

# IfM-Background Paper

## Preliminary assessments of the IfM Bonn on the economic impact of the coronavirus pandemic on the “Mittelstand” businesses in Germany

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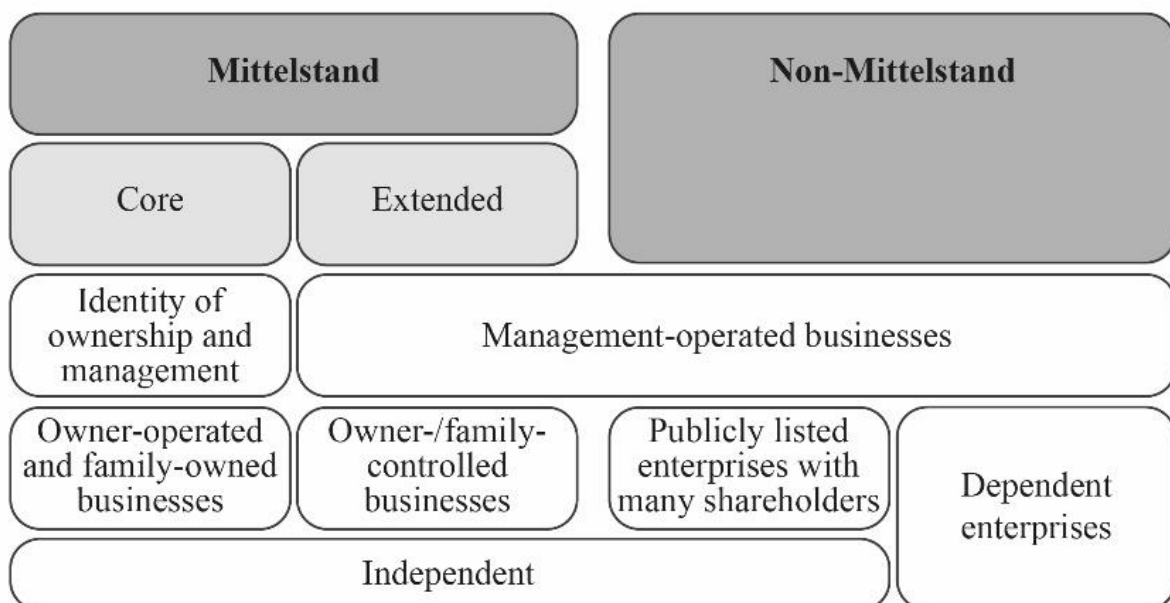


## Preface

Significant parts of small and medium-sized enterprises in Germany are affected by the corona virus pandemic. Many entrepreneurs have been shocked by this. The quick announcements of official support measures on federal and state, sometimes municipal level, assist entrepreneurs to overcome the psychological shock. What makes the situation particularly challenging to cope with, however, is the current uncertainty about how long the prescribed and voluntary measures will need to be in place, to curb social contacts at home and internationally. For many businesses and entrepreneurs, this situation will prove difficult to life-threatening, but others will also look for creative ways to keep the damage as small as possible. Nor can it be ruled out that we currently consider the consequences of the pandemic too harmful, if a gradual restart of certain economic sectors were possible from May onwards.

In the past, the German “Mittelstand” businesses (definition see Figure 1) has proven to be stabilizing in times of crisis, due to their stronger long-term orientation compared to management-led companies, but also due to their overall lower dependence on foreign markets. The current crisis may be different from the previous ones. What can be done to support SMEs in such a way that they can contribute to maintaining economic cycles during and after the corona pandemic?

Figure 1:



Source: Pahnke & Welter (2019)

For the following considerations, the IfM Bonn assumes **two crisis scenarios**:

- 1) Scenario 1: a standstill of 2 to 2.5 months in specific consumption-oriented and manufacturing sectors and then a gradual exit from the restrictions, with reviving economic activity and increasing consumption.
- 2) Scenario 2: A standstill of more than 6 months, which spreads to other sectors of the economy or triggers a further demand shock as the restrictions cannot be removed.

