equity rather than grants. The New University Challenge Fund will create GBP 50 million in venture capital for the purpose of carrying out joint public/private R&D and will establish seed venture capital funds for universities to commercially exploit their research.

However, in some countries, the main problem remains the lack of recognition of the importance of collaborative research between the public and private sectors and the value such innovative activity has for small firms and for entrepreneurship. For some, a change in conception of the role of universities would be required, *i.e.* to regard universities not just as centres of education, but as public service institutions that should contribute to economic development. In countries such as the Czech Republic, neither research co-operation between SMEs and public research centres nor technical consulting for SMEs are prohibited by regulation, but their worth is not recognised and the tools to foster joint activities have not been put in place. Similarly, in the case of *Hungary*, the lack of promotional schemes has an adverse effect on SMEs in that they are unable to obtain technology and know-how from universities and other publicly financed research centres.

In addition, the research results of publicly financed institutions may not be adequately protected and remunerated, with the result that these institutions sell their findings abroad at very low prices. Universities and academic institutions may have little incentive to explore whether SMEs may provide a market for their know-how. This may also be linked to the fact that large foreign-owned firms attract the bulk of intellectual innovative capacity in some countries.

For certain small companies (*e.g.* technology-based), ***intellectual property*** represents a large share of their assets. Current intellectual property right (IPR) systems tend to favour large over small firms. In many countries, the filing process for patents and copyrights is costly and slow. Filing for international patents is extremely expensive and complicated. In addition, the costs of maintaining a patent and defending it in patent suits brought by competitors can be prohibitive, which in turn may discourage smaller firms from registering patents at all. Countries are exploring means to reduce costs for SMEs and to ensure that patents and copyrights are processed in a timely and efficient manner. Some countries help SMEs meet the cost of patent filings by providing a discount on patent fees.

Product standards, particularly ***technical standards***, may block smaller firms from entering new markets, especially foreign markets, even where these are transparent and non-protectionist. International harmonisation and mutual recognition agreements can benefit small and medium-sized firms even more than larger firms by facilitating adaptation to differing product specifications. Without such arrangements, it is difficult for SMEs producing smaller product quantities to design, invest for and produce different products to meet the requirements of varying standards. Large firms can more easily overcome these

difficulties. Greater attempts should be made to involve smaller firms in the standards-setting process so that their needs and expertise are properly reflected. Ad-hoc involvement may not be sufficient.

### **Intellectual property regulations and SMEs**

In *Hungary*, administrative procedures for obtaining and maintaining IPRs tend to be lengthy and costly. Moreover, a lack of regulations controlling the means and methods by which an enterprise can access know-how originating in publicly financed institutions and universities leads to insufficient incentive to innovate or invent. SMEs are generally faced with lengthy and expensive negotiations to elaborate the required technology transfer agreements.

In *Korea*, applicants for IPRs must wait up to three years before an application is accepted or rejected. The costs of maintaining an IPR are high and increasing and settling infringement suits on property rights is often a lengthy process. Due to lack of information, the market for patents generally does not function well.

In *Japan*, the patenting process takes on average 24 months, equivalent to the European Union, but longer than in the United States (18 months). Responding to complaints regarding patent procedures and costs, the government is committed to reducing the time between an application and first action by the Patent Office to 12 months by the beginning of the year 2000. The cost of maintaining a patent was reduced as of June 1998.

In the *United Kingdom*, a number of measures have been undertaken to counteract delays regarding IPR infringement suits and the difficulties encountered in meeting legal deadlines for filing IPRs abroad. For instance, *fast track* procedures were put in place in July 1995 to allow combined (rather than separate) patent search and examination. Patents can be obtained in as little as one year.

The *European Union* Commission has recently proposed a Directive to provide a common framework for utility models, which is a form of patenting that accommodates “small inventions”. These proposals would provide some degree of protection for innovations introduced by small businesses, often at less cost than through regular patenting systems.

