

EMPLOYMENT SECTOR

— Social Finance Unit—

***Germany: Is there a Case  
for Public Support to  
Micro-Enterprise/ Finance  
Programmes Targeted at  
the Unemployed?***

(Theme 1)

*A contribution to the  
ILO Action Programme on  
“Enterprise Creation by the  
Unemployed -  
The Role of Microfinance in  
Industrialized Countries“*

**Draft Paper**



International Labour Office  
Geneva

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**Draft Paper for the Virtual Conference  
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# **1. Is there a Case for Public Support to Micro-Enterprise/ Finance Programmes Targeted at the Unemployed?**

## **1.1 Description of the Problem and Proceeding**

In the face of unceasingly high unemployment and a low rate of economic growth German employment policy has found a central element of hope in business start-ups: There is a demand for a new "culture of self-employment" to bring fresh energy to economy and reduce pressure on the labour market.<sup>1</sup> This background also directs more and more public attention to business start-ups out of unemployment and there is a growing discussion if politicians should tread new paths – and which – to help unemployed persons on their way to self-employment. Having in view this particular group, however, one faces the basic question if it is a macro-economically promising perspective to employ promotional measures and envisage the unemployed, of all possible groups, to turn into tomorrow's job-creating entrepreneurs or how the factors of success for such an approach can be influenced. To tackle this problems this study proceeds along the following working questions:

- 1) Is there a significant demand for business start-ups on the part of unemployed individuals?
- 2) Should unemployed persons be able to start up businesses?
- 3) Do unemployed persons face problems of access within the established financing system?
- 4) Does the German financing system react to problems?
- 5) Is there a need for action?

However the investigation faces significant problems. Statistic recording of promotional programmes and effects as well as the academic analysis of the economic and social processes behind have not kept pace with the increasing interest in the development – neither in the case of conventional business start-ups nor business start-ups out of unemployment. Due to the lack of coherent and sophisticated statistics<sup>2</sup> we are confined in most cases to approximate values mostly based on estimation or individual regional or sectoral case studies. A particular obstacle lies in the fact that statistics documenting on particular fields of the overall trend, such as business registration, micro census and reports of the federal labour office (*Bundesanstalt für Arbeit*) are hardly compatible as yet.

Hence the investigation's approach has been a step-by-step approximation to the ILO's central points of investigation: As direct statistical information on business founders out of unemployment is hardly available at all it approximates possible figures by looking at business start-ups in general and particularly the fraction of founders of ultra-small firms,

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<sup>1</sup> Wießner, F., Kapital & Köpfchen, in: IAB Materials 1/1999, S. 15.

<sup>2</sup> Struck, J., Quo Vadis Gründungsstatistik, DtA-Wissenschaftsreihe, Bonn 1999. Or: Weiss, P., Entwicklung von Existenzgründungen in: Ridinger, R. and Weiss, P. (ed.), Existenzgründungen und dynamische Wirtschaftswicklung, Berlin 1999, p. 49.

which shares significant structural characteristics with the fraction of founders out of unemployment.<sup>3</sup> The concrete aim of the paper is to ascertain

- in which way business start-ups in Germany is a factor in German employment policy and in how far unemployed individuals share in the overall founding activities
- what actual problems business founders – especially those thereto unemployed – are confronted with
- the extent of support founders receive from the financing and promotional system.

Other tasks the ILO is taken on, especially reporting on macro-economic effects on income development of particular target groups, income distribution and effects on the governmental budget, can not be elaborated here, especially since there are only rudiments of a modern and differentiating micro financing system to be discerned in Germany.

We will now outline in how far the structure of the existing financing and promotional system hinders founders of ultra-small businesses or founders out of unemployment in their access to the system's services.

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<sup>3</sup> Confer also the results from the RWI report concerning the topics 5 and 6 of this ILO country report.

## **1.2 The Significance of Business Start-ups out of Unemployment**

The following chapter is centred around the question how significant business start-ups generally are in Germany and which role the unemployed play in the whole of starting-up activities. Even if as a matter of course not all unemployed individuals can become founders of businesses, particular attention is due to establishing ultra-small businesses as a way out of unemployment. According to a study by the *Deutsches Institut für Wirtschaftsforschung* 18 % of the unemployed toy with the idea of starting a business, but only 25 % of this very group have sufficient know-how or meet the conditions of creditability, e.g. in the form of securities<sup>4</sup>. If it is possible to design promotional schemes to the effect of providing at least this group of unemployed persons with the qualifications and financial means necessary for a successful business start, it is likely to become an impulse for growth and employment.

### **1.2.1 The Role Business Start-ups Play for the German Labour Market**

This study centres on founders of businesses who have so far been unemployed and now become self-employed by founding respectively taking over an enterprise or starting freelance occupation. Business start-ups out of unemployment are a fraction of business founders in general whose former employment status can either have been self-employed or employed, undergoing training or non-working for other reasons.

Basically the transition into self-employment can be connected with the immediate employment of further employees. This is unlikely to apply to a large proportion of business start-ups, but, according to the few empirical findings available, it does apply to almost 80 % of the founders supported by public authorities.<sup>5</sup> Of course, society's expectations of business start-ups are directed particularly towards this extra effect on the employment situation.

Up to the present no sophisticated statistics of business start-ups in Germany have been compiled. Some information about the number of business start-ups and its development can be gained from business registrations obligatory at the point of starting an enterprise. However, the respective set of statistics on business start-ups and withdrawals (cf. Table 1) on its part is of limited value as evidence. First, it contains a set of business registrations not based on founding activities in the actual sense of the term; second, the so-called freelance professions (such as doctors, lawyers, architects, business and tax consultants), who are certainly gaining significance on the labour market, are not covered in those records.<sup>6</sup>

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<sup>4</sup> DWI, ILO session in Bonn, April 1998.

<sup>5</sup> Thomsen, Uwe, et al., Beschäftigungseffekte von Existenzgründern in Schleswig Holstein, DtA, Wissenschaftliche Reihe – Vol. 8, September 1998, p. 70.

<sup>6</sup> Informationsdienst der Wirtschaft, 20/98, 14 May 1998.

**Table 1: Start-ups and windings-ups of enterprises in Germany 1990 - 1998<sup>7</sup>**

former Länder				new Länder			
Year	start-ups	windings-ups	balance	year	start-ups	windings-ups	balance
1990	372,000	280,000	92,000	1990	110,000		-
1991	391,000	297,000	94,000	1991	140,000	11,000	129,000
1992	398,000	288,000	110,000	1992	96,000	24,000	72,000
1993	407,000	298,000	109,000	1993	79,000	41,000	38,000
1994	419,000	328,000	91,000	1994	74,000	44,000	30,000
1995	452,000	358,000	94,000	1995	76,000	49,000	27,000
1996	434,000	373,000	61,000	1996	68,000	58,000	10,000
1997	436,000	363,000	73,000	1997	92,000	81,000	11,000
1998	442,000	371,000	71,000	1998	96,000	87,000	9,000
Germany							
year	start-ups	windings-ups	balance				
1990	482,000	280,000	-				
1991	531,000	308,000	223,000				
1992	494,000	312,000	182,000				
1993	486,000	339,000	147,000				
1994	493,000	372,000	121,000				
1995	528,000	407,000	121,000				
1996	502,000	431,000	71,000				
1997	528,000	444,000	84,000				
1998	538,000	458,000	80,000				

This set of statistics reveals an almost perfectly steady increase in business start-ups in the former federal territory. For the new *Länder*, having experienced a downright start-up boom in the early nineties, the increase of business start-ups in 1998 testifies that there is great motivation, too, to venture into self-employment.<sup>8</sup>

Parallel to this the past decade has seen a strong increase in the number of freelance professionals. This fraction of the overall group of self-employed persons has grown from 13 to 19 %.<sup>9</sup> According to estimations this number is partly due to the enormous rise of so-called bogus self-employment (i.e. founders who are self-employed in form but not in fact, as in actual fact they bear all the characteristics of paid employment). Their number is hard to estimate, literature renders figures ranging from 175,000 to 1.5 million.<sup>10</sup>

As a result of this development Germany's rate of self-employment, which is extremely low regarded on an international scale, has risen from approx. 8 % in 1990 to just under 10 % to date.<sup>11</sup> Many new self-employed persons take on further employees from the start or in the course of their work, a fact which explains why business start-ups are such a hopeful prospect for labour policy.

It has to be stated, however, that this positive development could still have been much more dynamic if the rate of failures occurring after a short time of operation wasn't

<sup>7</sup> Institut für Mittelstandsforschung, Bonn, Unternehmensgrößenstatistik 1997/1998 – Daten und Fakten – additional information by IfM, Internet.

