

New Start-Up Subsidy, Germany

This case study presents a national welfare bridge scheme, which supports the unemployed in business creation. The description presents the objectives and rationale for this approach and describes the different versions of the allowance that have operated in recent years. It also discusses the challenges faced in designing and implementing the scheme and the conditions for transferring this experience to another context.

Objectives

The objective of the New Start-Up Subsidy is to offer financial support to unemployed people for setting up a business. This can offer an additional option for escaping from unemployment alongside typical job search strategies. In addition, some of the subsidised businesses may create jobs in the future for other workers. It started in 1986 as the Bridging Allowance and was adjusted in 2003, 2006 and 2011. It continues to provide support to the unemployed for business creation.

Rationale

A common argument to justify start-up subsidies for the unemployed is based on the existence of capital market imperfections and possible discrimination against unemployed individuals, which may result in suboptimal rate of start-ups or under-capitalised businesses (Meager, 1996; Perry, 2006). Start-up subsidies aim to remediate the difficulties that unemployed people face in obtaining finance for business start-up by covering the cost of living and of social security contributions during the critical founding period. As well as stimulating more business start-ups, it can be argued that individuals who receive this kind of support and start their own business also increase their employability, their human capital and their labour market networks during the period of self-employment, which, in the case of failure, makes them better able to find regular employment. Start-up subsidies may also be promising from a macroeconomic perspective, since the entry of new firms generally increases competition, innovation and the productivity of firms. Investments in start-ups operated by people coming out of unemployment could be particularly relevant in periods of economic crisis when new business ventures could become one important driver of economic turn-around and new growth. Economies facing economic crisis and high unemployment rates contain a challenge and a chance for new activities; while market demand is restricted, there is larger supply of well-educated employees ready to start-up or work in new businesses (Fritsch et al., 2015).

The direct goal of the programme is to cover basic costs of living and social security contributions during the initial stages of self-employment, when the business might not be able to yield sufficient income. The programme's overall goal is to increase the survival probability of the individuals while the business is vulnerable and to enable them to generate

an adequate income out of their self-employment activities once they survived the initial period of starting the business. By doing so the government aims to integrate the individuals into the labour market and increase their long-term labour market attachment. Therefore, also a return to wage employment is seen as a success (see e.g. Caliendo and Kritikos, 2009a).

Although supporting start-ups by unemployed people is a policy that has been widely implemented around the world, it usually remains a relatively small component among economic policies. Some assess this type of intervention in a very critical way because of the low levels of economic impact that might be achieved (Shane, 2009). However, there has been a positive experience of using this type of initiative in Germany over many years.

Activities

Before 2003, the Bridging Allowance (*“Gründungszuschuss”*), introduced in 1986, was the only programme providing support to unemployed individuals who wanted to start their own business. Recipients of the Bridging Allowance received the same amount they would have received as unemployment benefits (plus a lump-sum of 68.5% to cover social security contributions) for 6 months. The Bridging Allowance was complemented by a second programme in January 2003, the Start-Up Subsidy (*“Existenzgründungszuschuss, Ich-AG”*), where the support comprised of a lump sum payment of EUR 600 per month in the first year, EUR 360 per month in the second year and to EUR 240 per month in the third, and both schemes were accompanied by a national media campaign.

The New Start-Up Subsidy (and the previous Bridging Allowance) is similar to programmes in other countries, including Australia, New Zealand, Sweden and the United States. More recently, new programmes were introduced in the United Kingdom, Finland and France. What makes the German case unique relative to similar programmes in the European Union is the number of individuals taking advantage of the two programmes (and it should be made clear that individuals had to choose between one of the two programmes). In the years between 2003 and 2006, about one million individuals participated in these programmes. It should be further noted that in 2010 there were 150 000 entries in the newly reformed Start-Up Subsidy. In 2012, after a further reform and lower unemployment, entries dropped to 20 000 start-ups out of unemployment.

Since the two schemes (i.e. the Start-Up Subsidy and the Bridging Allowance) differ sharply in terms of financial support and duration, they also attracted different types of individuals. Individuals participating in the Bridging Allowance were more educated and had higher earnings in the past (making the programme where the subsidy amount was related to the level of unemployment benefits more attractive); whereas participants in the start-up subsidy were on average less educated and had a relatively poor previous labour market performance. In 2006, both programmes were merged into one, the New Start-Up Subsidy (*“Gründungszuschuss”*), which is described in greater detail in this section.