In principle, IfM Bonn recommends that, in addition to those crisis management measures that federal and state governments in Germany have passed until 26th March 2020, government should also turn its attention to (possibly) more far-reaching or longer-term effects on Mittelstand businesses. The measures taken so far are likely to cushion the greatest crisis effects in the short term among entrepreneurs and SMEs of various sizes. In the longer term, entrepreneurs and SMEs will require further support, depending on their age (start-up, existing businesses, business succession) and their level of integration into the international division of labour and value chains.

### **Crisis resilience of existing companies**

- Companies can reduce (fixed) costs or reduce hours (e.g., rental costs) in the event of (expected) solidary behaviour of contractual partners. Landlords and suppliers are likely to have a keen interest in continuing the contractual relationship, like restructuring in insolvency.
- The current equity capital base generally indicates that Mittelstand businesses are well able to weather a crisis. Thanks to the excellent profit situation in recent years, the equity ratio of SMEs is higher than at the beginning of the financial crisis in 2008/2009, reaching 29% in 2017 (2003: 15%) and thus almost being on a par with that of large companies (32%).
- Thanks to strong growth rates in recent years, the average equity ratios of micro-enterprises also are now similar to those of large companies. However, the share of micro enterprises that do not show any equity capital on their balance sheet is much higher than that of larger enterprises. For example, around one in four companies (23% in 2016) in the size category with annual sales of up to one million Euros has no equity capital. (For comparison: the share of large companies without equity 4%). Of approx. 3.3 million micro enterprises with a turnover of be-

tween 17,500 and 1 million euros, around 770,000 have no capital buffer to fall back on in the crisis. They will (have to) initiate a liquidation with a higher probability already in scenario 1 than the larger companies. In the retail sector, the share of "capital-less" companies is somewhat higher. Accordingly, of the approx. 340,000 retail businesses with annual sales of between € 17,500 and € 1 million, around 110,000 must be regarded as potentially at risk. In Scenario 2, the liquidation rate is likely to rise sharply again - even among small and medium-sized companies.

- Measures such as short-time work (Kurzarbeit) and the additional subsidized credit assistance by KfW offer employers comprehensive relief (for these and more economic measures introduced by German federal government see for example [https://www.bmwi.de/Redaktion/EN/Downloads/a/a-protective-shield-for-employees-and-companies.pdf?\\_\\_blob=publicationFile&v=3](https://www.bmwi.de/Redaktion/EN/Downloads/a/a-protective-shield-for-employees-and-companies.pdf?__blob=publicationFile&v=3)). However, micro enterprises have little experience in applying for support measures or loans; and they generally shy away from borrowing. Therefore, the use of credit assistance support is likely to be subdued in service sectors in which it will not be possible to catch up on sales after the crisis. The instant financial transfers for solo entrepreneurs and micro enterprises, therefore, will be of great importance. These groups will be eligible to receive one-off payments to bridge income losses for 3 months, and under certain circumstances for 5 months.
- Employment relationships can be stabilized through the labour market policy measures taken so far. However, the short-time allowances should be approved on a weekly rather than monthly basis. The situation could be different for micro enterprises and economic sectors without digitizable services or marketing channels such as gastronomy/hotels or leisure/cultural enterprises.

With regard to the crisis resilience of Mittelstand businesses, the IfM Bonn assumes the following effects in summary:

**Scenario 1:**

- For most Mittelstand businesses, a short-term crisis should not lead to liquidation. Exception: businesses with few resources and high current fixed costs or those that shy away from taking advantage of support measures. In some sectors, lost sales can be made up for to a large extent once the crisis has subsided, but in others, e.g. the catering trade, they cannot.

- Nevertheless, the capital reserves for investments, etc. will be reduced. Investments depend on market expectations and require halfway reliable perspectives on when which official restrictions and shutdown regulations will be withdrawn.
- The existence of companies is particularly at risk in the cultural, entertainment and leisure industries, in retail, tourism and catering. The same applies to solo entrepreneurs with high fixed costs. Self-employed with low running costs are likely to pause their activities and resume them once the economy revives. For this group in particular, one-off payments and, subordinate to this, the basic income support should be appropriate support measures.