<sup>8</sup> Calculations by IfM, 8/99, based on enterprise registrations.

<sup>9</sup> Informationsdienst der Wirtschaft, 20/98, 14 May 1998.

<sup>10</sup> Peter Weiss, op. cit., p. 46.

<sup>11</sup> Deutsches Institut für Wirtschaft (DIW), Berlin, Wochenbericht (weekly report) 38/98.

quite as high. Of the overall number of approx. 2.0 million persons having made their first attempt at self-employment from 1990 to 1996, approx. 1.6 million have given up self-employment after a short time.<sup>12</sup> Industrial statistics show the same problem. The balance between start-ups and winding-ups in 1998 with a total of 80,000 was the lowest since 1990 and still on the decline as compared to 1997.<sup>13</sup>

The sudden increase in liquidations in the new *Länder* (44,000 in 1994 and 87,000 in 1998) is an unmistakable sign that here extremely few enterprises manage to outlive their critical first five years.

The conclusion suggests itself that one should regard not only the rate of start-ups but, most importantly, the net output ratio, i.e. the balance between start-ups and liquidations. This would entail a change of focus on the promotional programmes, which are, nowadays, orientated more towards the point of taking up founding activities than towards the whole process of starting and establishing the business.<sup>14</sup>

### 1.2.2 Significance of Small Businesses in the Whole of Founding Activities

It can be stated for Germany as well as for Europe that additional jobs are created mainly by small and medium-sized businesses while large-scale enterprises as a whole reduce employment. In recent years massive job shedding has taken place in Germany, in the years of 1996 to 1998 alone the number of people in employment subject to social insurance has decreased by 2.4%. At the same time, on the other hand, the number of jobs in ultra-small businesses (definition according to EU classification: up to nine members of staff), rose by 1.3%.<sup>15</sup>

The group of ultra-small businesses is by far the largest in number. Nowadays there are just under 2 million of such businesses in Germany, so that over 86 % of the German businesses have less than 10 members. The average number within this group of enterprises is 3 members, its share in the total of employed persons 23.5 %.<sup>16</sup>

As we see the whole of the existing small businesses includes a large proportion of "micro-businesses" (in 1997 about half of the self-employed persons in Germany were running **one-person-enterprises**<sup>17</sup>), and this applies even more strongly to founders. Only one in four new businesses started in the recent years has been an enterprise in the traditional sense. Business founders nowadays are predominantly one-person-enterprises or

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<sup>12</sup> IfM; Comment on start-up activity statistics (Gründungsstatistik), 1998.

<sup>13</sup> IfM, *ibid.*

<sup>14</sup> Cf. the concluding remarks in part 4 of this study.

<sup>15</sup> Handelsblatt, 18 Feb. 1999.

<sup>16</sup> BMWI, Unternehmensgrößenstatistik 1997/98 – Daten und Fakten, Studienreihe No. 96, Bonn, 1997, p. 410- 413.

<sup>17</sup> Statistisches Bundesamt, 1998.

employ one other member. Accordingly they are adequately termed "ultra-small businesses".<sup>18</sup>

Concrete information on other characteristics of business founders are available only from certain individual case studies. One particular survey carried out among applicants of a trading licence in Hamburg in 1998<sup>19</sup> renders the following figures:

- Business founders are typically (75%) aged between 20 and 40.
- Businesses are predominantly (77%) founded by males.
- Real start-ups (88%) outweigh those that are really take-overs of already existing enterprises.
- Most (57%) start-ups are full-time enterprises, but part-time businesses did make up a considerable 43%.
- 39% of the founders were in dependent employment before venturing into self-employment.
- 25% of the new self-employed persons were unemployed immediately before.

Besides to these characteristics concerning economic and social structure, before the background of the national economy's demand for a push in founding activities attention is due also to the founders financing structures. Here the survey quoted above yields the following figures:

- In 60% of the cases recorded the start-up capital requirements remained below 50,000 DM.
- The average amount of start-up capital required to start a full-time business was 39,000 DM.
- About three in four founders, at the time of the survey, denied to require outside capital.

Another study concentrating on the group of founders supported by public funds compared the incentives *Überbrückungsgeld* (bridging allowance) of *Bundesanstalt für Arbeit* and the classical nursery finance of *Deutsche Ausgleichsbank (DtA)*. It obtained the figures concerning start-up capital requirements.<sup>20</sup>

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<sup>18</sup> Thomsen, Uwe, op. cit., p. 70.

<sup>19</sup> Lüdemann, O., Qualitative Aspekte von Existenzgründungen, diploma thesis, University of Bremen, 1998.

<sup>20</sup> Struck, Jochen, et al., Gründungsfinanzierung und Überbrückungsgeld – Zwei Förderansätze, eine Zielgruppe?, DtA, Wissenschaftliche Reihe – vol. 8, September 1998, p. 17.

**Table 2: start-up capital requirements of business founders receiving public funding**

start-up capital requirements	cases supported by DtA (%)	cases supported by BA (%) <sup>21</sup>
up to 25,000 DM	3.3	50.7
25,000 to 50,000 DM	13.0	22.4
50,000 to 100,000 DM	23.6	14.3
100,000 to 250,000 DM	27.7	7.1
more than 250,000 DM	32.4	5.5
<b>Sum</b>	<b>100.0</b>	<b>100.0</b>

The two groups of founders of businesses supported differ considerably in their financing strategies:

- Of those receiving a bridging allowance (*Überbrückungsgeld*) 52% financed their start-ups completely by their own resources. On the average, 67% of the start-up capital requirements were covered by the founder's own resources.
- Only 23% were covered by equity from founders supported by the *DtA*.
- BA-founders had significantly lower start-up capital requirements than those supported by the *DtA*.

The structure of the programme may be responsible, among other things, for the fact that capital requirements of those supported by the *DtA* were relatively high in comparison with those supported by the BA and those interviewed in the Hamburg survey.<sup>22</sup> At least there are early figures from the programme „*DtA-Startgeld*“ newly created for micro-enterprises indicating that the average sum applied for in the course of the first 6 months was only 25,000 DM.<sup>23</sup>

The result shows, yet again, that many founders of businesses, especially those venturing out of unemployment, have relatively low start-up capital requirements.

<sup>21</sup> Cases supported by BA means unemployed individuals having started self-employment with *Überbrückungsgeld* (bridging allowance).

<sup>22</sup> Cf. section 3 of the country report for more details.

<sup>23</sup> Dr. Jochen Struck, *DtA*, on the steering committee session for the German country report within this ILO project, Bonn, 27 Oct. 1999.

### 1.2.3 Business Start-ups out of Unemployment

Starting in business out of unemployment at first seems to be an even greater step than from a situation of employed work or training, as unemployment basically implies a failure in terms of the business system. Apart from that, along with the rise in unemployment, the search for radically new alternatives and the interest in self-employment thus motivated, are growing more and more salient.

These facts have triggered off discussion in Germany about the strategy of public funding. Most importantly, some argue that this approach was based on the irrational idea of "turning the weakest into the strongest", which was a mistake in the logic. There is some undeniable truth in this way of putting things, as the move into self-employment may well be motivated by sheer desperation. Even if such a start-up is supported financially, it is even more likely to fail,<sup>24</sup> the effects of the promotional measures then becoming detrimental for all parties involved.

This debate, however, should allow for the fact that the situation for business start-ups has undergone radical changes. Economy and society as a whole have shifted their focus onto the service sector, widening the room for new fields of activity. Business start-ups in the services are usually undemanding in terms of capital and labour input, and in this way the effort put into conventional management is typically kept low. What is more, economic development, especially in industrial enterprises, leaves more and more persons unemployed who are well able to stand their ground as small businessmen.<sup>25</sup> Now for this particular group it is most important to distinguish between unemployment "involuntary" and "opted". Many founders follow the strategy of registering unemployed prior to starting into business to gain time for their own preparation and, at the same time, obtain additional financial aid. This problematic aspect will be discussed in detail in the context of bridging allowances as an incentive. However, it also proves to impair the informational value of the following figures.

The rate of business start-ups out of unemployment is estimated to be about one in five,<sup>26</sup> while there is only a vague idea about the rate of unemployed persons becoming self-employed. At least it can be said that in 1998 100,000 unemployed persons have received promotional funds to set up in business, which is equal to approx. 2.5% of the total number of persons registered unemployed.<sup>27</sup>

A comparative analysis of founders out of unemployment (BA-founders) and founders of businesses supported by DtA-funds (DtA-founders) shows that ultra-small

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<sup>24</sup> The *RWI* explains this in a study in part 5 of the ILO German country report.