From 2002 to 2011, these schemes had an annual budget of EUR 1.5 billion to EUR 3.5 billion and between 100 000 and 250 000 participants used them annually. According to official statistics (*“Micro-census”*), between 300 000 and 400 000 start-ups were created every year during this period. Thus, start-ups out of unemployment covered a significant share of yearly start-up activities. Overall start-up activities were also above average. Furthermore during this time, there were between 2.1 million and 4.6 million unemployed persons in Germany. This means that between 3% (at the peak of the programme) and nearly 10% of all unemployed individuals used the programme each year. Indeed, the programme includes some built-in-flexibility meaning that expenditures vary with the unemployment

cycle, with high (low) expenditures in times of high (low) unemployment rates. This can be explained by the fact that start-up subsidies are particularly attractive when unemployment is high and employment alternatives are scarce (Fritsch et al., 2015).

The programme provides financial support to unemployed individuals (and those who are at risk of becoming so), who aim to start their own business. The public unemployment insurance supports the first 6 months of self-employment (plus up to 9 additional months). In the first 6 months, the recipient receives the same amount he or she would have received in case of unemployment as benefits; an additional amount of EUR 300 per month is added to cover social security contributions. The payment of the lump sum of EUR 300 can be extended for another 9 months if self-employment is the main activity of the individual and they can demonstrate their business activities.

In order to receive the subsidy, the individual needs to be eligible for unemployment benefits for at least 150 days and present a business plan that is approved by a chamber of commerce or a similar institution. This third-party institution has to analyse to what extent the business idea as described in the plan is sustainable and has the potential to create a sufficient income base for the applicant. Additionally, start-ups are only supported if they are planned as the main occupation.

For the largest part of its existence, the unemployed were entitled to the subsidy if they fulfilled the requirements. An amendment in late 2011 turned the subsidy into a discretionary entitlement needing approval from the caseworker at the local labour office in addition to the third-party approval of the business plan. The main reason for this reform was the requirement to reduce public expenditures. After the reform, local labour offices were more restrictive in approvals of start-up subsidies and the number of supported start-ups dropped from 120 000 cases in 2011 to 20 000 cases in 2012 and a similarly low number in 2013.

Project financing

The average programme costs per person varied between EUR 11 000 and EUR 13 000 between 2002 and 2011, depending on the individual amount of unemployment benefit claims (which again depend on previous labour earnings) and the approval of the subsidy extension of 9 months.

The instrument can be seen as relatively inexpensive, as alternatively most of the individuals would remain unemployed for about the same and sometimes even for a longer time period and would receive the same amount of money as support. It is paid out of the statutory unemployment insurance.

Challenges encountered

There are some concerns related to financial promotion of start-ups by the unemployed. First of all, supported individuals may become self-employed even without financial support. This is referred to as deadweight loss and is usually difficult to determine. Another concern is displacement effects, whereby incumbent or non-subsidised firms may be displaced by supported start-ups. Finally, firms may substitute employees with subsidised self-employed workers (i.e. pseudo-self-employment), which are workers who appear to be self-employed but are in practice employees. In highly regulated labour markets such substitution effects may play a certain role.

It is also often argued that start-ups out of unemployment will be less productive and less likely to create further jobs because they are started as a response to necessity and

opportunity. However, evaluation studies show that in Germany around 85% of the start-ups were either born only out of opportunity or out of a mixed motivation of opportunity and necessity (Caliendo et al., 2006; Caliendo et al., 2007; Caliendo and Kritikos, 2009a; 2009b; 2010; Caliendo and Künn, 2011; Caliendo et al., 2012).

Further challenges appear with respect to the implementation of such instruments. The biggest challenge within the German approach was the selection of qualified third-party institutions that could appropriately analyse the business plans of the applicants to assess whether they have the potential to create a sufficient income base for the applicant. In the German system, chambers of commerce, tax advisers and similar institutions were chosen to do this job. They have to balance out their decisions between being too strict and, thus, not passing a proposal although it could have been successful, and not being strict enough, thus passing plans which have little chance of providing a decent income for the applicant.

A second implementation issue is that the selected institutions should have no own-interest in approving or not approving a business plan. Chambers of commerce for instance could have the incentive to “protect” the existing businesses in the markets, thus being too strict. Tax advisers were often confronted with the prejudice of not being strict enough as they might have been able to create future customers by passing all kinds of business plans. Looking back from the German experience, it can be concluded that the quality of the business plan probably played only a minor role. Instead, it seems that the most important point of the business plan was to induce sufficient efforts by applicants in preparing and approving a business plan to reduce the probability of deadweight losses.

