

Eekhoff, Johann

**Working Paper**

## The role of small and medium-sized enterprises (SMEs) in a market economy

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Direktoren: Professor Dr. Johann Eekhoff  
Professor Achim Wambach, Ph. D.  
Geschäftsführer: Dr. Steffen J. Roth

# **The Role of Small and Medium-Sized Enterprises (SMEs) in a Market Economy**

Professor Dr. Johann Eekhoff

**Otto-Wolff-Institut Discussion Paper 2/2011**

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## Introduction

During the past financial and economic crisis and especially in the phase of recovery after the crisis the German economy performed much better than the other economies in the European Union. The rate of unemployment declined from its peak of 12.6 per cent in 2005 to the actual rate of 6.5 per cent (October 2011), i. e. from 5.2 million to 2.7 million unemployed persons. The decline in unemployment was only interrupted for a very short time during the world wide recession in 2009. Although the gross domestic product (GDP) declined by 5 per cent in that year, the total number of employed persons remained almost the same. It decreased by only 0.3 per cent. In the following two years the growth rate of GDP reached 3 to 4 per cent and the reduction of unemployment continued. In several sectors of the economy there are more jobs offered than asked for.

This performance of the German economy is the background for looking into the special conditions and characteristics of the economic system. Delegations from several countries came to Germany to learn more about the "Mittelstand" i. e. the role of small and medium-sized enterprises (SMEs). These experts assumed that there must be a very successful SME-strategy in Germany, a kind of German SME-model. I think it worthwhile to investigate this question because the SMEs are standing for competition, engaged leadership and social stability. But in order to avoid misunderstandings I would like to stress two points:

- (1) The German economy was in a critical situation during the nineties and at the beginning of this century. The diagnosis at that time was: The social systems are becoming increasingly expensive. The labor markets are inflexible and the German industry is outdated and not competitive. So the positive development started only six to seven years ago.
- (2) The main reason for the new strength of the German economy is not the structure of the enterprises but the understanding and readiness of the trade unions to change their policy from fighting for maximum wages to organizing more flexibility and security in the labor market. The increase in real wages in the last 12 years was only 4.8 per cent.

The change from a stagnating economy with increasing unemployment to an economy with moderate growth and decreasing unemployment is due to the improvement of competitiveness by accepting increases in nominal wages only, i. e. unchanged real wages. Two lessons can be learned from this development: Firstly, an increase in real wages below the increase in productivity reduces the costs of production and creates new jobs.<sup>1</sup> Secondly, for the individual employee real wages are not identical with purchasing power. This can be explained by the following effect. One advantage of moderate wage increases – you could say of employment orientated wages – is the increase of employees contributing to the social systems (health, pensions, unemployment) and thereby reducing the burden for the already employed persons. Putting it the other way round: The contributions to the social systems would be definitely higher and purchasing power would be lower in the hypothetical development with higher wage increases during the last 12 years. The single employee focuses on his wage but ignores the interaction between wages, employment and contributions to social systems.

Another remarkable change during the last 10 years was the introduction of working hour accounts in Germany. In busy times when a company has many orders employees work extra hours, which are accumulated on their personal account. Monthly payment remains the same. In times of low demand, for example in a recession, employees work less hours. They get the same monthly payment until the accumulated hours on their accounts have been used up or exceed a limited credit of let us say 60 hours. This arrangement allows a high degree of flexibility in the working time at the one hand and stability in monthly payments as well as in employment on the other hand.

This is not to say that the structure of the enterprises has no effect on the economic development. I only want to stress the importance of the wage policy and general economic policy in this context, because the German economy

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<sup>1</sup> This is a very important empirical contribution to the controversy on the functioning of the labor market. The often mentioned hypothesis that the increase in wages increases purchasing power and creates jobs is not in line with the findings in the last decade in Germany. The theoretical reasoning says that an increase in wages beyond the increase in productivity raises production costs creates losses in certain production lines and leads to a layoff of employers or a stop in hiring new employees.

experienced two extremely different decades. But these observations in two different cycles might conceal the influence of small und medium-sized enterprises on the level of economic activities.