<sup>25</sup> Cf. hints from Wießner, F. to the qualification level of the recipients of *Überbrückungsgeld*, in: *Das Überbrückungsgeld als Instrument der Arbeitsmarktpolitik – eine Zwischenbilanz*, in: *Mitteilungen aus der Arbeitsmarkt- und Berufsforschung*, 31, 1998, p. 129.

<sup>26</sup> Interview with IAB, Frank Wießner, Oct. 1999.

<sup>27</sup> Wießner, F., *Das Überbrückungsgeld als Instrument der Arbeitsmarktpolitik – eine Zwischenbilanz*, in: *Mitteilungen aus der Arbeitsmarkt- und Berufsforschung* No. 1/1998, p. 125.

businesses dominate the figure of business start-ups out of unemployment.<sup>28</sup> There are significant differences also among the founders themselves:

- Founders out of unemployment are older and can claim longer working experience although not necessarily a higher qualification than "normal" founders.
- Just under three quarters of the founders out of unemployment opted for starting a business in the services sector, 25% in the crafts sector (multiple naming was possible).
- Almost without exception founders of businesses out of unemployment started from scratch.
- Founders out of unemployment covered 52% of their start-up capital requirements from their own resources and in the vast majority of the cases the need for outside capital was marginal. The question if this is partly due to the lack of access to credit funds has to remain open at this point.

The typical financing strategies on the part of founders out of unemployment turn out to be one of the main differences between them and conventional founders. The point that to support founders out of unemployment means to attempt, of all things, to "turn the weakest into the strongest", is not a striking one in all of the cases anymore, considering the changed overall circumstances. Unemployed founders have to be viewed with a more discriminating eye, in fact every individual case by itself. In a nutshell, business start-ups out of unemployment have grown to be a complex field of genuine start-ups and start-ups performed bowing to necessity, new enterprises promising and hopeless, and different individual personalities each to be seen pronouncedly in their own right. Concludingly it must be stated that there are better chances for business start-ups out of unemployment than there used to be, at least in theory.

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<sup>28</sup> Struck, J., et al., op. cit.

## **1.3 Main Problems connected with business start-ups out of unemployment**

Having explained by deducing from statistical evidence that the business start-ups out of unemployment are a potential factor of relief to the labour market, we will now point out the main problems facing the respective founders. Again, we will approach the topic by considering the general problems founders of businesses are faced with in Germany. Attention is to be paid particularly to the financing problems connecting with setting up small and ultra-small businesses that are widely discussed in Germany under the heading of "credit gap (*Kreditlücke*)".

### **1.3.1 Problems Connected with Small Business Start-ups in General**

In order to establish an independent business the founder requires some range of qualifications and knowledge. Assessment of the market situation and a sound business concept are as important as the awareness of legal, tax-related and social standards for enterprises. The main factors hampering founders of ultra-small businesses are summarised in the following terms by a report from the European Commission:<sup>29</sup>

- cultural and economic impediments resulting from a hardly promising current situation,
- difficulty with activities preliminary to the intended start-up, the training of the would-be business men and the examination of the plan's ultimate practicability,
- difficulty in obtaining the start-up capital required by small-scale projects,
- difficulty arising from the communication between the future self-employed persons and the authorities in charge,
- difficulty with the change in the founder's occupational status and the social effects on himself and his family

A business's prospects of success, however, are determined not only by managing skills, business idea and marketing performance, but, among other factors, by the adequate financing structure tailored to fit the enterprise's size and degree of performance. Both factors decide upon the ongoing existence or failure of the enterprise. This study, however, is intended mainly to highlight the commonly acknowledged central problems of financing in the shape they take on in Germany.

### **1.3.2 The Problem of the "Credit Gap"**

A large number of sources point out a lack of access to loans as the main handicap of founders with small-scale projects or stigmas like unemployment, foreign nationality etc. From the point of view of theoretical economics such a market failure is unlikely, as gaps in

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<sup>29</sup> European Commission, Hindernisse für die Gründung von Kleinstunternehmen in der Europäischen Union, Schlußbericht, Luxemburg 1999, p. 10.

the market should be discovered, filled by new offers and, if applicable, remunerated by a risk mark-up in interest. The theory of the "Credit Gap" explains why, in spite of that, market failures do occur in ultra-small start-up businesses. In this context we will now outline an analysis by David Storey<sup>30</sup> which has gained importance within the English-speaking world.

Storey sees the main causes for credit rationing and the resulting credit gap in

- 1) asymmetric information between the bank and the enterprise to be founded and
- 2) the recognition of the fact that the scope of control the bank exercises over those enterprises it keeps credit arrangements with is insufficient (lack of control).

Under ideal circumstances all enterprises would behave in a conform way and the bank would be aware of this conformity. As the enterprises, on the contrary, vary greatly in capacity and efficiency, transparency and motivation, the said asymmetry is an invariable condition of business transactions between banks and enterprises, and as such influences risk assessment in the following ways:

- Lending banks have no share in the profit of a successful enterprise. Their "maximum gains" are confined to interest and full repayment of the credit.
- If, in the negative case, the project financed turns out to fail, the borrower at worst declares his/her bankruptcy and lacks the sufficient securities, the bank loses everything, both the credit and the interest yet to be paid.

As we see, a credit agreement means full risk on the part of the bank. There is no compensation of the form that investment earnings from successful enterprises cover the losses from risk-entailing lending commitment in the field of "small businesses".<sup>31</sup>

The banks meet this situation according to the principle of minimising risks. In allocating credits they give preference to larger firms whose structure allows them to offer sufficient securities. Smaller firms carry, speaking without bias, a higher risk and tend to be charged with higher interest rates (risk surcharge). The resulting danger lies in the fact that those higher interest rates are accepted only by high-risk projects and enterprises, which in turn impairs the bank's credit portfolio – in other words – an "averse selection" becomes prevalent.<sup>32</sup>

Storey refers to facts documented by studies from the Anglo-Saxon world to point out the actual disadvantages faced by particular groups:

- start-ups by blacks in the USA tended to receive fewer credits than those by white people and were more strongly underfunded.
- Afro-Caribbeans in the UK faced significantly greater problems to obtain funds than Asian and white firm owners.

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<sup>30</sup> Storey, D.J., *Understanding the Small Business Sector*, London and New York, 1994.

<sup>31</sup> Storey, D.J., *op. cit.*, p. 249.

<sup>32</sup> Cf. Mishikin, 1994, p. 35f.

Time is not made easy either for founders intending to join the market with new technologies, as they are even less assessable for the banks.

On the whole, Storey concludes that there is no widely spread credit shortage, but there certainly is one affecting very small enterprises and the special groups of enterprises started by "ethnic non-white" persons or based on high technology.<sup>33</sup> The elimination of the divergence between the participant in the market would demand either atypical, non-rational moves on the part of banks and founders or the services of intermediaries to bridge between suppliers and demanders and help the gradual collapse of fixed old structures in every individual case.

Storey's findings cannot be directly applied to the German market. On the one hand here the chance of achieving a compensation of risks by raising interest rates is limited as compared to Great Britain due to the legal regulation of the top interest rate. What is more, in Germany the problem of credit shortage is mitigated by the widespread regional branching of German savings and co-operative banks. Nevertheless the problem of credit shortage as affecting small and new businesses is a concern in German literature.<sup>34</sup>

### 1.3.3 Particular Financing Problems Faced by Founders of Ultra-small Businesses

In the process of starting a business the prior-ranking tasks are for the founder to work out a sound business concept and to find sustaining solutions of financing. The financing has to be flexible enough to adjust to the turns in the process of a business start, which hardly are assessable. The founder of a business cannot be presumed to have the full extent of know-how necessary. On the contrary, his strength may be his concrete business idea and the awareness of chances and risks in its realisation. Therefore the German promotional system puts the principal bank beside him as an expert and mentor.<sup>35</sup>

This means that in the said questions the new businessman can basically rely on his bank's advice and support. Notwithstanding, as the founder of an ultra-small business – possibly out of unemployment –, he comes across a banking system whose efficiency and professionalism have developed in the course of operations with a completely different set of clients and of much larger scale. Research literature, at least, represents a variety of problems in micro-loan business, the most important of which will be outlined here.

From the bank's point of view the main sources for problems are :

- insufficient quality of the business concept, lack of business know-how and qualifications and lack of interest in counselling services<sup>36</sup>

<sup>33</sup> Cf. Storey op. cit., p. 244, 246f.

<sup>34</sup> Audretsch/Elston, 1996, p. 80f.; Egehn-Hörnle/Licht, 1996, RWI 1996, p. 55; DtA/Struck 1995. p. 5.

<sup>35</sup> The legal grounds for the status of the principal bank within public promotional measures is in Krüger, U./Evers, J., Gescheiterte und verschuldete Existenzgründer – Rechtliche Verantwortung der Banken? In: Schuldenreport 1999, Baden Baden 1998, p. 138-152.

