GERMANY'S MITTELSTAND MODEL: KEY FEATURES AND POTENTIAL FOR MULTIPLICATION OF RESULTS

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Abstract: In the middle of the globalization process, Small and medium enterprises are challenged to devise new strategies geared to improving competitiveness and future prosperity. This paper centers on crucial aspects, attributing to the international success of *Mittelstand* companies, as one of the symbols for the resilience of the German economy. Revealed are the historic, sociological and psychological features of the term, which is much more of an ethos and a fundamental disposition of a business mindset. Analyzed are the quantative and qualitative characteristics that allow Germany's SMEs to embrace new challenges and remain strong, vibrant and innovative. Presented are key characteristics of the so-called "hidden champions"- the "elite" of the SME sector and notably Germany's export "superstars". Described is a set of common value chain traits and a number of synthesized practical lessons that could be implemented. Described is the export potential of SMEs as the basis for Germany's current account, which is the biggest in the world in absolute terms. Special attention is devoted to the concept of the vocational education and training as deeply embedded and widely respected in German society. Widely regarded as one of the biggest advantages that Germany has, especially for manufacturing and a source for development of human capital. Further discussed are the main advantages and strengths, such as the high degree of engagement and ownership on the part of employers and other social partners. Revealed is the intricate web of checks and balances on company, community and state level, which insures the short-term needs of employers do not distort broader educational and economic goals. In the article is also presented the Codetermination as a very important part of the way Germany is doing business. The system of industrial relations ensures equal participation of employees and shareholders in company's decision-making and complement economic legitimacy of a company's management with a social one. Analyzed is the role of work councils, unions and firms and the necessity to remain flexible when circumstances change and new challenges arise. The conducted analysis concludes that there is a benefit due to the increased flow of information between board and workers. Due to their knowledge of a firm's specific operations and processes, employees are good at monitoring managerial performance and bring first-hand knowledge to the board's decision making. Codetermination is an institutional arrangement that in principle can be replicated in other countries.
Keywords: Mittelstand, small and medium enterprises, economic globalization, competitiveness, codetermination, dual vocational training system.

1. INTRODUCTION

Following the global financial crisis of 2007-2009, the world economy plunged in stalling growth, financial turmoil and stock market turbulence. As one of the key players in the economy and a significant driver of growth, the Small and Medium Enterprises (SME's) found themselves particularly vulnerable. By sheer number, SME's prevail on the world business stage and although precise data is hard to obtain, it's estimated that they account for 95% of enterprises across the world and 60% of private sector employment (Ayyagari et al. 2011). Small and medium firms contribution varies widely between countries and regions, from 16% of GDP in low-income countries to 51% of GDP in high-income countries, playing especially key role in the latter and thus exacerbating the situation. The drastic drop in demand for goods and services coupled with a tightening in financing severely depleted SMEs working capital. Subsequent effect was widely spread, due to their enormous contribution to social well-being, output, employment and gross domestic product (GDP). "A rising tide lifts all boats", former US President John F. Kennedy famously said in a 1963 speech and the same could be said about the economic growth we're witnessing at the moment. The cyclical upturn in global activity started in 2016 and is keeping its momentum. In Bulgaria SMEs represent around 98% of all businesses and provide almost 76% of private sector jobs for the active labor force. This year's projected rise of 3.1% in global GDP (WB, 2018), presents these enterprises with new challenges, such as how to deal with the process of economic globalization. The concentrated impact of global markets on specific industries and regions makes the economic consequences for SMEs acutely recognizable and presents them with the need for a strategic response. This article sets aim at construing the German *Mittelstand* as a model for success and outlining key characteristics suitable for multiplication. Presented is the Apprenticeship system as one of the key advantages for Germany's manufacturing and a source for development of human capital as well as the characteristics with potential for multiplication of results. Special attention is devoted the system of industrial relations and its explicit social dimensions.