## Definition of Small and Medium-Sized Enterprises in Germany and in the European Union

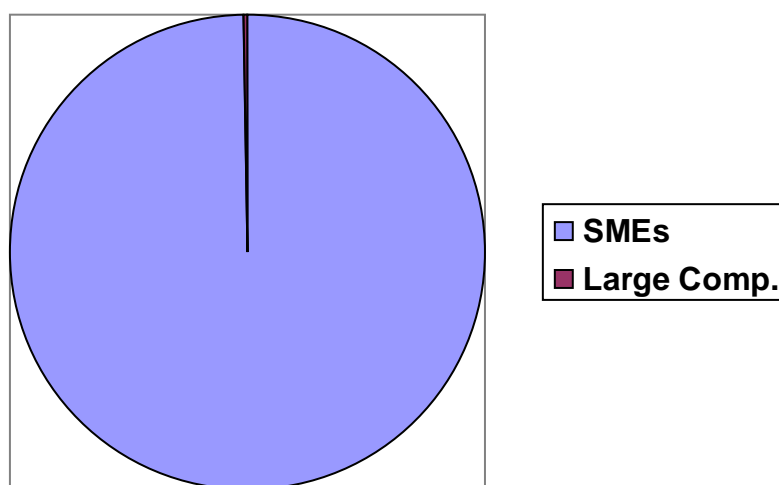
Especially for statistical reasons – i. e. for the observation of changes over time or the comparison of different countries – a quantitative definition is very helpful. In Germany and several other countries small and medium-sized enterprises are defined by two characteristics:

- the number of employees less than 500 *and*
- the annual turnover less than 50 million Euro

By this definition 99.6 per cent of all enterprises are small or medium-sized – in total 3.62 million. Only 0.4 per cent of all enterprises are large companies – in total 20 000.

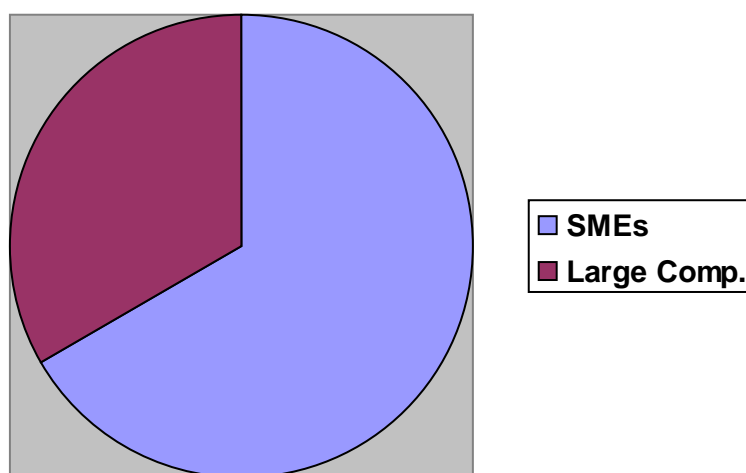
The following impressive graphic makes clear that the structure of the enterprises in Germany is dominated by small and medium-sized companies – many of them are very small.

### Structure of Enterprises in Germany



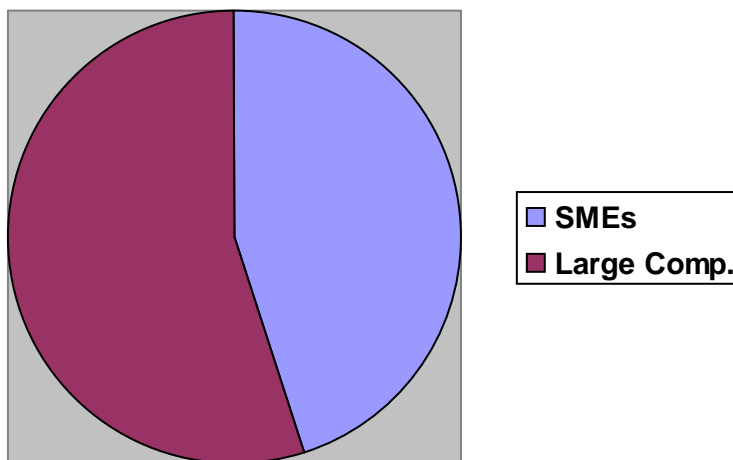
60 percent – that are 15.17 million – of all employees are working in SMEs. Of course the owners of the SMEs are working as self-employed in their enterprises. So the total number has to be increased by at least 3.64 million. Often two members of a family share the ownership and the management. Including these self-employed owners and the self-employed persons working on their own (single person “enterprises”) it comes to 4.3 million persons, so that the total number of persons in SMEs is not far from 20 million. The following graphic shows the proportion of dependant employees in SMEs and large companies.