<sup>36</sup> Trippen, 1976, p. 229, Laub, 1994, p. 250.

- insufficient rate of profitability in financing the start-up considering the high expenses for consulting, especially if loan sums are small and support from public authorities applies<sup>37</sup>
- insufficient quantity and quality of securities<sup>38</sup>
- lack of information as a basis for credit standing investigation, particularly for lack of data from the past<sup>39</sup> or, if applicable, hardly assessable ideas for a product<sup>40</sup>

A lack of profitability in servicing funding activities for a start-up presents an obvious problem of its own. According to an estimation by the *Deutscher Sparkassen- und Giroverband* (DGSV) the costs of a credit standing investigation in connection with an application for public funding amount to an average of about 1,500 DM.<sup>41</sup> Other Banks reckon with amounts even between 2,500 and 4,600 DM per loan application.<sup>42</sup> These costs arise almost regardless of the loan sum allocated, as costs of transaction for start-up loans are mainly determined by costs of information and control, which are the higher, the less clearly cut the business concept is.<sup>43</sup>

As the principal bank's return for the administration of development funds is no more than a margin of approx. 1%, only applications for loans over 150,000 DM can be handled without affecting costs. Accordingly, more than 75% of the loans refunded by public means in Germany exceed 100,000 DM.<sup>44</sup> There is considerable difficulty in having applications for smaller sums accepted by the principal bank. However, there are considerable differences between the various banking groups existing in Germany<sup>45</sup>, within the banking groups themselves and even within some individual banks.<sup>46</sup> We will look at this problem more closely when examining the German promotional system.

From the entrepreneur's point of view the main sources for problems are, on the other hand :

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<sup>37</sup> Rüdiger Schiller, director of DtA, explains: "From a survey we know that an average of four in ten credit applications are turned down by the credit institutes. Many of them have a reasonable concept, but cannot take the hurdle of the principal bank."; also cf. Kaufmann 1997, p. 142, Granger 1998, p. 32f., Reifner/Evers 1998, p. 52

<sup>38</sup> Lizano/Mesalles 1995, p. 36, Engeln-Hörnle/Licht, 1996, p. 198f., Reifner/Evers, 1998, p. 50f., Young, 1996, p. 106; Putman, 1998, p. 67, Erbs 1998, p. 78) and lacking equity rate (Trippen, 1976, Kaufmann, 1997, Braunschweig et al., 1998, DtA/Struck, 1995, p. 5).

<sup>39</sup> Hughes, 1996, p. 31, Ennew/Binks, 1995, p. 59; Erbs, 1998, p. 78.

<sup>40</sup> Audretsch/Elston, 1996, p. 84.

<sup>41</sup> Geisen, B.: Der mühsame Weg durch den Förder-Dschungel, Welt am Sonntag, 9 July 1995, p. 38.

<sup>42</sup> According to information from *Bund der Selbständigen Nord* (BDS) on 8 April 1998.

<sup>43</sup> Cf. Schulte, R., Das Risikoverhalten von Banken gegenüber Existenzgründern, in: Ridinger, R./Weiss P. (eds.), op. cit., p. 116.

<sup>44</sup> Statistics of the Deutsche Ausgleichsbank, 1st quarter 1995, Welt am Sonntag, 9 July 1995, p. 38.

<sup>45</sup> Savings banks and co-operative banks are considerably more active in the credit business with small firms than the commercial banks are: In 1996 the co-operative banks passed on 9997 start-up loans of *Deutsche Ausgleichsbank*, the savings banks passed on 4080, and the commercial banks only 1096. Cf. Reinking, G.: "Größtes Problem im Mittelstand: Die Banken", Welt am Sonntag, 2. March 1997, p. 51.

<sup>46</sup> Cf. "Existenzgründungsberatung – Für die Kreditinstitute bleibt noch viel zu tun", in: Handelsblatt, 10 Sept. 1998, p. 23; Habschick, M.: "Am Tropf der Banken verhungern manche Gründer", in: Handelsblatt, 8/9 Jan. 1999, p. K8.

- insufficient counselling services on the part of the bank, particularly failure to consider the business plan in working out the financing arrangement and, in consequence, to tailor the arrangement to the very needs of the project<sup>47</sup>, the same applying to the insufficient utilisation of incentives<sup>48</sup>
- lack of securities accepted by the bank<sup>49</sup>
- insufficient quality of financing, particularly lack of transparency and insufficient matching of maturities<sup>50</sup>
- insufficient adjustment of the loan in the period following the start-up<sup>51</sup>

In the case of founders of businesses out of unemployment these problems are even more serious, as an unemployed person's standing and prospects of success may be rated even lower.

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<sup>47</sup> Laub, 1994, p. 250; Erbs, 1998, p. 71; Granger, 1998, p. 47f., Reifner/Evers, 1998, p. 20.

<sup>48</sup> Laub, 1994, p. 99; RWI, 1996, p. 185, 187; Döhle, 1997, p. 194f., Eckert, 1990, p. 69f.

<sup>49</sup> Laub, 1994, p. 98; Bank of England, 1998, p. 19; Eckert, 1990, p. 167ff.; EU Commission, 1997, p. 9.

<sup>50</sup> IFM, 1982, p. 135, EU Kommission, 1997, p. 9, 26; Herter, 1991, p. 62, Braunschweiger u.a. 1998, p. 48.

<sup>51</sup> Herter, 1991, p. 62, IFM, 1982, p. 59; RWI, 1996, p. 61ff.

## **1.4 Funding and Promotion Possibilities for Business Start-ups and Access for Unemployed Persons**

Whoever intends to set up a business in Germany is unable to avoid the banking sector. Notwithstanding new and successful incentives such as the Start-up and Hi-Tech market segment "*Neuer Markt*" (New Market) a loan is the central financing element in 95% of business start-ups. In addition there are elements provided by public funding institutions. These may be for example low-interest loans or guarantees provided by specialised public funding institutions or are conveyed by banks and savings banks. In this way there are close institutionalised connections between public funding programmes and financing services on the private sector, becoming apparent particularly in the so-called principal bank precept.

Founders of businesses out of unemployment have access to two alternative principles of financial support: general business start-up programmes on the one hand, special programmes for unemployed persons or founders of ultra-small businesses on the other. In this context business start-ups out of unemployment have access to two alternative funding schemes.

In the following we will describe the fundamentals of the financing and promotional system existing in Germany. We will examine in particular in which way access to the system is made possible or difficult for founders of ultra-small businesses and founders of businesses out of unemployment due to this structure. After that we will point out how banks and public authorities have reacted to the apparent problems of access.

### **1.4.1 The Banking System**

As has been said before, the most conspicuous characteristic of start-up financing in Germany is its strong orientation on the banking sector. In Germany the rate of financing by means of risk capital is low. The possibilities of funding open to founders are offered almost exclusively by the banks. In this way the basic structure strongly differs from the Anglo-Saxon system where it is easier for enterprises to gain access to the capital market.

Apart from that, banks in Germany act as intermediary for the public authorities in translating the funding programmes into action. This principal bank system is uniquely found in Germany relying on the privileged relationship between the client and his principal bank and representing a long-term bond of trust, which is particularly important in loan funding for enterprises with their asymmetrical distribution of financial information.<sup>52</sup>

By and large, business finance as well as start-up financing is carried out by the traditional banks, which in Germany occur in three organisational varieties:

#### **Commercial Banks:**

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<sup>52</sup> Cf. Quack, S. und Hildebrandt, S., Hausbank or Fournisseur? Bank services for small and medium sized enterprises in Germany and France, WZB, Berlin, 1995.

Commercial banks in Germany traditionally keep close business connections with the large industry and services corporations. After having ignored small businesses as clients for a long time, their interest in allocating credits to this group of clients has been growing since the 1980s. Small and ultra-small businesses, however, are still confined to a marginal role in the activities of commercial banks. Financial press persistently reports that commercial banks are withdrawing from credit business with small enterprises. The magazine *Impulse*, for example, has found out by enquiries that in 1999 a major bank in northern Germany has asked all its clients whose volume of turnover was below 5 million DM to look for another bank.<sup>53</sup>

### **Savings Banks:**

The importance of savings banks lies in their being widely present on a local scale and well integrated into politics and economy on both the local and the regional level. Contrary to the private banks they are, for the most part, subject to obligations under public law. In the market segment of small business start-ups, where they compete with co-operative banks, they discharge some quite important duties. At state level savings banks are organised in giro associations. These giro associations on their part, together with the federal state governments, are the owners of the state banks (*Landesbanken*). The state banks themselves are not always directly in touch with the personal sector, but they play a vital role in translating measures devised by the federal state governments into action. The merits on the part of the savings banks within business start-up activities leap to the eye: approximately 50% of the public funds are extended by them. However, even here there is an increasing tendency to define the minimum credit sum for a rewarding funding arrangement and to look for new strategies for volumes below that minimum.<sup>54</sup>

### **Co-operative banks:**

The starting of co-operative banks, like that of the savings banks, dates back to the first half of the 19th century. These institutes were situated more in rural areas structured by the agricultural context. The most prevalent form is the *Raiffeisenbank* und the *Volksbank*. The co-operative banks can make use of an extensive branch network and also operate in areas where the traditional banks are hardly present at all. Their main concern, prior to attaining maximum profitability, is to satisfy the needs of the associates and clients. The characteristic they share with savings banks is that they are based on a local level and operate in a decentralised way. To compensate for the disadvantage that lies in their small size they are organised in umbrella organisations on the federal state (*Länder*) and national level and in the *Deutsche Genossenschaftsbank* (German Co-operative Bank).

