

MITTELSTANDSMONITOR 2007

STABILISING THE UPSWING
STRENGTHENING EMPLOYMENT AND INVESTMENT

Annual report on cyclical and structural issues relating to
small and medium-sized enterprises - Abridged version

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When referring to individual capitals, e.g.

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Preface

In Germany, as in almost all industrialised countries, more than 99% of all enterprises are small or medium-sized (SMEs). They produce nearly half the enterprise sector's gross value added. Their main qualitative feature is that owners and responsible management are identical. Small and micro enterprises – which de facto include all start-ups and most young enterprises – belong to this sector as do larger enterprises with several hundred employees and a leading position in the world market. Through their diversity they ensure economic stability and form an integral part of a balanced enterprise size structure that facilitates structural change, promotes innovation and thus ultimately helps to boost growth and prosperity in a national economy. Despite the enormous importance rightly attributed to small and medium-sized enterprises time and again in the debate about economic and social policy, the economic situation of SMEs is not apparent from the official statistics.

Only few institutions possess sufficient statistical information bases of their own that would put them in a position to make regular observations on issues concerning SMEs. However, reliable data and unbiased opinions (based on empirical evidence) are needed if the debate about key issues of economic life is to be conducted in an objective manner. For this reason Creditreform (Verband der Vereine Creditreform), IfM Bonn (Institut für Mittelstandsforschung), RWI Essen (Rheinisch-Westfälisches Institut für Wirtschaftsforschung) and the Centre for European Economic Research (ZEW) have joined a KfW initiative to publish the MittelstandsMonitor, which is a joint annual report on cyclical and structural aspects relating to small and medium-sized enterprises. The basic idea is to collect and compare new expert findings in order to subsequently present them to the public in a concise form. The prime objective is to conduct an analysis based strictly on objective facts. The partners' exclusive databases complement each other and provide a comprehensive empirical basis for the MittelstandsMonitor.

The assessment of the cyclical economic situation of small and medium-sized enterprises and the development of company start-ups and liquidations are a standard element of the report. This is supplemented each year by different topics relating to the small and medium-sized enterprise sector that are of current economic interest. The 2007 edition focuses on the subjects "Internationalisation of SMEs" and "SMEs and corporate tax reform".

The project partners decided to entitle the MittelstandsMonitor 2007 "Stabilising the upswing - Strengthening employment and investment". The strongly improved SME business climate and the balanced mood across all size categories are evidence that SMEs fully participated in the dynamic upswing of the last year. The upswing was also supported by the recovery of domestic demand that occurred in 2006. The good business prospects also boosted the in-

vestment propensity of small and medium-sized enterprises, which is, however, still (slightly) below its long-term average. The substantially improved business climate was also clearly reflected in the employment contribution made by SMEs. The increase in employment is expected to continue in 2007, since the majority of SMEs reported having positive employment plans for the first time since the beginning of the time series. The fundamental factors support the view that the upswing in Germany has a good change of surviving the stresses and strains that lie ahead for 2007 with no more than a few injuries and no lasting damage (Chapter 1).

After an increase in the two preceding years the number of business start-ups again fell in 2005. In 2006 this decline even intensified. While the rise in the number of start-ups in the years 2004 and 2003 was mainly due to start-ups by unemployed people the most recent decline is due to the fall in the number of these start-ups. The tightening of the eligibility criteria for financial support by the Federal Employment Agency and the merger of the two promotional instruments of start-up grants (Existenzgründungszuschuss) and tide-over allowances (Überbrückungsgeld) were reasons for this development. In addition, the recovering business cycle also contributed to creating more paid employment opportunities. For this reason a larger share of potential business founders decided not to go into self-employment. A positive feature is that the number of start-ups is still higher than the number of liquidations and, thus, the stock of businesses in Germany is growing. Multivariate analyses have shown that an increase in start-up figures can be achieved through an improvement in the start-up climate. This applies to both an improved attitude to entrepreneurship in the population (cultural start-up climate) and an improvement in the economic and legal framework (structural start-up climate). The so-called 'culture of the second chance' is one aspect of the start-up climate. Empirical analyses have shown that the start-up conditions for entrepreneurs who failed (restarters) are worse, at least in certain areas, than those for restarters who were successful in the past or for first-time start ups (Chapter 2).