### Employees in SMEs and in Large Companies



SMEs have a proportion of 40 per cent of the total turnover in Germany. Due to inflation the number of SMEs decreases as the amount of turnover is fixed. As the upper limit for the turnover is a nominal figure, the number of SMEs decreases with the rate of inflation. Another qualification has to be made: It should be noticed that turnover is not a good indicator for the contribution to GDP (Gross Domestic Product) or the value added.

## Turnover of SMEs and Large Companies



The official definition of SMEs of the European Union is more restricted:

- number of employees less than 250 *and*
- annual turnover less than 50 million Euro

The main reason for the smaller number of employees in the European definition is that the small member states would otherwise have almost no big company. Another reason could be that the member states with a low GDP per capita have a higher proportion of really small enterprises and that it is intended to direct the flow of subsidies from European programs mainly to relatively poor countries.

The theoretical und practical discussion has shown that not the number of employees but the ownership of enterprises is the most relevant characteristic. The quantitative delineation between a medium-sized enterprise employing 499 workers and a large company employing 500 workers is somehow artificial. Therefore the enterprises are differentiated in family enterprises und non-family enterprises or owner-run enterprises and manager-run enterprises.

It is not astonishing, that 95 per cent of all enterprises in Germany are run by its owners as compared to the figure of 99.6 per cent SMEs. That means: With a few exceptions all family enterprises are SMEs. Obviously there are SMEs which are joint-stock companies run by a manager. On the other hand there are large family

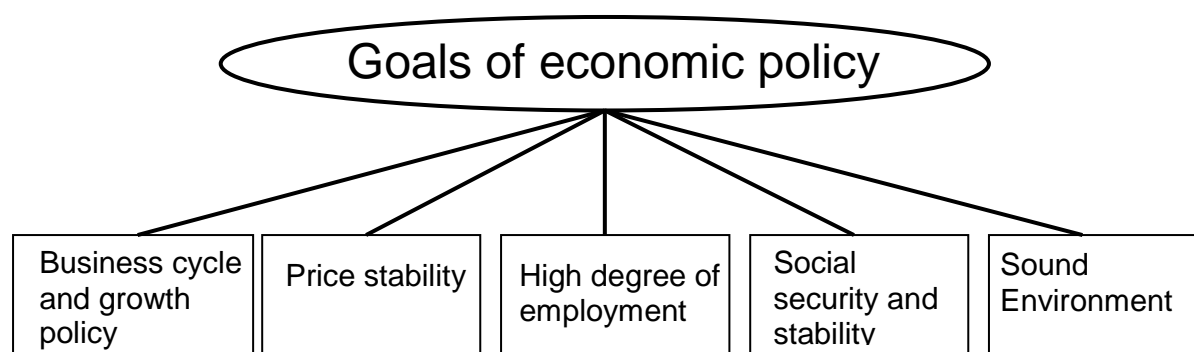
enterprises which are run by the owner. These large family enterprises count for only 0.1 per cent of all family enterprises. Family enterprises are defined as follows:

- At least 50 per cent of the equity has to be owned by up to two members of a family or two other persons.
- These two owners or a single owner are at the same time managers of the enterprise.

This means: Ownership and management of a family enterprise lie fully or to a large extent in the same hands. In general there is no principal-agent problem, because the agent (manager) is at the same time the principal (owner). This has far reaching consequences for the orientation and the decisions in such an enterprise.