During the past two decades there has been an attempt at developing an alternative to the traditional banks. Some new banks have emerged, mostly in the form of co-operative

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<sup>53</sup> (will be given later)

<sup>54</sup> According to interviews Jan Evers, IFF, has performed with leading consultants for business clients of four major German savings banks in August and September 1999.

or commercial banks. They were founded either for social or economic purposes like the *Bank für Klein- und Mittelunternehmen* (*Bank für KMU*, bank for small and medium-sized enterprises), with aims of an explicit social nature like the *GLS Gemeinschaftsbank* (*GLS*), or with a pronounced ecological commitment like the *Ökobank*.

The two latter types are only marginally involved in funding ultra-small businesses. The *Bank für KMU*, in contrast, placed its special focus on the segment of small and medium-sized businesses and made a central point of client coverage (consultancy). A closer look at the customer profile shows, however, that even here medium-sized businesses prevail over ultra-small businesses in terms of funding.

The fact that funding offers by the banks to support start-up businesses are still strongly limited is all too obvious. To compensate for this an extensive system of public funding has been in operation for the past decades.

## 1.4.2 The Public Funding System

### 1.4.2.1 Fundamentals of the Funding System

The system of start-up funding established in Germany presents quite a complex picture.<sup>55</sup> The German federal system consisting of 16 federal states (*Länder* or *Bundesländer*) since German unification, besides the federal government (*Bund*) and the EU, is a source of a large number of promotional measures. So there is an estimated total number of 3,500 different promotional programmes,<sup>56</sup> a systematic description of which would exceed the scope of this study.<sup>57</sup>

Basic features of the system of start-up finance in its present form is a vast amount of (partly combinations of) different kinds of measures including various offers such as :

- interest-subsidised loans to improve the equity provision
- provision of risk capital
- loans at a low or reduced rate of interest
- support in access to outside capital by means of guarantees and counter-guarantees
- subsidies and allowances for a range of investment schemes
- tax concessions

To be named are in addition to this a variety of programmes of direct and indirect financial support – and a number of other supportive activities. There are also institutionalised funding of science, technology and innovations, sales promotion for

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<sup>55</sup> Klemmer, P., Friedrich, W., Lagemann, B., et al., *Mittelstandsförderung in Deutschland – Konsistenz, Transparenz und Ansatzpunkte für Verbesserungen*, Untersuchungen des Rheinisch-Westfälischen Instituts für Wirtschaftsförderung, 21, RWI Essen, 1996.

<sup>56</sup> Geisen, B., *Der mühsame Weg durch den Förderdschungel*, Welt am Sonntag, 9 July 1995, p. 38.

<sup>57</sup> For an elaboration on this topic cf. Klemmer, P. u.a., a.a.O., S. 79 ff.

enterprises orientated towards foreign trade, and institutionalised funds for counselling and training. This range of offers is completed by the promotional measures on the part of the *Bundesanstalt für Arbeit* with particular regard to tide-over allowances (*Überbrückungsgeld*) since the late 80s.

In Germany the major organisations for enacting the various subsidy or lending programmes are the *Kreditanstalt für Wiederaufbau (KfW)* and the *Deutsche Ausgleichsbank (DtA)*. Both are credit institutes under public law operating on a national scale. The guarantee banks (*Bürgschaftsbanken*), which are represented in all federal states, are another important factor.

- ***Kreditanstalt für Wiederaufbau***

The *Kreditanstalt für Wiederaufbau (KfW)* was founded in 1947 for the administration of the funds allocated to Germany by force of the Marshall plan. Initially they were intended for iron and steel industry, energy supply industry and infrastructure. The loan was granted directly to respective companies without implementing another bank as intermediary. This changed in the mid-50s. From then on the *KfW* has been concentrating on financing enterprises by means of long-term loans and the services of the principal banks. These programmes operate by subsidising loans by offering the principal banks credits with better interest rates. As a return for transmitting the principal bank receives a commission (0.75 % to 1,25 %). The *KfW* is mainly orientated towards medium-sized and large-scale credit transactions and in this context can be understood as a refinancier.<sup>58</sup>

- ***Deutsche Ausgleichsbank***

The *Deutsche Ausgleichsbank* was founded in 1950 with the aim of helping displaced persons to settle anew. In time the bank has shifted its focus on to supporting small and medium-sized businesses, one of its main concerns now being funding schemes for business start-ups. The *Deutsche Ausgleichsbank* concentrates much more on small and medium-sized businesses than the *KfW*. However, the systematic approaches to funding are almost similar.

- ***Guarantee banks (Bürgschaftsbanken)***

These banks exist in every federal state of the Federal Republic of Germany. They were founded in the early 50s with the aid from public authorities as mutual assistance institutions (credit guarantee associations, *Kreditgarantiegemeinschaften*) within the trade organisations (e.g. chambers of commerce and industry, chambers of handicrafts) in co-operation with the lending industry. The aim of the *Bürgschaftsbanken* is to fill security gaps

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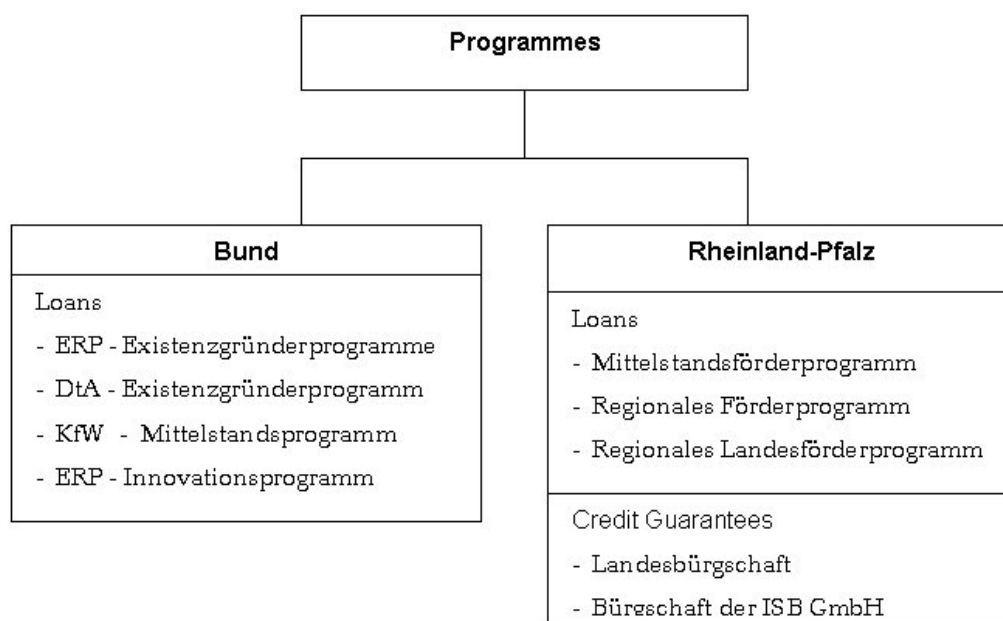
<sup>58</sup> Evers, J./Reifner, U., Die soziale Verantwortung von Kreditinstituten in der EU, Schriften des Institut Für Finanzdienstleistungen e.V., Vol. 2, Baden-Baden 1998.

in the context of financing arrangements. They do this in a responsible way where these gaps might prevent credit allocation. Thus in 1997 approx. 49 % of the total of guarantees furnished served the start-up or take-over of an enterprise.<sup>59</sup> The *Bürgschaftsbanken* operate at a profit in most of the business years, but one must take into account that they are subsidised by counter-guarantees from the federal government on a level of as much as 60 %. The costs of 1 % to 2 % on conclusion and a further annual 1 % are to be borne by the founders.