SMEs have clearly become more internationally oriented. This is evidenced by both the share of SMEs that are active abroad and the share of turnover which they generate abroad. Companies active abroad tend to be larger and belong to the R&D intensive manufacturing sector. Moreover, the internationalisation – in the form of import competition, imported inputs and investments by foreign companies – in now also reaching SMEs that are not themselves active abroad. SMEs active abroad show a significantly higher productivity and innovative activity than firms that only address the domestic market. In addition, in the last few years employment developed better in export-oriented SMEs and SMEs investing abroad than in SMEs concentrating on domestic markets (Chapter 3).

An assessment of the fiscal importance of the SME sector shows that in the period 2000 to 2004 on average about 47% of corporate taxes in Germany were paid by SMEs. With regard to the corporate tax burden, by European comparison and depending on the calculation method used, Germany ranks between seventh and eleventh place of the 12 countries surveyed. Simulation calculations on the impact of the government's reform concept on the tax burden of representative small and medium-sized model enterprises have shown that the measures planned by the German government would reduce their tax burden. Thus, SMEs are the main winners of the planned corporate tax reform (chapter 4).

The following institutions participate in the MittelstandsMonitor: Creditreform, IfM Bonn, ZEW, RWI, KfW

Summary

Chapter 1: The cyclical situation of small and medium-sized enterprises

SME sector has a full share in the dynamic upturn

The very strong improvement in the SME business climate in the course of the last 12 months to a new record high for the whole of Germany and the economic sentiment that is near-balanced across all company size categories show that SMEs fully participated in the dynamic upswing experienced by Germany in 2006. As a sector that is comparatively strongly geared to the domestic market, it benefits particularly from the fact that, in addition to consistently reliable exports in recent years, domestic demand is also again making a positive contribution to growth for the first time. The dynamic SME business cycle was built on the broadest possible basis. The order books and the business climate improved in both parts of Germany, though the improvement was more sustained and pronounced in the West than in the East. The sentiment in all main economic sectors improved substantially and was not only above average in all sectors at the same time for the first time since 1994 but also climbed to a multi-year peak. With the manufacturing industry and wholesale trade, the sectors oriented disproportionately on exports continued to be in the lead. However, due to the recovery of domestic demand, the problem sectors of the last years, i.e. retail trade and the construction industry, also experienced a cyclical turnaround in 2006 - in addition to the service industry, which had already seen a very solid development for some time.

Driven by the upward trend in sales and excellent earnings, SMEs' willingness to invest increased for the fourth year in succession: more than 42% of the SMEs were recently planning new projects, which is an increase of around 5% over 2005. Although this is the highest figure since 2001, it is still slightly below the long-term average (just under 46%). The comparatively moderate increase in the investment propensity suggests that SMEs first want to have more certainty about how the business cycle will develop in the medium term before investing more heavily than in the past in the expansion of production facilities.

The substantially improved business climate was also clearly reflected by the employment contribution made by SMEs. For the first time in six years the SME sector had a positive impact on employment in 2006, with the share of enterprises increasing their staff numbers exceeding the share of enterprises with declining staff numbers by 16.7 balance point. This is a new all German peak and a record increase of 20.1 points over the previous year. The increase in employment is expected to continue in 2007 since the majority of SMEs reported having positive employment plans for the first time since the beginning of the time series.

However, the upswing will also have to face stresses and strains in 2007. This regards in particular the restrictive fiscal policy and the foreseeable slowing of the US economy with its impact on the entire global economy; an increase in the key interest rates and a correction in the property sector in the USA are likely to have an adverse effect on consumption. SMEs are therefore expecting a slowdown in 2007 from the currently very good business climate, as is shown by the fact that business expectations have increasingly been lagging well behind the assessments of the current situation. Nonetheless, the fundamental factors support the view that the upswing in Germany has a good chance of surviving the stresses and strains that lie ahead for 2007 with no more than a few injuries and no lasting damage. Slower growth in the USA is likely to be offset to a considerable extent by the greater internal dynamism in other parts of the world, for example in Asia. This means that, to a greater or lesser extent, distinct moderation can be expected, but no collapse of the global upswing. Against this background, the sound growth in German exports is also likely to continue, particularly as the international competitiveness of Germany companies will remain high. Given the increasing utilisation of capacities and the restrictions in depreciation opportunities announced for 2008, this means that the investment momentum will remain at a disproportionately high level and merely slow down somewhat. Consequently, the expansion of employment is also likely to continue with less dynamism – and this may at least mitigate the contractionary effects of the VAT increase on consumption. This will not suffice to maintain the high dynamism of the last year. However, real growth of around 2 % - and thus above the long-term average since German reunification - forecast by the participating institutes looks possible for 2007 and should be reflected in a favourable assessment of the business climate by SMEs.