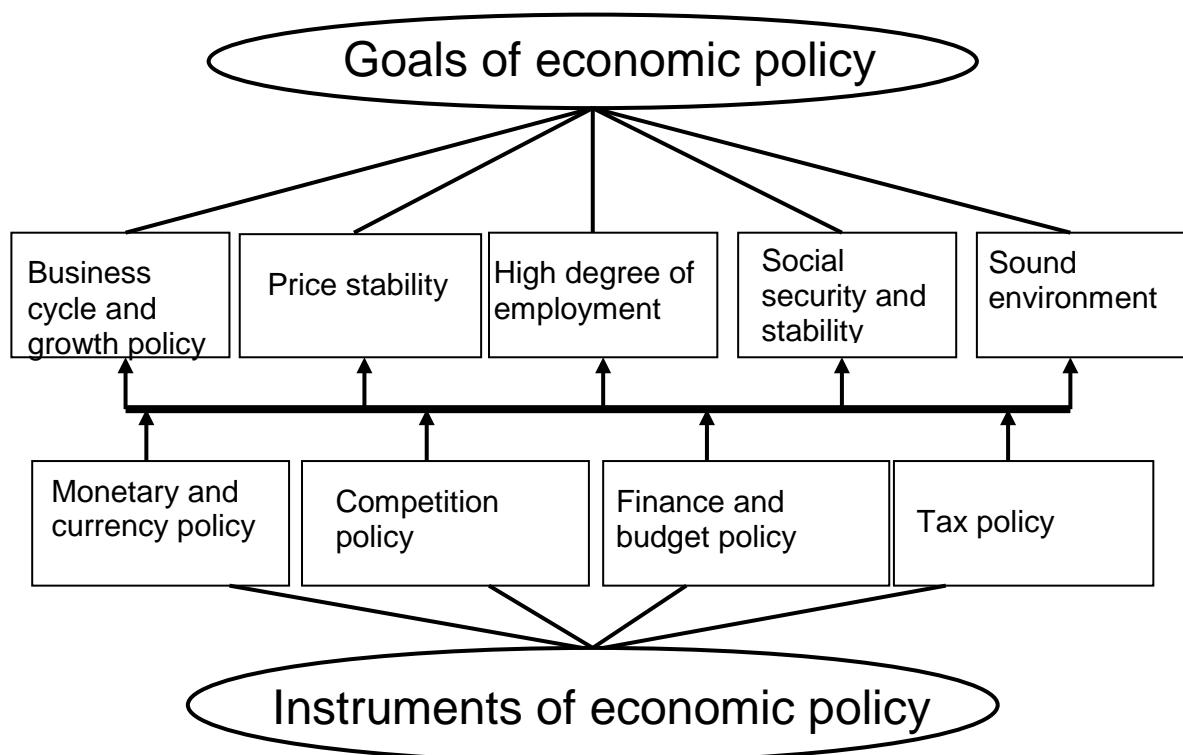
### **SME-Policy is Part of General Economic Policy**

It has to be stressed that small and medium-sized enterprises are not a tiny part of most market economies but make up the largest part. Therefore general economic policy is to a large extent at the same time SME-Policy. How SME-Policy is embedded in general economic policy becomes clear by looking at various subdivisions of economic policy.

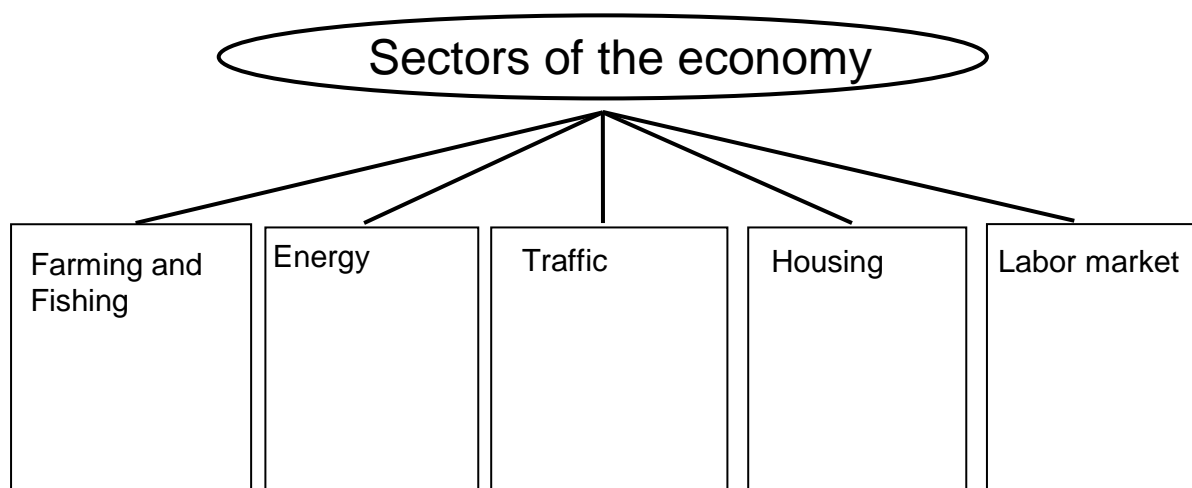


These general goals are at the same time goals of the SME-policy. Another perspective is to look at the instruments of economic policy.