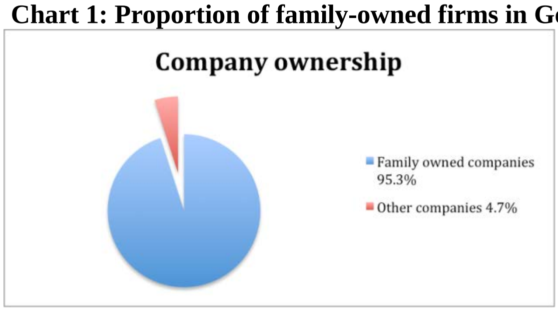
2. SIGNIFICANCE OF THE MITTELSTAND IN THE GERMAN ECONOMY

After 1945 Germany started rebuilding with distaste for big business, which was tarnished by associations with the Nazi regime. Big firms were displaced from Berlin (Daimler, Siemens, etc.) and breathed new life into Baden-Württemberg and Bavaria, hotbeds of the *Mittelstand.* The division of the country had a further positive effect on regional smaller firms. Analyzing the SMEs in Germany entails understanding of the term *Mittelstand*. Its modern definition consists of several aspects and has to be differentiated from the broad meaning of the term small and medium enterprises. While SME implies the use of economic units, *Mittelstand* specifies not only a certain group in the wider ecosystem of firms, but also historic, sociological and psychological characteristics- a term that goes much deeper and has come to define a business mindset. *Mittelstand* has its roots in the medieval order of society, where one's socio-economic status was defined by birth or occupation (the German word *stränd* refers to an estate). It describes a certain social status similar in meaning to "middle class" only with preindustrial connotations. In this regard a *Mittelstand* company cannot be restricted to the standard definition of SME by the number of its employees, the value of assets or its turnover.

2.1. Qualitatative and quantative aspects The powerful link between enterprise and owner has been pointed out invariably as the most significant qualitative aspect of the *Mittelstand* and crucial for the enterprise's success or failure. Over 95% are family-owned and considerable percentage is in the manufacturing sector. A large number of today's market leaders were established at the beginning of the 20-th century or after World War II. They have several attributes in common, among which:

- Their founders were talented innovators, continually searching for alternative ways to improve their products or develop new ones;
- The companies boasted leadership style distinguished by social responsibility, personal guidance and strong relationship with the employees;
- A management style that accentuates long- term results and long- term relationships, both with the customer and the highly qualified staff;
- Tight focus on market niches, typically in areas such as mechanical engineering;
- An ingredient of simplicity.

Chart 1: Proportion of family-owned firms in Germany



(Source: IfM Bonn; European Commission)

Due to the complexity of qualitative definition, economic policy makers use more pragmatic, quantative classification for SME. Regardless of the selected indicators, the quantative analyses will invariably be a purpose-oriented estimation, which simplifies the evaluation. *Mittelstand* could be used as a synonym for SMEs in Germany only while keeping in mind the qualitative aspect of the term, its diverseness and limits. This classification, however does not consider the differences in company structures of European member states, particularly when measuring smaller and larger or Northern and Southern countries.

Table 1: SME classification in the European Union

Company category	Number of employees	Turnover	or	Balance sheet
Medium sized	50 to 249	Up to €50m		Up to €43m
Small	10 to 49	Up to €10m		Up to €10m
Micro	Up to 9	Up to €2m		Up to €2m

(Source: European commission)

2.2. Hidden champions With the internationalization of the economy, some German export oriented SMEs have become multinationals over the years. This goes for some of the so-called *hidden champions*, i.e. little known medium sized firms, often located somewhere in the countryside, which are the world market leader for some very specific niche product where they offer the highest quality. Often called the “elite” of the SME segment, they produce specialized capital goods, testing equipment, machinery, pharmaceuticals and other highly knowledge-intensive products. Products like pipe organs (Orgelbau Klein), battery chargers (FRIWO), movie-making equipment (ARRI), fish-processing machinery (BAADER), car seats (RECARO), etc. Hermann Simon identified the phenomenon through an interest in international competitiveness, where concentrated research revealed that Germany’s long-term export success is largely due to the strengths of medium-sized companies, coining the term and establishing a framework to describe them:

- Revenues bellow €4 billion;
- Top 3 in the world or number 1 on its continent in their respective industries;
- Not well known in general public.

Simon’s conclusion seems essentially practical. He goes so far as to state his structured thesis is not a “recipe for success”, as “…once the recipes for success are broadly disseminated, they lose their value, because others adopt and imitate them” (1996, p.62). Regardless, here are a number of lessons that *hidden champions* teach us (Simon, 1996):

1. Success begins with ambitious goals;
2. Narrow market focus with a global orientation;
3. Stay close to customers in both performance and interaction;
4. Continuous innovation in both products and processes;
5. Establish clear-cut competitive advantage in products and services;
6. Rely on your own strengths. Never outsource key competences;
7. “More work than heads”- a good balance between practice and theory;
8. Leadership that is both authoritarian in the fundamentals and participative in the details.