## **Human resources**

The main asset of most enterprises, particularly smaller ones, is their human resources. Regulations affecting employees and labour market flexibility can adversely affect the dynamism of the economy as well as overall job creation in OECD countries by unnecessarily obstructing the start-up and functioning of small firms. Although necessary to protect employees, labour-related regulations which are overly rigid or inflexible can suffocate a healthy SME sector. Regulations in this area can also have negative impacts on the flexibility of SME activities – their most important advantage.

*Labour regulations* should promote a flexible workforce. This is essential for SMEs which need the ability to rapidly adjust their business activities to changing market conditions. Many aspects of the current regulatory environment impose extra hiring and firing costs on small firms and otherwise handicap them in their ability to compete for, deploy and retain qualified workers. Countries may have regulations on fee-charging recruitment services which inhibit SMEs in their search for qualified employees. Regulations may also restrict the recruitment and dismissal of personnel, payment of overtime and use of part-time and temporary labour.

In many countries, regulations give entrepreneurs limited freedom with respect to wages, working hours, flexible work times, and entitlements to holiday, sick and other types of leave. There may also be restrictions on fixed-term labour contracts or limitations on their duration. Costly personnel grievance procedures are a particular burden for SMEs, who may encounter difficulties in staying abreast of and complying with complex regulations concerning hiring, firing, social benefits and employment conditions. Some countries have reformed their industrial legislation based on agreements reached by trade unions and business organisations. In Spain, the main features include the establishment of new contracting modalities (notable in what refers to part-time, temporary and discontinuous permanent employment), lowering dismissal costs (which encourages turning temporary contracts into permanent arrangements) and streamlining the process of authorisation of objective dismissal. While giving due consideration to workers' rights, there is generally a need for greater flexibility in SME labour regulations in order to enhance performance as well as job creation.

## Labour regulations and SMEs

In *Hungary* through the new Labour Code, employers' rights were extended while employees' rights were generally restricted. Labour relations provide entrepreneurs, in practice if not always by law, with a great degree of freedom with respect to working hours, overtime, etc. However, one problem is "tactical" sick leave, where employees go on sick leave for 12 months and are protected from dismissal, which affects SMEs more than larger firms.

In *Japan*, the Labour Standard Law is amended as of 1999 so that the maximum period for a fixed-term labour contract will be extended from one to three years for some categories of workers. The maximum working time has been extended to 10 hours per day and 52 hours per week. Furthermore, the amendment with regard to the "Arbitrary Work System", which will be implemented in 2000, will enable the adoption of a system which gives workers greater freedom in terms of the flexibility of their working hours.

The firing of workers in *Korea* used to be strictly regulated because of the widespread practice of lifetime employment. But the Labour Standard Law has been amended so that layoffs can be pursued for the purpose of restructuring.

In *New Zealand*, the Employment Contracts Act allows for personal grievance procedures to be taken by employees who consider themselves victims of unfair dismissal. The cost of defending themselves is a burden on SMEs and can reduce their flexibility in making adjustments to meet variations in labour requirements.

While there has been a long-standing dispute about whether or not minimum wage regulation can effectively contribute to worker welfare, the *United States* Fair Labor Standards Act seems to affect small firms more than large firms. As small firms employ more teenagers and other workers subject to minimum wages than do large firms, small firms are more heavily hit by the legislation.

*The European Union* Directive on the Organisation of Working Time establishes a maximum 48-hour working week, including overtime, calculated over a four-month period, and minimum requirements in relation to rest periods, annual holidays and night work. Although derogations can apply for a wide range of activities and flexibility is built into the provisions, SMEs claim that this Directive is being interpreted in an inflexible way that is restricting their ability to make best use of their labour resources (Coyne, 1998).