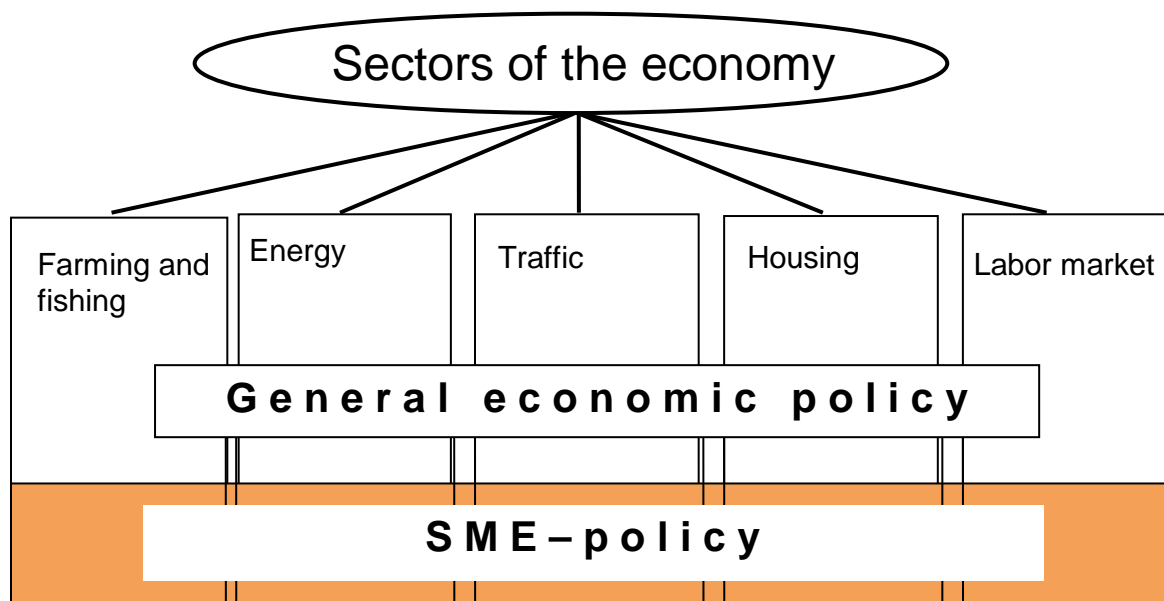




All these instruments affect SMEs. Another view can be taken from the perspective of a sectoral subdivision of the economy.



This list can easily be extended. But I think it is self explaining that SMEs are not a sector of the economy but enterprises which can be active in all sectors of the economy. This is visualized in the next figure.



### Advantages of Family Enterprises

Family enterprises are *interested in the long term results* of their activities. They are not driven by anonymous share holders to maximize quarterly profits. Their focus is the medium and even long term stability and development of the enterprise. This view enables them to accept a reduced profit during investment phases and on the other hand to refrain from speculative engagements.

The owners of *family enterprises rely on the persistence of their company*. In most cases the enterprises are their only source of income during their active phase and their life insurance, not only for the active members of a family but for the other members as well. Many owners stay at the top of the enterprise beyond the normal pension age. Even if they hand over the enterprise to a successor they keep working as long as possible – in some cases too long, because not all former bosses can stop giving good advice. But in general the continuity of persons and the long-term experience contribute to the success of the enterprise. In any case, the pension problems – especially due to a deteriorating age structure of the population – are not worth mentioning for the large number of families owning an enterprise.

Especially in Germany the SMEs and again the family enterprises play a dominant role in *vocational training*. This is an additional asset for the German economy.

Vocational training has a long tradition. Only a few decades ago young persons starting an apprenticeship had to pay for the first three years of training. Actually the trainees receive a payment, but much less than a full trained worker. In other words, this is a way to start employment with low wages which is a big problem in other countries. This gliding into full working hours and full payment is a positive side effect of the training program during the first three years.

The main goal of vocational training is to qualify workers. The schedule of the apprenticeship consists of three days of practical training in an enterprise and two days studying at a vocational school (dual system). Family enterprises play an outstanding role in employing and training young workers not only for their own needs but as well for large companies which engage the skilled workers after the three years of training period. In this way they contribute to the high quality of skilled labor in Germany.