The realisation of public funding programmes and the allocation of incentives entails the participation of a large number of intermediary resp. infrastructural facilities (chambers, centres for technology and counselling as well as private financing consultants and experts). In 1996 the data base SAFIR listed no less than about 150 "donors" who handle and pay out promotional means for the small business community.

#### 1.4.2.2 General Survey of the Instruments of Financing and Promotion

The federal state of Rheinland-Pfalz lends itself as an example for a systematic visualisation of the various instruments of the German financing and promotional system:<sup>60</sup>



<sup>59</sup> Cf. *Verband der Bürgschaftsbanken*, Pressemitteilung – Bericht 1998 (press release by the association of guarantee banks), Internet.

<sup>60</sup> Hölscher, R., et al., *Finanzierung von Existenzgründungen in Rheinland-Pfalz – Eine empirische Analyse unter besonderer Berücksichtigung der Rolle der Kreditinstitute*, University of Kaiserslautern, Kaiserslautern 1999.

The centre is made up by the three large-scale lending programmes of the *Deutsche Ausgleichsbank*: EKH-programme, ERP-business programme and DtA-business programme. The resources from these programmes can also be allocated cumulatively for a certain share of the start-up investments. Apart from the DtA programme for capital resources aid the principal bank takes the full credit risk.<sup>61</sup>

The conditions of these programme loans are interest-subsidised for the founder and thus far below the market rate of interest. There are varying redemption-free periods for loans, depending on the individual credit, mostly in the first years of the start-up. The loans can be allocated cumulatively, but their amount is subject to defined maximums of the assessment basis, usually the start-up investment costs. The maximum in the *DtA* programme for founders is 75 % of the overall costs subject to subsidy. The highest amount that can be subsidised is 1 million DM; with the *DtA* programme for founders it is 4 million DM. The *EKH-Eigenkapitalhilfe* presumes an obligatory rate of own recourses of 15 %.

### **1.4.3 Problems of Access Faced by Founders of Ultra-small Businesses and Unemployed Founders**

The empirical studies available coincide in the whole in stating a range of basic problems for founders of businesses in Germany. Typically they meet the same difficulties in obtaining

- a bank loan
- public funds
- competent financial counselling.

These problems are basically faced by all groups of business founders. for founders out of unemployment, however, they are more pronounced and accompanied by additional difficulties.

#### **1.4.3.1 General Problems of Access for Founders of Businesses**

- **Problems of access to a bank loan**

At present there is hardly any information on the ways founders of businesses in Germany can obtain a bank loan. As a consequence, IFF has carried out an empirical investigation into 12 banks in the areas of Berlin, Hamburg, Cologne and Munich.<sup>62</sup> The results from this first test of access, probably unique even on an international scale, show

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<sup>61</sup> Cf. Lüdemann, O., op. cit., p. 28.

<sup>62</sup> Evers, J./Habschick, M.: Existenzgründungen – Zugang zu Bankkrediten und Beratungsqualität – eine empirische Studie im Auftrag des STERN, Hamburg 1998 (Summary in STERN vom 10 Sept. 1998, p. 186 ff).

that access to loans from traditional banks to finance a business start-up is hardly assessable for the founder: Only 20 % of the test cases resulted in an acceptable financing offer, although all the test cases were designed to match actually existing cases of successful business start-ups.<sup>63</sup> This result must be judged an utterly negative one. Only those credit institutions that organise their counselling in special centres for founders achieved better results. This group also included the winner of the test.

- **Access problems to public means of subsidy**

The few empirical studies available testify at the same time that public support programmes hardly ever reach the founders of businesses: In the Hamburg survey of applicants for a business license only just under 9 % of the founders requiring outside capital<sup>64</sup> met the DtA's criteria for eligibility for aid. The study on business start-ups in Munich even came up with a rate of only 3.3 % of founders who availed of loans from public funds.<sup>65</sup>

It is also interesting to note that in many of the bank consultations actual possibilities are not even mentioned to the founders: Promotional means for the start-up were proposed only in 25 % of the consultations of the IFF test. According to a survey by RWI of the small and medium-sized businesses in the new federal states (*Neue Bundesländer*) only 60 % of those financed by the ERP and only 40 % of those not supported at all had been informed about the promotional options by their banks.<sup>66</sup>

It must be stated as a result that founders of businesses face access problems with respect to both bank loans and public funding.

- **Possibilities of access to competent counselling**

To start with founders of businesses even face structural deficits in the range of offers as far as access to counselling interviews with the banks are concerned. The said IFF test<sup>67</sup> showed that of all cases of a person contacting a bank only 61 % resulted in counselling appointment at all. This is due to heavily defects of the organisation within the bank and partly also to serious shortcomings in counselling and customer service. To name only one apparent fact, applications were often rejected in an insufficient way or without justification by reasons (67 %). What is more, even those financing offers actually made were often unsatisfactory in terms of quality. The most prevalent shortcomings in the financing constructions proposed were – apart from the said failure to consider funds – that

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<sup>63</sup> Only one of the cases involved an ultra-small businesses in the actual sense.

<sup>64</sup> Lüdemann, O., op. cit.

<sup>65</sup> Cf. Brüderle J., Preisendörfer, P., and Ziegler, R., *Der Erfolg neugegründeter Betriebe – Eine empirische Studie zu den Chancen und Risiken von Unternehmensgründungen*, Betriebswirtschaftliche Schriften, 140, Berlin, 1996.

<sup>66</sup> Cf. Klemmer, P., et al., op. cit., p. 187.

<sup>67</sup> Cf. Evers, J./Habschick, M., op. cit.

the liquidity needs were underestimated and the measures deployed were deficient in coincidence of maturities.

### 1.4.3.2 Access Problems for Founders of Ultra-Small Businesses

- **Problems of access to a bank loan**

Access to loans and promotional programmes mediated by the principal banks bears even more difficulties for the group of founders of small and ultra-small businesses than for the "average" of founders describes above. The following chart shows which extra obstacles can attach to the stages of the business start-up even before the founder of an ultra-small business can participate in the programmes.<sup>68</sup>

**Table 3: Access problems**

<b>Stages of credit uptake</b>	<b>Nature of obstacle</b>
Stage of planning	<ul style="list-style-type: none"> <li>• Fear of the consequences of raising a loan</li> <li>• The act of contacting a bank is judged hopeless in advance</li> <li>• Negative feedback from the founder's family ("too risky – you'd better keep your job")</li> <li>• High prerequisites on the part of the bank about the start-up concepts (e.g. plan for cash budgeting)</li> </ul>
Application	<ul style="list-style-type: none"> <li>• Lack of support in the task of setting up a start-up concept – often especially badly trained business consultants (if sponsored by public authorities)</li> <li>• The start-up project may not be sufficiently advanced</li> </ul>
Credit standing investigation	<ul style="list-style-type: none"> <li>• If the start-up does not aim at a full-time business: no public funds available, moreover assessment of profitability may be inadequate</li> <li>• Possibly not enough equity</li> <li>• Small loan amount</li> <li>• If the funding only concerns working capital, it is mostly denied by the banks for lack of acceptability <b>{to serve as collateral}</b></li> </ul>

Knowing this background it is not surprising that empirical analysis of access to loans show that applications for large credit sums have far more success(58%) than those for smaller amounts where only 37% were successful.<sup>69</sup> Apparently founders of ultra-small

<sup>68</sup> Interviews with bankers and founders; all the reasons listed were mentioned in at least one interview. In: Evers, J., Pierret, D., Benchmarking in Micro Lending, Länderbericht Deutschland, Studie des Institut für Finanzdienstleistungen, Hamburg, 1999.

<sup>69</sup> Cf. Schulte, R., op. cit.

businesses face even greater disadvantages in obtaining credit than founders of businesses in general.

- **Access problems to public means of subsidy**

The central funding offer for founders of businesses in Germany are the large-scale lending programmes of the *Deutsche Ausgleichsbank* (*Eigenkapitalhilfe*, *ERP-Existenzgründungsprogramm* and *DtA-Existenzgründungsprogramm*). In how far these offers are actually made use of by the group of founders of businesses is hard to say. Basically it can be stated that in the *DtA*'s statistics on credit allocation micro loans only make up for a minor amount in relation to the total amount lent.