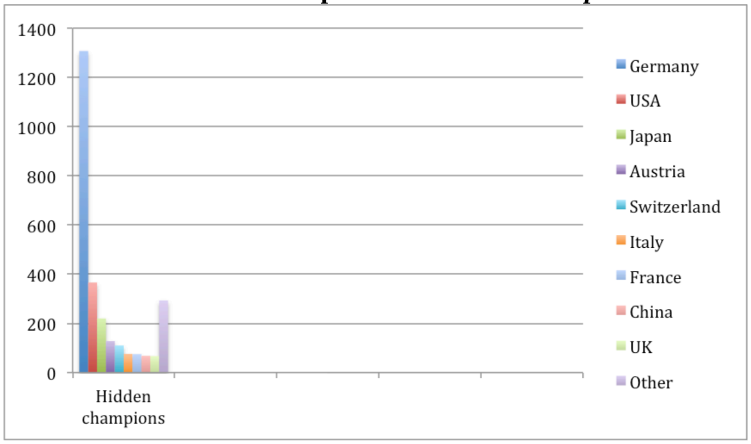
Beyond these “prescriptions” sits a simple, but not a simplistic view on the key features of the *hidden champion*. *Hidden champions* do not subscribe to short-lived craze or popular words like “outsourcing”, “time competition” and “strategic alliance”. It could be deduced that the success of a *hidden champion* is not due to one specific factor, but to the accumulation of the implementation of many small steps, slowly and consistently to improve performance. A global perspective and specific competence ensure the foundation for the strategic drivers of innovation and marketing. Sequentially, strategic drivers determine the value of proposition and interactive engagement with the customer.

Figure 1: Profile of a typical hidden champion

(Source: Database German World market leaders 01.10.2010)

Although the research was initially based in his home country, Simon has identified *hidden champions* worldwide. Even so, no other state boasts as many as Germany, which has more than 1300 identified world market leaders from the *Mittelstand* that successfully found niches for their products.

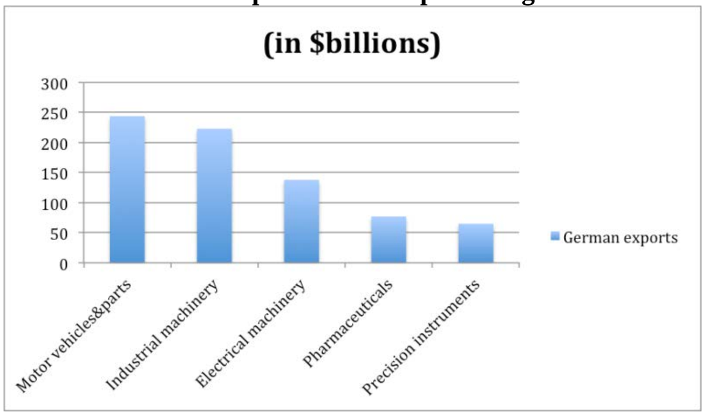
Chart 2: International comparison of *hidden champions*



(Source: Deutsche Weltmarktführer, 2012 figures)

2.3. Export performance of the *Mittelstand* Despite the rise in nominal wages, the focus on quality explains why German exports rebounded quickly after the global financial crisis. Quality makes exporters less vulnerable to changes in price, including those driven by rising wages. German exports in 2016 amounted to $1.34T with imports at $1.06T (UN Comtrade, 2016). The main export market for German goods is the European union, followed by the USA and China. The branches with the highest export ratios are the automobile sector, Industrial and electrical machinery. SMEs account for around 30% of direct exports and 19% of total exports (BMWi, 2010), not counting their contribution as suppliers. Exports as share in revenue is lower in small than in large enterprises. The data is not concise, because a big part of small firms' products are wholesaled and many of their goods are integrated into export products of large enterprises. For SMEs the proximity to neighboring countries plays an important role. Producers and consumers are dispersed in space and overcoming the distance between them can be costly. Much commercial activity pertains to "space bridging", and making good use of locational opportunities, thus reducing the cost of transport. That is the reason why a quarter of the exports from Germany to Switzerland are coming from the bordering region Baden-Württemberg.