Family enterprises on the average do not pay top wages. But they offer a low hierarchy, *close contact to the owner*, interesting and diverse tasks and a relatively high job security. This has to do with the long tradition of keeping employees in times of slack demand as long as possible.

In addition, continuous *contact between the leading staff and the customers* is a very important element of the success story of family enterprises. Especially in the machine and tools industry customers depend on reliable partners. Family entrepreneurs which are internationally active specialists, rely on a stable staff of high skilled experts staying with the company over many years, sometimes over the total working life.

Family enterprises can *play on global markets*. Most of them are producing in a market niche and have accumulated technical knowledge over many years. They continuously improve their products by an intensive communication with their customers. Because of the close contact with the users of the products, the enterprises are able to find solutions for specific problems and needs of their customers. It goes without saying that these enterprises have their own research and development units. The families are very motivated to stay ahead of there

competitors. This can only be achieved if they invest heavily in new products and product quality.

Examples for German family enterprises operating successfully on the world market for many years: railway brakes (Knorr Bremsen), electric plugs and power connections in any dimension (Mennekes), knives for cutting machines (Supradienes), motor driven saws (Stihl), laser cutting (Heräus, Trumpf).

Small and medium-sized enterprises usually stay in competition with other enterprises offering the same or similar products and services. By far the most SMEs are price takers, which means, that they cannot influence the price level in their specific market. Thus these enterprises contribute to a low concentration rate and low monopoly power in the economy. They decrease the necessity of controlling monopolies, oligopolies, cartels etc. It is always complicated to control national champions acting on the world market and even those dominating a regional market.

In small enterprises there is almost no chance for corruption. One reason is a high loyalty of the employees. But the main reason is that the important decisions are made by the owner of the enterprise. A precondition for corruption is the separation of decision making and ownership. Only employees who have no share in the enterprise can take advantage from corruption, because they do not bear the cost of the damage to the enterprise. Put it the other way: The owner of a family enterprise cannot gain an advantage by taking money for buying a machine and adding the sum of the bribe to the price he has to pay for the machine. He would be the gainer of the bribe and the loser of at least the same amount of money added to the normal he has to pay.

Family entrepreneurs have deep roots in the community. They are most welcome as employers, taxpayers, sponsors, members in charitable organizations, committees etc., taking responsibility for social life to the advantage of both, the enterprise and the community. The hostility against the business sector and companies, which can be observed in parts of the society in several countries, is

focussed on anonymous large joint stock companies and banks, not on family companies.

### **Limits of Family Enterprises**

Several family enterprises have difficulties to build up sufficient equity capital for large investments or in periods of strong growth. For most of them the only source of additional capital is the profit of the enterprise less the money for the daily life of the family. Therefore it can come to a conflict between keeping the owner control within the family and to abstain from investing in a large project on the one hand and sharing ownership with an additional owner – or changing the legal form of the enterprise – and increasing production or research by large steps on the other hand.

Another problem is continuity as the owner gets old and wants to resign. In several cases there is no family member who is able and ready to run the enterprise. First of all the owners try to find a new owner from outside. This means that they try to sell the enterprise. In a few cases the enterprise has to be closed, because nobody is interested in the enterprise or the potential owner are not ready or able to pay the price asked for. Empirical studies show a declining activity and a reduced level of investment prior to the change of ownership and a sharp increase in these activities immediately after the change. In most cases new ideas are brought in, so that the enterprise can expand.

### **Friendly Environment for Family Enterprises**

Family enterprises have a heavy weigh as a stabilizing element in the German economy and the society as a whole. They play an outstanding role in the training of the labor force. We might say they are a “nursery” or “seedbed” for large companies and the restructuring of the business sector according to the needs of the customers. In this field they are the dynamic factor of the business sector. And they are a pool of growth.