**Table 4: Dimensions of *DtA* loans refinanced from public funds<sup>70</sup>**

1997	EKH		ERP – Existenzgründung		DtA – Existenzgründung		Betriebsmittel (working capital)	
	Number %	Amount %	Number %	Amount %	Number %	Amount %	Number %	Amount %
up to 30,000	40.8	8.6	25.3	4.2	30.4	4.5	34.6	5.5
30,000 to 75,000	30.0	17.3	32.3	12.5	29.4	11.7	28.6	12.7
75,000 to 150,000	15.8	19.6	19.3	16.1	19.5	16.9	0.2	19.5
150,000 to 300,000	7.8	18.9	12.9	20.9	12.7	21.6	10.9	21.8
more than 300,000	5.6	35.6	10.3	46.2	8.0	45.3	5.8	40.5

While loan amounts below 30,000 DM resp. 75,000 DM must be regarded as minor, they make up more than half of the number of individual loans allocated by most of the programmes. The informational value of this set of data, however, is limited as far as credit allocation to ultra-small businesses or to founders out of unemployment is concerned due to the fact that e.g. loans allocated with *Eigenkapitalhilfe* (EKH, capital recourse aid) can at best cover only 25% of the total investments. Founders of businesses seeking a loan of 30,000 DM, would consequently have to make a total investment of 120,000 DM. This exceeds by far the start-up capital of 50,000 DM required by founders out of unemployment under normal circumstances (cf. section 1.2 of the study).

<sup>70</sup> According to an analysis by Deutsche Ausgleichsbank (DtA) made for IFF, 1998.

- **Access problems to competent counselling**

A survey carried out by the *bifego-Institut*<sup>71</sup> shows the correlation between the loan sum required on the one hand and the bank's counselling motivation on the other.<sup>72</sup> When asked to rate the bank's interest in business start-ups with a credit sum up to 50,000 DM on a scale from 1 to 6 the demanders of loans rendered a mark of only 4.03. Demanders for a credit sum of over 50,000 DM on their part marked the bank's motivation with a higher 3.37. The judgement of the bank's commitment covered a range from 3.68 for smaller loans and 3.29 for larger amounts. This means that founders of ultra-small businesses meet lower motivation in the bank from the start. The figures also show that demanders for large credit amounts tend to benefit more easily from services they cannot be directly billed for (compiling information, mediating contacts, various counselling services).<sup>73</sup>

Even if access to credit has been obtained the IFF findings revealed an insufficient quality of the financing, which can, under certain circumstances, become threatening to the founders' livelihood in the founding process. In the 1998 study this applied especially to projects up to 50,000 DM where a third of the test enterprises were, by preference and recommendation on the part of the bank contacted, to be financed exclusively by a current account advance. This method of finance is not only expensive but above all insecure, because the bank has the unilateral possibility of reducing the credit line at any time.

Another shortcome often traceable in financing concepts for founders of ultra-small businesses is the concentration on investment needs, leaving too little attention for financial requirements for working capital. Exactly this factor, however, for the group of founders of ultra-small businesses and founders out of unemployment is vital above the odds, as this group becomes active predominantly in the services sector.

For the bank it is easier to grant a loan for the acquisition of machines, buildings or real estate than for financing working capital. Financing of a real estate or a machine is still the most promising operation in terms of a security which can, in case of problems arising, be divested. On these terms it is not surprising that in the question of credit allocation enterprises with higher requirements for fixed assets tend to be preferred to new service enterprises. This brings about the fact that among small start-up businesses the proportion of handicraft businesses receiving funds is high in relation to service enterprises.

Accordingly the banks do not pay sufficient respect to the fact that many enterprises have become to less capital-intensive and instead have developed higher working capital needs. The public funding schemes introduced by KfW and DtA since 1997, that are aimed specially towards providing working capital, have definitely helped to improve the situation. The *DtA-Startgeld* provides further support for this new orientation – as will be described below.

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<sup>71</sup> (bifego) – *Betriebswirtschaftliches Institut für empirische Gründungs- und Organisationsforschung*.

<sup>72</sup> Cf. Schulte, R., op. cit., p. 97ff.

<sup>73</sup> Schulte, R., op. cit., p. 193.

- **Access to small-scale guarantees**

The problems of access to a small-scale credit correspond with problems of access to a small-scale guarantee. The average bail in Germany is on the rise and reached the amount of just under 200,000 Euro already in 1994.<sup>74</sup> This does by all means correspond to the financing needs of genuine medium-sized businesses, but hardly to those of ultra-small business start-ups. This is caused by similar problems of transaction costs as indicated above with regard to the bank's consideration of public funding programmes: The commission is a fixed percentage, which accordingly seems profitable for the guarantee banks especially in the case of larger sums.

#### **1.4.3.3 Access Problems for Founders out of Unemployment**

The negative risk rating of founders of ultra-small businesses by the banking sector applies even more to the group of founders out of unemployment, which is stigmatised from their outset as problematic or already having failed. And it is objectively true that they can mostly offer less in securities (e.g. because their savings are used up). Here the following problems emerge :

- Banks usually demand of the founder a share of 20 to 25 % in equity, which is reduced to 15 % in the case of public funding programmes.
- In order to cover the risk when dealing with founders of ultra-small businesses banks resort to property accumulated by the borrower in the past. Also personal securities are often demanded to be put up by a third party. Small-scale entrepreneurs and unemployed individuals often fail to offer sufficient securities.<sup>75</sup>
- The application for a financing arrangement has decisive power. It has to be submitted along with a convincing business plan. An application that is badly prepared or fails to meet formal standards is likely to be turned down even if its substance is sound. A bank cannot be expected to help the client in developing further an application failing to meet formal aspects.<sup>76</sup> Moreover the preparation of such an application prerequisites, among other things, special financial know-how.
- The granting of a loan is fundamentally a question of trust. This trust can be established by way of steady contact and a financial situation that has been relatively steady for a longer period of time, which does not usually apply to unemployed persons.<sup>77</sup> In those cases even the principal bank precept does not help.

If these problems coincide with a start-up project that is hard to assess, which is supposed to lead to success not at the basis of a drawn out plan but only on a step-by-step basis, the obstacles between the founder and the credit become insurmountable. This has been shown also by a IFF survey carried out in 1999 on behalf of a major bank by

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<sup>74</sup> The European Observatory for SMEs, 1996, p. 200.

<sup>75</sup> Evers, J., Le financement des micro et petites entreprises en Europe du Nord: obstacles et initiatives, in *Techniques financières et développement*, No. 37, Dec./Jan. 1995, p. 6.

<sup>76</sup> Cf. interview with N. Oefner, Volksbank, 14 May 1998.

<sup>77</sup> Cf. Interview with U. Cordua, entrepreneur, 5 May 1998.

interviewing consultants advising business customers and start-up business consultants about the practices of business start-ups.<sup>78</sup> The study revealed that only about 5 % of the credit applications from unemployed founders of businesses won approval. Among persons not unemployed the rate of approval was up to 10 times higher.

#### 1.4.4 Reactions of the German Promotional System on Problems of Access

Against the background of the problems outlined above the standard offers of start-up loans – though widely tried and tested and efficient for many demands – are obviously not sufficient. A number of new initiatives show that the financing and promotional system in Germany does react to these problems with new products. *DtA-Startgeld* (DtA-start-up-money) and a new scheme of the *Bürgschaftsbank Brandenburg* (guarantee bank in the state of Brandenburg) are important examples. Within the public sector the *Überbrückungsgeld* (tide-over-allowance) of the *Bundesanstalt für Arbeit* (federal employment office) has to be named especially. Moreover there are a range of special support programmes from the German federal states and the municipalities. As a whole the support schemes are evaluated in Section 3 of the ILO study for Germany.

##### ***DtA-Startgeld***<sup>79</sup>

- Financing is provided for starting self-employment.
- Natural persons, small businesses from trade and industry and freelancers can obtain *Startgeld*.
- The maximum sum is 50,000 Euro.
- A subsidy of 500 Euro is given to the credit institute passing on the money.
- Financing of 100 % of total financing needs, including both investments and working capital; equity finance is "desired".
- No combination with different DtA products.

It is to be stated that by means of this programme the loan requirements of ultra small businesses can be catered for more suitably with regard to amount and use of the loans. The procedure of credit application however is the same as with traditional promotional measures. Therefore a possible success within the group of founders out of unemployment cannot yet be proved.

##### **Small amount guarantees of *Bürgschaftsbank Brandenburg***

Another way to make access to credits easier for founders of micro businesses has been taken by the "10-Millionen-Programm" (10 millions programme) of the *Bürgschaftsbank Brandenburg*. It relieves banks from parts of the administrative expenses connected with allocating small amount guarantees. By means of this programme founders

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<sup>78</sup> Evers, J., Jung, M., Firmenkundenbetreuerbefragung im Auftrag einer Großbank, 1999, unpublished IFF paper.