Chapter 2: Business fluctuation - Current start-up trends and the influence of the start-up climate on start-up behaviour

After an increase in start-up figures in 2003 and 2004 a decline was recorded in 2005, which also continued in 2006. According to the KfW Start-Up Monitor the number of both full-time and part-time start-ups fell in 2006 to lowest level in the last seven years. While the increase in 2003 and 2004 was driven by start-ups by unemployed people, the decline in 2005 and 2006 was mainly due precisely to these start-ups. The reason for the decline are the stricter eligibility criteria applied by the Federal Employment Agency (since the end of 2004) for start-ups seeking financial support in combination with the merger of the two most important promotional instruments, the start-up grant (Existenzgründungszuschuss) and the tide-over allowance (Überbrückungsgeld), to form the new self-employment grant (in mid-2006), for which there has been less demand. At the same time the recovering business cycle also contributed to creating more paid employment opportunities. Due to this development many potential business founders decide not to go into self-employment but instead take up a paid job.

After a moderate decline in 2005 the number of liquidations increased substantially and in 2006 is expected to have fallen to the level of the years 2003/2004. However, liquidation figures in Germany are still lower than start-up figures and, thus, the stock of companies is continuing to grow. However, since the difference between liquidation intensity and start-up intensity is small this growth is not very pronounced. This is an indication that many start-ups are little innovative or not innovative at all and just squeeze out or replace existing businesses. Company insolvencies, which are a subset of liquidations (share of insolvencies in total liquidations in 2005: 8.3 %), have shown a declining trend since 2002 (in Eastern Germany) and 2004 (in Western Germany).

The start-up activity is not only influenced by changes in start-up promotion or the business cycle but also by the start-up climate. The latter, in a narrower sense, means the values and basic attitudes towards start-ups and entrepreneurship not expressed by individual persons but shared by the majority of the people in a specific region. In a broader sense, the start-up climate comprises besides these values and basic attitudes (cultural start-up climate) also the economic and legal framework in which the start-up climate occurs (structural start-up climate). The first multivariate analysis carried out for Germany on the influence exerted by the start-up climate on the start-up activity has shown that both components of the start-up climate can bring about an increase in the number of start-ups. From an economic point of view it is interesting to find out which means are suitable to have a positive impact on the start-up climate. Possible ways might be to further expand entrepreneurship-specific teaching and information offered at schools, universities and other educational institutions so as to

enable people as early as possible to become self-employed and provide the necessary knowledge as part of their human capital.

Another aspect of the start-up climate is the so-called "culture of the second chance". The share of entrepreneurs who failed in the totality of business founders (restarters) ranges between 11% and 18%. Start-up conditions in Germany are less favourable in specific areas for restarters than for start-ups that were already successful in the past or for first-time start-ups. The restarters are facing a much more complicated legal framework than other business founders. In addition, it is more difficult for them to obtain access to public financing programmes, they are generally facing more serious financing problems and have more difficulties in acquiring orders. Analyses have also shown that companies managed by restarters are less successful than those set up by restarters who were successful in the past or by first-time start-ups. Restarters tend to withdraw from the market much faster and show a lower employment growth. It is not yet clear whether this is due to the difficult framework conditions or other reasons (for example the lower entrepreneurial capabilities of restarters). It is uncontested, however, that lack of information continues to be a major obstacle for potential restarters who want to set up in business once again. Ways to overcome these obstacles might be, for instance, to provide specific information and advisory services to potential restarters and to offer qualification measures for start-up advisers.