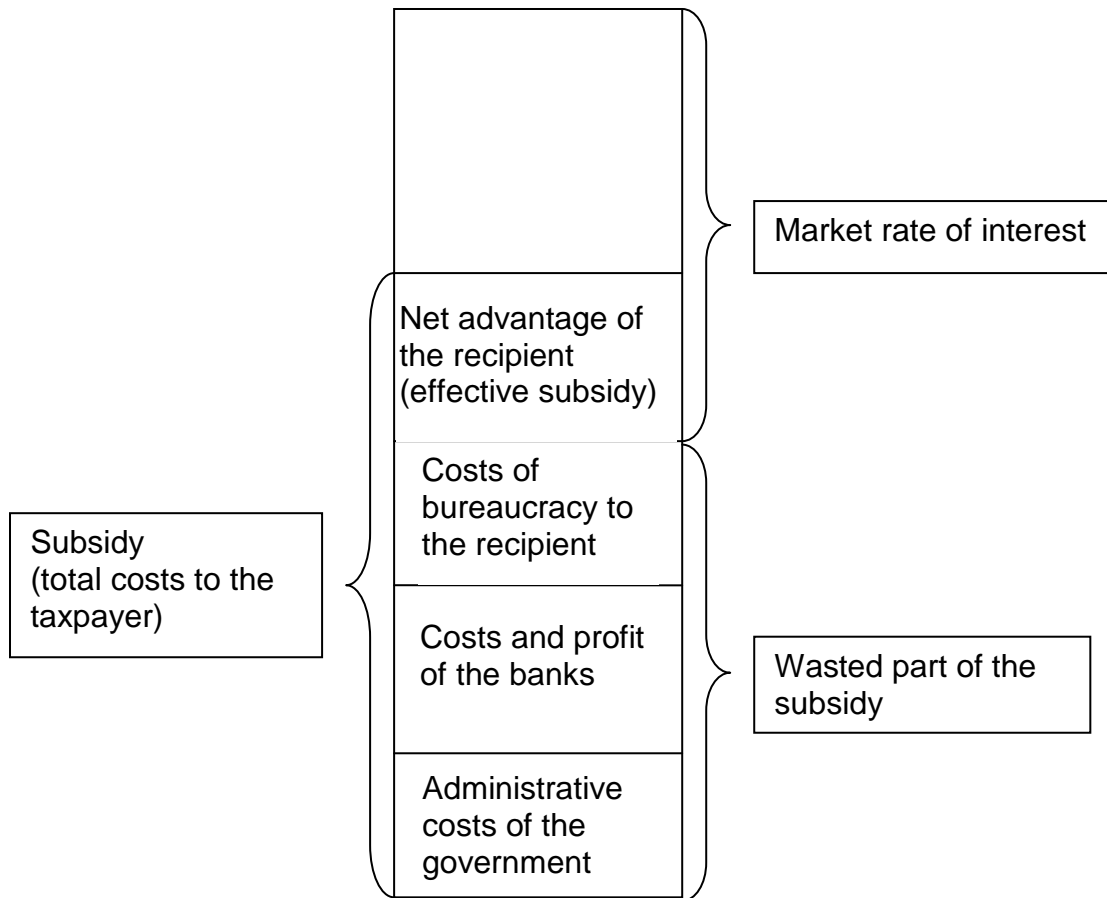
Economists and politicians from other countries often ask whether there is a special type of SME in Germany and whether we have special programs supporting SMEs and family enterprises. The general answer is, there are many

programs of the European Union, the member states of the EU, the federal states and the local authorities supporting SMEs, but almost all programs are restricted to founders, i. e. to the start of an enterprise, and every single program has a very low intensity of subsidies, i. e. they offer only small monetary advantages. Consequently many SMEs do not even ask for support.

To restrict subsidies to a short time and to keep them at a low level is a consequent policy because a general subsidy for SMEs does not make sense if these enterprises are expected to contribute to the wealth of society. This means SMEs are expected to be profitable in the private and the social sense. Therefore it must be sufficient to offer a friendly environment to SMEs and family enterprises.

In most member countries of the European Union there are subsidies for founders. The usual program contains a reduced interest rate. All governments are eager to show their engagement for SMEs – with little money. But the SMEs are not able or not willing to gather the necessary information on these programs, mainly because the net effect of the subsidies is negligible. Thus the large number of credits which could be subsidized is impeded by a low effectiveness of the reduced interest rate. Especially in times of low interest rates there is almost no positive effect of the subsidy. This can be explained by the following graphic.

## Low effectiveness of interest subsidies



The experience in one of the German Länder (German Federal States) confirmed that the enterprises are very reluctant to accept a subsidy. The Länder-Government started with a subsidy of 0.5 percentage points. There was no response. The subsidy was increased to 1.0 percentage points. The same result: no response from small and medium-sized enterprises. After a further increase of the subsidy to 1.5 percentage points, a few enterprises showed up. Finally the subsidy was increased to 2.0 percent points.