***Social security regulations*** pertaining to retirement, pensions and health benefits may present special problems for SMEs. These rules tend to accommodate large firms – in terms of economies of scale in managing and financing health and retirement plans – and are often unavailable to smaller firms unless they pool together. The unit costs of health coverage, pensions and unemployment insurance are generally higher for SMEs due to smaller volume, less choice in the kinds of pension plans in which SME employees can enrol, less tolerance for errors in hiring decisions, and greater turnover leading to higher negative ratings on unemployment insurance. Another problem is the lack of portability of pensions and health-care plans from one company to another. This reduces the mobility of personnel since it disadvantages employees who change firms, thus limiting SME recruitment.

### **Social security regulations and SMEs**

In *Japan*, qualified pension fund schemes reduce the mobility of personnel since they disadvantage employees who move from one company to another. Only defined benefit systems, which technically cannot transfer an individual worker's paid contributions, benefit from favourable tax exemptions. Under the current system, a worker who leaves receives a refund but on unfavourable terms. There is usually a minimum 15-year period of affiliation before any refund can be made. The tax treatment of retirement allowances also discriminates against workers who leave before fulfilling 20 years of employment in the company.

In *Turkey*, different social security systems are managed by different institutions, causing a lack of portability of the contributions of mobile workers. Standardisation of the schemes is necessary.

In the *United States*, the problem of portability of pension funds (retirement plans) seems less serious, although it is reported in some cases that small firms are unable to ensure portability and that insurance carriers have been unwilling to do so (Boyes, 1998).

In general, the sheer number of employee-related regulations and accompanying administrative work are believed to be a deterrent to hiring workers. Over a certain threshold of employees, a greater number of regulations must be complied with in most countries. As a result, black labour markets may emerge, characterised by working conditions far below minimum regulatory requirements. Heavy regulatory burdens in this regard may also make it difficult for many smaller firms to comply with all requirements, despite their best efforts. This is of concern to regulatory authorities as more important regulations, such as those pertaining to safety and health, may be neglected.

*Stock options*, which are a new and valuable approach to compensating employees, are prohibited, excessively regulated or improperly taxed in a number of OECD countries. Stock options are an effective way for SMEs at the start-up or growing stage to recruit or maintain employees at lower salaries by offering them stock in the company. They are now widespread in the United States and have spurred the growth of the rapidly expanding information technology and software sectors. Stock-based incentives enable young, high-growth companies to attract and retain talented employees without drawing on scarce cash flow.

However, securities rules governing the issuance of stock incentives and fiscal rules for taxation of these incentives influence their flexible use by SMEs and whether workers will find it sufficiently attractive to work for an early-stage company. Some countries require that social charges be paid on these options. In the United States, companies which have certain forms of option plans may receive a tax deduction. Stock options may also be confined to SME founders and upper management or they may be available for a broad range of employees. The costs and benefits of regulatory approaches for stock options, and their potential value to SMEs, is an area for further investigation.

## Stock option regulations and SMEs

In *Japan*, stock option schemes were in principle prohibited by the Corporate Law, but this restriction was lifted for all firms in 1997 and many companies are now introducing schemes. A disadvantage in taxation pertaining to such schemes was eliminated in April 1998, and since then more than 170 firms have introduced stock option schemes.

In *Korea*, stock option schemes were not very popular due to restrictions, such as not being available to part-time professional researchers. Since April 1994 when the availability of stock options was expanded, the scheme has been widely applied and facilitates the recruitment of quality workers by SMEs.

In *Spain*, the use of stock options as a remuneration formula is not a common practice. Industrial legislation does not, from a regulatory standpoint, hinder stock options, provided the scheme is agreed upon between the entrepreneur and the workers. Fiscal laws provide that shares yielding under ESP 500 000 a year or ESP 1 million over five years are not regarded as remuneration in kind, and therefore not subject to taxation under personal income. This should provide an added incentive for stock options, but the lack of liquidity of SME shares still makes it an unattractive and scarcely used formula.

In the *United Kingdom*, the recent Finance Act reduced the value of own-company share options allocable to an employee tax free to GBP 30 000. This hampers tax-efficient remuneration of “star” employees in growing SMEs which can not afford large cash payments.