### **Scenario 2:**

- In this case, a higher rate of liquidation and a spill-over to other economic sectors acting as suppliers can be expected. International demand is likely to fall further away gradually. In general, investment and innovation activity will decline. Lower oil and construction prices, on the other hand, are likely to spur business recovery.
- Half of the 2.3 million solo entrepreneurs and half of the 1.8 million entrepreneurs with employees may experience prolonged periods of no income and business earnings. In this case, job losses must be expected, especially among micro enterprises and, amongst these, especially those with very low turnover. After all, companies with an annual turnover of less than € 100,000 already employ 1.2 million people. Even if not all of these jobs will be lost (because some of these businesses are likely to be economically non-independent legal entities) and even if one third of the jobs are retained, the loss of around 850,000 jobs can be expected, which should roughly represent the lower limit of the expected employment losses. Assuming that the crisis effects on businesses will gradually become more severe with higher annual sales, the upper limit of job losses is a good 1.6 million. This number is of course only a first rough estimate.

The stability of the portfolio and investment power of Mittelstand businesses will be strengthened by the measures put into place over the past weeks until 26th March 2020. The government should examine graduation of its support, depending on how strongly the respective sectors are affected by the crisis. In scenario 2, the measures already taken would have to be extended or adjusted and/or supplemented, if necessary.

Furthermore, the suspension of the obligation to file for insolvency also protects existing companies. The insolvency law also allows so-called protective umbrella procedures with 3-month payment of the insolvency compensation to be used for personnel costs, which is provided by the Federal Employment Agency and financed from funds financed by regularly employer's contributions to the Agency. Insolvency compensation does not have to be paid back. In the long term, it could, therefore, make it easier to kick-start the company's activities, for example, because it may enable necessary reinvestments. In the case of company pension entitlements, it is difficult to reach an agreement with the Pension Insurance Association (Pensionsversicherungsverein). Moreover, the introduction of the reorganisation procedure before insolvency, planned under the new EU directive, could be brought forward. Tried and tested measures such as "round tables" of KfW and the chambers of commerce work in a similar way.

### **Securing the income of the self-employed**

The income replacement benefit under the Protection against Infection Act and, to a lesser extent, unemployment benefits II benefits contribute to stabilising the household incomes of self-employed and solo entrepreneurs. They also serve to ensure payment of their health insurance contributions. However, payments under the Protection against Infection Act are only suitable for improving short-term liquidity if they can be made quickly. Fast processing of disbursements is the responsibility of the federal states.

Basic income provision: A first rough estimation by the IfM Bonn that considers solo entrepreneurs in sectors confronted with a huge contraction in demand, and takes also the assets of the households the self-employed belongs to into consideration, shows that up to 300,000 self-employed persons could be eligible to unemployment benefits II. Some of these could already be among the 70,000 unemployment benefits II-Community of dependence (Bedarfsgemeinschaft) with a self-employed household member.

In the past, basic income support has basically proved its worth as an instrument for overcoming short-term business crises resulting in unemployment. However, it should be remembered that this instrument has not been designed for the current extreme situation. Accordingly, recourse to the assistance is linked to conditions that must be relaxed in the current situation, which, according to the current state of knowledge, is also envisaged with regard to the mandatory asset audit. From IfM's point of view, in the current Corona crisis, it does not seem appropriate to link the granting of benefits to the priority depletion of assets.

Of the current recipients coming from self-employment, more than a quarter had to use accumulated assets before receiving unemployment benefits II. *Necessary* business assets are excluded from this, but the exemption is sometimes interpreted quite restrictively by the job centres. Unemployment benefits II is granted based on an income forecast for the next six months. On the other hand, only expenses incurred during this period of approval are recognised (depreciation, therefore, has no income-reducing effect) and must be assessed by the respective Job Centre as operationally necessary, unavoidable and appropriate.