This experiment gives an indication of the costs occurring to the enterprises in connection with a subsidy. At the point of 1.5 percentage points the enterprises seem indifferent between asking for the subsidy or refrain from taking public money. If they get 2.0 percentage points their net advantage is 0.5 percentage points, 1.5 percentage points are wasted. Additional money is wasted for carrying out the program, controlling the correct use of the subsidy and gathering the

money from the taxpayers. So the relation of costs to benefits for subsidies consisting of a few interest points can easily exceed 3 to 1.

The experiment was made in a period with fairly high market rates of interest. But it can be seen, that there are high costs of bureaucracy within the enterprises. In addition there is a high degree of insecurity. The enterprises have to meet certain conditions which can be interpreted differently by the payer of the subsidy and the receiver of the subsidy. The enterprises fear the subsidy could be reclaimed for any reason.

The conclusion is: If SMEs get a subsidy this should only be for a very short time. In practice this is the case. The more general conclusion: Subsidies are connected with a waste of money. Therefore in most cases it is better to avoid subsidies, to reduce taxes, i. e. leave the money in the private sector, and reduce bureaucracy.

Another experience in Germany with subsidies shows: The big subsidies go to large companies, mostly declared as industrial policy or as a measure to stabilize employment. Examples are the shipbuilding industry, air planes, coal mining, and large high speed computers. The other sectors of the economy and again the SMEs had to bear the losses of these government interventions into business decisions.

### **What about Tax Advantages and Disadvantages?**

The general rule is to make no difference in taxation between large and small enterprises. The aim is the equal treatment of all companies regardless of their type of ownership. One necessary exemption is the inheritance tax which has to be paid by private citizens. In this case the tax rate on private property is reduced if it is tied up in the family enterprise and if it will not be taken out of the enterprise in the next ten years. The earnings on private property in family enterprises are of course subject to income tax.

A general problem affecting all companies is the settlement tax which was introduced in 2009. According to this concept all earnings on private capital are taxed by a flat rate of 25 per cent. In addition, earnings on equity capital in the



companies are taxed by a corporate tax with a rate of round about 30 per cent. The result is a much higher tax on earnings on equity capital than on earnings on borrowed money. This makes it generally more difficult to raise equity capital. And it sets incentives to evade the corporate tax by lending money instead of increasing equity.

## **No Special Economic Policy for SMEs**

The general goals for a successful economic policy are good goals for SMEs. Because this is known from general economic policy, I want to enumerate only a few of the most important goals and exemplify the meaning of one of these goals.

- Price stability
- Reliable rules
- Competitive wages (no minimum wages)
- Private equity instead of public ownership
- Free movement of goods and services ...

One example for the importance of these goals is competitive wages. There is a strong tendency in the German society to guarantee minimum wages by law. The idea is that every person who is working should be able to earn enough money to meet its basic needs and not depend on public assistance. The problem: Many persons with handicaps or low skills are not able earn this amount of money. If there is a strict minimum wage law this group is excluded from employment. On the other hand it would be extremely helpful to use these skills – not only to save public money but above all to offer those persons the opportunity to contribute to their own living costs and to take part in business activities.

The experience is that mainly family enterprises feel responsible for the low skilled. Their tradition shows that it is not necessary for every person of a family to earn enough money if the members of the family are standing together. State money is not the only alternative. Families are small social units and usually they are very efficient in absorbing social problems. This experience enables them to solve many problems in an enterprise.

## **Outlook for SMEs in a Globalizing World**

I do not share the vision of skeptical citizens or even economists that improved methods and ways of transportation, rapidly shrinking costs of communication and the possibility to get almost all market information at any time in any place will lead to an economic concentration in large companies acting at a global scale. First of all regional markets will remain. But much more important: The development of SMEs has shown their ability to compete on global markets and even expand their activities into other countries because they are specialists in niches. The technical development requires more specialization and more enterprises which are the top specialists on a certain product, a computer program, or a high-tech tool.

### **Contact:**

Professor Dr. Johann Eekhoff  
Vulkanstr. 47  
53179 Bonn  
Germany

Tel. +49 228 943 1977  
Fax +49 228 943 1978  
E-Mail: [j.eekhoff@uni.koeln.de](mailto:j.eekhoff@uni.koeln.de)