## CONCLUSIONS

Evidence points towards exceptional growth and employment creation by small firms characterised by entrepreneurship and innovative activity. This underscores the importance for governments to review policies and framework conditions that have a bearing on firm creation, expansion and exit. Certain types of regulations – particularly those relating to finance, innovation and human resources – can impede small-firm start-up and growth and dampen overall economic performance.

In the area of *finance and access to capital*, the question is not whether access to capital *per se* is problematic for small firms due to regulations, but the fact that SMEs are often unable to pay the cost of obtaining financing. An underlying issue is the competitiveness of financial markets, *i.e.* how financial markets function and whether regulation (or lack of regulation) plays a role. Bank lending to SMEs, in particular, seems to be linked to the degree of regulation of financial markets. For example, in Japan where financial markets were highly regulated, there was no incentive for banks to lend to smaller firms. In the United States, in contrast, the combination of government lending programmes and the dynamism of the more deregulated financial market has generally ensured access to finance for SMEs.

In the area of *technology and know-how*, relatively few SMEs are actively involved in research and the purchase of R&D services from other firms or research organisations is not very common, largely due to the nature of the businesses in which most SMEs are engaged. Therefore, public/private co-operation in research and collaborative alliances (*e.g.* technological links, technology transfer) take on increased importance. But regulations in many countries tend to erect barriers to useful research links between publicly financed research and private enterprise, to the production of commercially useful technologies in the public sector and their exploitation, and to the transfer to and use of public research results by small firms.

In the domain of *human resources*, regulations concerning areas ranging from education, training and employment conditions to health and safety at work

have a bearing on the flexibility and performance of small firms. Such regulations are often not geared to the staff size and resource limitations of smaller firms but also create a cumulative burden through financial and reporting requirements. Apart from regulations that govern working conditions and employment practices, there are also rules regarding who can do certain types of work (professional skills, trade and craft certifications); mandated wage scales; pension and health benefits and their portability between jobs; use of stock option schemes to reward and retain employees; and regulations that hinder the movement of personnel between firms. While their intrinsic value to employees is not questioned, these regulations are often not adapted to smaller firms who can see their valued flexibility severely reduced by rigid labour requirements.

In addition to the specific regulatory areas discussed above, other rules have a bearing on the performance of small firms, particularly relating to: *i*) the start-up of businesses, including licensing and entry to certain sectors; *ii*) transmission of businesses, including inheritance rules, capital gains taxes and redundancy commitments; *iii*) closure of businesses, including insolvency and bankruptcy laws and legal services; *iv*) marketing, including government procurement; and *v*) access to information infrastructure and use of information technology. This project has attempted to delve into the implications of regulations for small-firm performance. More analysis will be needed to identify regulatory obstacles – either common or specific to particular countries – to fostering a viable and effective SME sector. This will aid countries in directing regulatory reform efforts to the needs of smaller as well as larger firms, to adapting their regulatory regimes to the needs and characteristics of small firms, and in identifying those regulations which are particularly onerous and inappropriate to fostering a dynamic small-firm sector, so important to economic performance and growth.

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## ANNEX: EXAMPLES OF COUNTRY REPORTING