<sup>79</sup> Cf. publication in website of *Deutsche Ausgleichsbank*.

can make use of the technical skills of the chambers, and because of credit standing investigation being performed by different hands the chances of credit approval and access to credit rise considerably. The programme was launched in early 1999 and consists of the following elements:

- Guarantees for investments up to 100,000 DM; however not for interim financing or excess loans; 80 % covering.
- Working out of a business plan together with chambers of commerce.
- Passing of the business plan to the guarantee bank, not to the principal bank.
- Investigation of business plan by the guarantee bank. Passing on of positive results to the principal bank.
- No fees are charged before the business plan is sent to the principal bank. Fees are 0.75 % for taking out the loan and 0.8 % regular commission.

The high demand<sup>80</sup> of this only recently introduced scheme speaks in favour of this approach, even more so since providing means of security is of high status for the banks.

### ***Überbrückungsgeld of Bundesanstalt für Arbeit***

The most widely known scheme to help the unemployed on their way to business start-ups is *Überbrückungsgeld* (bridging allowance) by the *Bundesanstalt für Arbeit* (federal labour office) financed by unemployment insurance<sup>81</sup>. With regard to a sustaining high rate of unemployment in the Federal Republic of Germany business start-up out of unemployment is financially supported since 1986 according to § 55a of AFG. Meanwhile *Überbrückungsgeld* is settled by § 57 SGB and since 1994 it is paid out for 26 weeks. In this period the founder still receives his unemployment benefit, in spite of possibly having gains from his enterprise.

In the judgement of IAB benefits from the scheme are more and more demanded. As a result of improving support terms in 1994 the number of supported cases has risen significantly from 37,297 in 1994 to 70,634 in 1995, which is nearly a doubling.<sup>82</sup> In 1998 as many as 98,000 individuals have started self-employment with support from *Überbrückungsgeld*. In relation to the total of business start-ups in 1998 (527,000) round about one in five cases is a business start-up out of unemployment. According to a survey of IAB 70 % of the originally supported founders are still self-employed three years after starting the business.<sup>83</sup>

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<sup>80</sup> From February to September 1999 there were 106 applications. That is round about the same level as in the whole of 1998 in this segment. Interview in October 1999.

<sup>81</sup> Spendings of BA are generally financed by the contributions of employees and employers. Moreover the BA receives subsidies from the federal budget.

<sup>82</sup> Wießner, F., Existenzgründer bevorzugen Servicebereich, IAB Kurzbericht No. 10/1997.

<sup>83</sup> According to information by IAB in an interview in October 1999.

## **1.5 Conclusions Concerning Financing and Support Facilities for Founders out of Unemployment**

Based on a number of empirical studies a failure of market mechanisms in the area of small and micro business start-ups can be stated. Financing problems effect business start-ups out of unemployment more than averagely. So there is a theoretical basis to justify governmental interventions in this market segment. In the German micro financing system there already are such interventions on quite a large scale. So the only question is if these measures are efficient in macro-economic terms. So finally we give a résumé of in how far the existing financing and promotional system meets the specific needs of founders out of unemployment and in which points there is still need for action concerning subsidy programmes of public authorities. Doing this we centre on the following questions :

- Which are the problems yet unsolved of the German finance and support system with regard to the target group of founders out of unemployment?
- Which actions do public authorities on the basis of these problems have to take to develop the German promotional system?

Our suggestions here are only cursory. The following parts of this study will show in more detail where concrete potentials for the development of the German support system can be found.

### **1.5.1 Unsettled Questions Concerning Financing and Promoting Business Start-ups out of Unemployment**

The German system of financing and promoting business start-ups consists of the two elements **credit** and **guarantee**. It is quite a powerful instrument for a large number of tasks. Its problems are mainly in the field of micro financing and thus they hit the target group we are concerned with here in particular. The most far reaching and most widely known scheme is "Überbrückungsgeld" (bridging allowance). It is characteristic of the German situation that this scheme is designed as a sheer subsidy programme. For Germany still has a long way to go for a highly developed and efficient "micro financing system". This is proved by the fact that only very few founders of micro businesses can make use of public means when financing their project with loans.

#### **• Problems with Efficiency of Financing Programmes**

As business start-ups imply a high risk both for the founder and for the grantor of credits and subsidies, the significance of credit standing investigations by the bank with regard to start-up projects must also remain high in future. In any case the capital markets will keep their important function to assess the survival rates of new enterprises on the market and to avoid misallocation of capital and subsidy means to serve the interest of all persons involved. However German support practice either puts as high obstacles in the

way of founders of micro businesses as to prevent their projects, or shuts out the market machinery by subsidising finance conditions below the market level.

Unaffected by this there are structural problems of access to finance and subsidy means for founders of ultra-small businesses and founders out of unemployment. The market machinery will not be able to settle these problems in future. The key problem is expenditure for examination, counselling and administration in credit standing investigation, rendering small loan amounts inefficient for the banks – regardless of the banks' willingness to be responsive to the respective founder. This problem is even greater with unemployed persons, as the individual risks are higher and the details of the projects possibly are less well planned.

Some of the difficulties arising from this have been noticed already and are taken up within the promotional programmes. Innovative approaches as the *DtA-Startgeld* (DtA-start-up-money) or the offerings from the *Brandenburgische Bürgschaftsbank* (guarantee bank in the state of Brandenburg) prove this.

However these are only small beginnings to solve the largely existing problems within German micro financing. This is also true with the *Überbrückungsgeld* (bridging allowance) of the *Bundesanstalt für Arbeit* (BA), which in different respects is open for new ideas to develop it. Though even in an altered form it cannot replace a sustainable start-up or enterprise financing.

- **BA-Überbrückungsgeld: Successes and Problems**

*Überbrückungsgeld* as the most important example for micro financing in Germany is seen controversially because of purely being subsidy.<sup>84</sup> Moreover no market mechanisms are included in this measure (credit standing investigation, etc.). So there is no selection of viable start-up projects. According to the findings of its accompanying research the *IAB* gives a rate of failure of 30 % after 3 years for the business start-ups supported with *Überbrückungsgeld*, whereas the *DtA* assumes a failure rate considerably higher than 30 %.<sup>85</sup> The following weak points in *Überbrückungsgeld* are the reasons:

**Low quality of business start-up:**

Interviews by the *IAB* ascertain a low rate of additional bank financing. This hints at (a) difficulties to have access to bank loans and (b) high numbers of marginal self-employment without growth prospects, as expansion typically is not possible without credit financing.

**Bandwaggon effects:**

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<sup>84</sup> Because of its design *Überbrückungsgeld* figures in a special way in German start-up financing, making comparisons with other micro financing schemes very difficult. This will be explained in more detail in the other parts of the German study.

<sup>85</sup> Cf. Struck, J., et al., op. cit., p. 20.

Bank counsellors for business credits report that the efficiency of *Überbrückungsgeld* is reduced by high bandwagon effects. A number of founders who intend to become self-employed anyway register as unemployed before starting in order to benefit from the scheme. Moreover it is conjectured unemployed individuals with prospects of a new job gain from fictitious business start-ups until they begin with their job.

#### **Covered failure:**

The success rate given by the IAB is doubted because of various reasons. Many founders go back to employment after business failure. They will, however, not report their failure in the interviews of the IAB, in case they walked off with subsidy without genuinely intending to start a business.

The *Bundesanstalt für Arbeit* (federal employment office) is aware of these problems. It is in favour of developing *Überbrückungsgeld* with regard to these aspects.<sup>86</sup> Nevertheless programmes like *Überbrückungsgeld* should not be the core of a modern, efficient micro financing system, but only have a function of addition.

### **1.5.2 Potentials for Improving the German Support System for the Target Group Founders out of Unemployment**

Against the background of the macro-economic aims connected to a large push of business start-ups, public authorities' promoting micro financing products for founders of businesses is sensible in result. The field of counselling and training the founders with regard to all questions of financing and special risks for atypical founders is concerned in first place. The established banking system is confronted with economically well-founded limits in this question; so new organisational structures and methods of credit allocation are necessary.

To sum up three decisive starting points for more efficient offerings for micro financing of business start-ups out of unemployment can be derived :

- Increase in efficiency of subsidy by means of better orientation of the instruments towards the target, that is to say avoiding bandwagon effects and misallocation of means for projects that cannot sustain the market.
- Concentration of subsidies on the central economic problem of access to credits: Subsidy of credit administration costs rather than interest rates, which cannot solve the problem of founders of ultra-small businesses.
- Linking of allowances to the founder with the instruments of common bank loans. This means that the efficient methods of risk assessment by banks can be of use for this

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<sup>86</sup> Wießner, F., Positive Zwischenbilanz für „Überbrückungsgeld-Empfänger“, in: IAB Kurzbericht, No. 1/1998, p. 7.

group as well to have an indicator for the possibility of sustainable existence without being denied access to the credit system as general practice up to now.

A concrete perspective for developing the German promotional system will be drawn up in the other parts of this study of the situation in Germany.