Another crucial question of implementation concerns whether there should be an entitlement to the start-up subsidy once all preconditions are fulfilled or whether caseworkers (from the unemployment agency) should make discretionary decisions. In Germany, after the most recent reform, the entitlement for the start-up subsidy was replaced by a discretionary decision of the caseworker at the local labour office. Since then, the number of supported business founders has dropped dramatically. The empirical evidence, however, makes it clear that it is effective to offer the start-up subsidy as an entitlement (i.e. without further screening by the local case worker), if the aim is to promote the programme on a large scale. On the other hand, entry requirements need to be set sufficiently high to ensure an efficient self-selection process into the programme.

Last but not least it should be emphasised that such an instrument will have a small impact on unemployment if it is introduced as an isolated programme and if necessary complementary steps are not taken. Specifically, such a programme is not a substitute for other reforms. In Germany, the start-up subsidy became a success story because it was introduced jointly with a major labour market reform.

Impact

The New Start-Up Subsidy and its predecessors have been subject to extensive evaluations in the short- and long-run (Caliendo et al., 2006; Caliendo et al., 2007; Caliendo and Kritikos, 2009a; 2009b; 2010; Caliendo and Künn, 2011; Caliendo et al., 2012). A first index to measure the success of start-ups is their survival rate. Recent studies estimate that 56 months after start up, the business survival rates are – depending on gender and region – between 55% and 70%. Earlier survival analysis (irrespective of previous employment status) revealed a 50% chance of survival after five years. However, not every closed business is a failure *per se*, given that a secondary goal of the support scheme is to enable individuals to return into the labour market. Between 20% and 23% found regular

employment in due course, such that only a very small fraction of individuals returned to unemployment or inactivity.

Up to 40% of the founders had at least 1 employee. The number of persons employed by them varied on average between 2.6 and 5.1. The additional jobs created for each subsidy, was on average 1, i.e. for each 100 000 subsidised start-ups, 100 000 additional jobs were created.

When comparing the performance of participants in the start-up subsidy with a control group of other unemployed individuals using statistical matching techniques, the programme effect is highly positive. Participants spend around 20 months more in employment (self-employment or dependent employment) and have monthly labour incomes that are EUR 700 (men) and EUR 300 (women) higher than the comparison group.

The deadweight losses correspond to the proportion of beneficiaries who would have started their own business even if they had not received government support to do so and who would have survived the initial stages of self-employment without the financial support. Recent estimates report deadweight losses of about 15%.

Displacement and substitution effects harming existing businesses also appear to be limited. Given that the programme guarantees beneficiaries' transfer incomes only for a short time period it is difficult for them to harm other businesses by offering products at dumping prices.

The longitudinal analysis reveals that the majority of business founders generate lower earnings in the first year after their start-up (as it is expected – supporting the argument for the present programme) than what they earned before, when employed. In the subsequent years of their self-employment activities more than half of the start-ups earned a higher income from self-employment than from their previous employed position.

Conditions for transfer

The wealth of evaluation evidence points to a number of major success factors of the programme, which can provide lessons for the development of start-up subsidies in other countries:

1. *Support subsistence.* The time horizon of the financial component should be neither too short, nor too long. The German experience allows for a design of between 6 and 15 months, with financial transfers being equal to the unemployment benefits otherwise received.
2. *Use a screening mechanism.* The requirement of developing a business plan and getting it approved by a third party helps to ensure that only those individuals who seriously aim to found a business gain access to the programme. It therefore has to be ensured that third parties are objective referees when approving business plans. The main point is that entry requirements via the business plan or other elements have to induce an efficient self-selection into the programme. Efforts of preparing and approving a business plan have to be sufficiently great as to ensure a self-selection and to exclude deadweight losses.
3. *Demonstrate commitment.* A further important prerequisite of the programme is that participants have to give up unemployment benefits in exchange for accessing the programme. The German experience suggests that a rate of 1:1 is appropriate. This shows their commitment and ensures that individuals are not only maximising benefit duration.
4. *Conduct outreach.* A crucial question regards the outreach of the programme. Start-up subsidies have only been used by a substantial number of persons in Germany, whereas in other countries the number of participants is around 10% or less of that found in

Germany. It also seems that public grants need special advertisement. In Germany the support of start-ups out of unemployment was widely advertised in newspapers and other mass media. Moreover, unemployment agencies made regular announcements about these programmes creating high awareness about the existence of such support.

5. *Recognise that not everyone is an entrepreneur.* It should be clear, that not every unemployed individual is prone to be self-employed or an entrepreneur. Hence, it is important to stress that such a programme – in order to be efficient and beneficial – needs to have restrictive entry requirements. To spur the growth of the newly founded businesses and to support entrepreneurs with the ambition to create larger businesses such a programme may be accompanied by an initial and ongoing support, for instance via offers for coaching.

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