### *FINANCE AND ACCESS TO CAPITAL*

COUNTRY	PROBLEM IDENTIFIED	REGULATORY ASPECT
<b>Czech Republic</b>	Generally limited SME access to equity finance	Steps being taken to develop stock market and venture capital market
<b>Hungary</b>	Limited SME access to stock market due to complicated and expensive registration procedures	Steps being taken to facilitate SME listing on stock exchange
<b>Japan</b>	Few bank loans to SMEs due to lack of competition in financial sector	Deregulation to promote competition between banks and other financial institutions
<b>Korea</b>	Limited SME access to capital due to inadequate functioning of stock markets	Role and functions of over-the-counter markets need to be strengthened
<b>New Zealand</b>	Few observed problems from the supply side	On demand side, government programme to increase SME financial management capabilities
<b>Spain</b>	Excessively strict standards for SME registration and listing on stock market	Reforms needed to facilitate small-firm access to stock listings
<b>Turkey</b>	Complicated and expensive procedures for SME registration on stock market	New stock market to be established for small start-ups with growth potential
<b>United Kingdom</b>	Limited institutional investment due to lack of access to pension fund capital in the European Union	Proposed European legislation to reduce restrictions on equity investment by pension funds
<b>United States</b>	Federal securities laws have caused difficulties for SME stock listings	Recent reforms to ease registration requirements for small firms

## **TECHNOLOGY AND KNOW-HOW**

<b>COUNTRY</b>	<b>PROBLEM IDENTIFIED</b>	<b>REGULATORY ASPECT</b>
<b>Czech Republic</b>	Limited innovation in universities due to restrictions on use of research results	Steps being taken to change legislation to enable universities to invest their research results in private companies
<b>Hungary</b>	Lengthy and costly procedures for obtaining intellectual property rights	Reforms needed to facilitate IPR ownership by small firms
<b>Japan</b>	Public sector researchers in universities and laboratories prevented from starting private firms	Amendment proposed to National Public Service law to permit such business activities
<b>Korea</b>	Limited access of small firms to research results from universities and public institutes	Steps being taken to facilitate transfer of research results to SMEs
<b>New Zealand</b>	Limited access of small firms to research results from universities and public institutes	Steps being taken through Technology New Zealand scheme to facilitate access by SMEs to new technology
<b>Spain</b>	Limited research and technology co-operation between universities and small firms	Steps being taken to facilitate joint research activities among universities, R&D institutes and SMEs
<b>Turkey</b>	Limited research or innovation on the part of small firms	Technology Development Centres established to improve linkages and innovative activity by SMEs
<b>United Kingdom</b>	Limited remuneration packages for academic researchers for co-operation with SMEs	Changes proposed to government accounting regulations
<b>United States</b>	Few regulatory problems; frequent spin-offs from university research	Legislation (e.g. Bayh-Dole Act of 1980) allowed university researchers to profit from research and inventions

## *HUMAN RESOURCES*

<b>COUNTRY</b>	<b>PROBLEM IDENTIFIED</b>	<b>REGULATORY ASPECT</b>
<b>Czech Republic</b>	Need for more flexible working conditions with regard to hours and part-time contracts	New Labour Act should increase small firm flexibility with regard to personnel working conditions
<b>Hungary</b>	Personnel recruitment difficult for small firms due to high social security costs	Overall reform of the social security system will lower small-firm contribution rates
<b>Japan</b>	Low labour mobility due to pension schemes that disadvantage employees moving from one company to another	Proposed regulatory changes would enable transfer of employee pension fund contributions
<b>Korea</b>	Lifetime employment system limited personnel flexibility of small firms	Revised Labour Standard Law of 1998 increased flexibility for small firms with regard to recruitment and dismissal
<b>New Zealand</b>	Low compliance of small firms with health and safety requirements for their employees due to information deficiencies and cost	Reforms may be needed to the Health and Safety in Employment Act and Accident Compensation Corporation scheme to assist small firms
<b>Spain</b>	Limited flexibility for small firms in hiring and firing employees	Labour reforms of 1997 allowed new contracting modalities and lowered dismissal costs
<b>Turkey</b>	Limited personnel mobility due to wide variations in pension schemes and lack of portability among firms	New legislation needed to increase compatibility and portability of pension schemes
<b>United Kingdom</b>	Recruitment of qualified personnel difficult for small firms due to administrative complexities and cost	Steps being taken to align and simplify rules and administration for taxes and social security
<b>United States</b>	Difficulties for small firms in providing health coverage for employees	Proposals to facilitate small-firm access to health-care plans and financing

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