Chapter 3: Internationalisation of SMEs

Globalisation - in the form of increasing integration of international markets and cross-border production - on the one hand means increased competitive pressure for SMEs but also offers the opportunity for SMEs to become themselves active in foreign market. In the medium term the clearly higher growth rates in the international markets in comparison to the German market could entail a profound change in the structure of the German SME sector: while SMEs active abroad benefit from better export opportunities and direct investments there is at the same time the danger that SMEs only focusing on the German market will be ousted from the domestic market.

Overall, SMEs have clearly become more internationally oriented. This is evidenced by both the share of SMEs that are active abroad and the share of turnover which they generate abroad. However, there are substantial differences depending on company size and industry. Companies active abroad tend to be larger and belong to the R&D intensive manufacturing industries. But there is also a substantial share of small enterprises and service companies which are already active abroad.

The competitive pressure exerted by foreign suppliers on domestic markets has also increased in recent years. The internationalisation – in the form of import competition, imported inputs and investments by foreign companies – is now also reaching SMEs that are not themselves active abroad. It can be assumed that cross-border financial interlocking through direct investment will gain increasing importance in the next few years - also for smaller German enterprises. A survey of companies in CEE countries, which are important especially for SMEs, shows that in future competition will become more intense in the area of more sophisticated goods.

Depending on the industry, internationalisation has different impacts on the development and structure of SMEs. The more open an industry is the more apparent is the structural change. More strongly internationalised industries show an increasing share of medium-sized and large SMEs, which is contrary to the trend in the SME sector as a whole. Another major result of the study is that SMEs active abroad show a significantly higher productivity and innovative activity than firms that only address the domestic market. In addition, in the last few years employment developed better in export-oriented SMEs and SMEs investing abroad than in SMEs concentrating on domestic markets. However, the direction of the impact interaction between foreign activities and company development is open. High productivity and innovative activity can be both the prerequisite for and the result of foreign activities. In any case they are indispensable for companies to defend their position in international competition.

Given the growing importance of internationalisation and the related opportunities for small and medium-sized enterprises the SME sector is an important target group of German foreign trade promotion. A broad range of support programmes and measures is available in this area; however, the awareness of the instruments available and their rate of utilisation differ greatly. This is an indication that the foreign trade needs of SMEs are very heterogeneous and that there is still considerable potential for improving the support for this target group.

Chapter 4: SMEs and corporate tax reform

This chapter deals specifically with the tax burden of SMEs given the current legal situation and the consequences of the reform concept planned by the German government for SMEs. An assessment of the fiscal importance of the SME sector shows that in the period 2000 to 2004 on average about 47% of corporate taxes in Germany were paid by SMEs. This is a significant share of total corporate tax revenue.

In order to assess whether Germany is attractive for SMEs as a tax location the effective average tax load of a larger SME in twelve EU member countries is simulated and compared internationally. The simulation shows that in comparison with eleven other member states of the European Union, and referring to the segment of incorporated companies, the effective tax load in Germany is the highest. Only France has an even higher effective tax burden. The high tax burden in Germany is almost exclusively due to earnings-related taxes. When the shareholder level is also included in the simulation Germany ranks better in place nine. Looking at firms in the legal form of a non-incorporated company Germany ranks even better in seventh place. Though the average burden from earnings taxes of non-incorporated SMEs in Germany is low it has to be taken into account that in the event of high earnings the marginal tax burden of such companies may be higher than that of incorporated companies, and this means that non-incorporated SMEs will have less scope to implement investments.

Simulation calculations on the impact of the government's reform concept on the tax burden of representative small and medium-sized model enterprises have shown that the measures planned by the German government would reduce their tax burden. The main beneficiaries of the planned measures will be companies, which due to their size and financing structure can fully benefit from the reduction in tax rates and which are not affected by major elements of the planned counter-financing measures. Thus, SMEs are the main winners of the planned corporate tax reform. Calculations made with the help of the European Tax Analyzer for an incorporated SME in the manufacturing industry show that calculated over a period of ten years the effective tax burden at the company level would decline noticeably by 24.82% to EUR 1,381,410. If the shareholders of the company are also included in the calculation the total tax burden of the SME would only decline by 9.81% to EUR 2,302,746.