***Recommendations on basic income provision for solo entrepreneurs and self-employed persons:***

- The asset audit, which has now been considerably simplified for (currently) up to six months, is to be welcomed. However, a general renunciation of the asset audit is problematic from a regulatory point of view, as it would be inappropriate to support high net worth households in the event of short-term losses.
- A simplified income forecast for only 2 months (instead of the 6-month average) and a (provisional) renunciation of measures to reduce the fixed costs of living (e.g. the obligation to move houses or to change tariffs in the private health insurance).
- Basic income support is designed as assistance at the individual level to ensure a minimum livelihood for the so-called household community in need (Bedarfsgemeinschaft). It does not constitute liquidity support for the business. The income transfers for solo entrepreneurs and micro enterprises provided by the federal government thus has a more comprehensive effect (some cities also pay a lump sum of, e.g. 2,000 Euros to self-employed persons).

**Apprenticeship in Mittelstand businesses**

In scenario 1, with the exception of specific sectors such as the hotel and restaurant industry, IfM Bonn expects rather small effects on the willingness of enterprises to provide apprenticeships. The general difficulties in finding good apprentices are already too large. In scenario 2, the propensity to provide apprenticeships could decline further, particularly among micro enterprises.

**Start-up activities**

Start-up activity will initially decline - especially in those sectors where demand is slumping due to the crisis. In addition, the current border restrictions resp. shutdown



make it difficult or impossible for people from abroad that are interested in setting up a company to enter the country. In 2019, start-up activity was stable in the commercial sector, which still accounts for the vast majority of start-ups. This number is expected to decline in 2020, even without the consequences of the corona pandemic (partly due to the reintroduction of the master craftsman requirement in a number of trades). In the case of many (chambered) liberal professions (tax consultants, lawyers, doctors, veterinarians, architects, engineers), a decline in the propensity to set up a business is not to be expected.

The extent to which start-up activities will decline depends on the duration of the acute crisis.

- If scenario 1 remains roughly the same, many of the planned start-up projects will undoubtedly be implemented with a time delay.
- For scenario 2 it is unclear whether the reactions to scenario 1 will only be intensified. It is possible that start-ups will again be used more as an alternative to (expected) unemployment; this could in turn have an impact on their long-term employment effects and growth prospects. In any case, in the medium term (after the acute crisis has abated) a temporary increase in the number of start-ups can certainly be expected again.
- In general, more start-ups with IT-relevant business concepts or digitizable offers can be expected, even if the necessary immigration of skilled workers will be more challenging to realize for the time being.
- The corona crisis will generally reduce the survival rates of newly created companies. There will be differences depending on the sector, possibly less oriented towards old survival patterns but more towards the crisis-related slump in demand. So far, about 78% of all start-ups were active on the market after one year (measured against the year of foundation 2012), and 40% after five years. This differs, however, according to the size of the company at the time of its foundation (lower for start-ups without employees) and according to the economic sector (below average in transport, motor vehicle trade, art/entertainment/recreation, hotels and restaurants).

## Data basis

- Stock of enterprises and survival rates: Statistical Business Register. Enterprises with at least one employee subject to social security contributions, and/or taxable turnover of more than 17,500 Euros. That is, micro enterprises with lower turnover (i.e. solo self-employed) are not fully covered
- Self-employed stock: extrapolations of the German Microcensus (seasonal self-employed under-recorded)
- Business registration statistics as a basis for the business start-ups and liquidation statistics of the IfM Bonn, data from the tax authorities of the federal states for the freelance start-up statistics (data for 2019 beginning of April 2020)
- Equity capital ratios and development according to the German Bundesbank, supplemented by information from the German Savings Banks Association
- Self-employed persons in basic income support according to the Panel "Labour Market and Social Security" (PASS) of the Institute for Employment Research (IAB) Nuremberg and statistics of the Federal Employment Agency

## References

Pahnke, A., & Welter, F. (2019). The German Mittelstand: antithesis to Silicon Valley entrepreneurship? *Small Business Economics*, 52(2), 345-358. <https://doi.org/10.1007/s11187-018-0095-4>

## Webpages

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