Chart 3: Top 5 German export categories

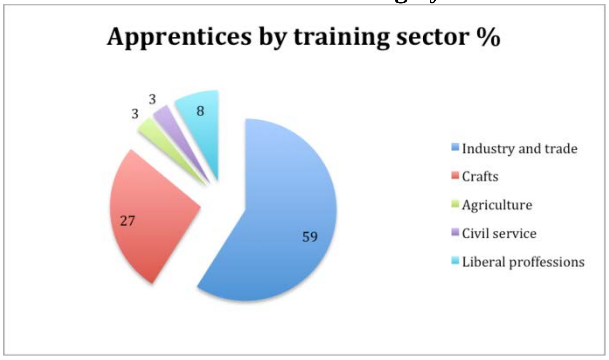


(Source: UN Comtrade, 2016 figures)

3. IMPORTANCE OF THE DUAL VOCATIONAL SYSTEM

The German model of high quality production is dependent on the vocational training system as the main source of vocational training in Germany. It ensures a flow of talented young people into industry that might not even consider industry in other countries by providing all aspects of theoretical and practical training for three quarters of adolescents, between 15 and 20 year of age (Wagner, 1998). Half of the week they work at the employer and the other half they attend school and receive general training. The biggest advantage is that the workers acquire not just firm specific, but industry-specific or occupation specific human capital. About 85% enter the apprenticeship after 9-10 years of schooling and around 15% have already passed 13 years of schooling, which provide the university entrance certificate. The final certificate of apprenticeship is regarded as a significant career step. The first degree takes 3 years, split between theoretical lessons at public vocational schools and practical training in the enterprises. Afterwards there are two career paths: either take the specialized supervisor (*meister*) exam after completing two additional years of training in various industrial and craft areas or attend university for further studies. The dual system is an important incentive to young people, because they can enter middle management positions without having to complete a higher educational track. The chambers regulate the apprenticeship training system and are responsible for the examinations. The state supports the establishment of external training centers that are managed by employer associations, trade unions and chambers and they negotiate the structure, including the types of offered training profiles.

Chart 4: Vocational training by sectors



(Source: Federal Statistical Office of Germany, 2016 figures)

Evidently, the vocational system is based on cooperation between different players, which ensures balance of demand and supply at the market for apprenticeship posts.

3.1 Main advantages and aspects suitable for multiplication of results The vocational training has deep roots in society and enjoys high reputation. The training provided to young people and the professional certificates they earn for a large spectrum of professions are valued on the labor market. An immediate effect is the extremely low youth unemployment rate and also a step towards dealing with the inevitable future bottlenecks due to the demographic change. The system is firmly oriented at solving problems and has a good balance of theory and practice if applied properly. It is crucial that mechanisms remain flexible enough in order to recognize and substitute underperforming educational programs and react to the emergence of new economic and professional fields by developing new educational programs. There is an increasing shortage of qualified specialists on the labor market. A company that provides vocational training, develops and retains appropriate specialists will remain competitive. A fundamental feature of the dual system is the fact that young people are exposed early to the social competences, which are critically important for professional success. Learning the concepts of teamwork and resolving conflicts with colleagues and superiors, customer service and developing initiative to solve problems- these are the competences that cannot be learnt in a classroom. The time of training allows the employer to obtain information about the skills and productivity of a young specialist in a relatively cost-effective way and facilitates hiring the right workers after training or parting ways without risk. The average cost of training of young people is lower than the cost of the search for trained external expert. In addition, during training, the company has the chance to compensate any drawbacks in the knowledge of future specialists through targeted instructions. A key advantage of the dual system is the high level of engagement of employers and other social partners. A properly structured system would have a complex network of checks and balances on a company, community and state level to guarantee that the common educational, political and economic goals are not suppressed by short-term needs on the part of the employers. The strong position of chambers within the dual system takes some burden off the state, enables practice-oriented and company related solutions and ultimately strengthens the economic self-management. Probably the most important aspect with potential for multiplication of results is training workers and, especially, training workers at the lower end of the skill distribution is crucial for increasing productivity of SMEs and to improving social cohesion by instilling a sense of belonging and contribution. Focus not only on the top percentiles, that are highly successful, but spread success throughout the ranks of the workforce by training different types of people for different types of occupations.

4. THE CONCEPT OF CODETERMINATION

Codetermination, i.e. the cooperation between workers and management in decision-making, has been an integral part of the German corporate governance and has existed in its current form since the Codetermination Act of 1976. It has an explicit purpose with a particular social dimension: as the German Constitutional Court established, codetermination is intended to ensure equal participation of shareholders and employees in a company's decision making and supposed to complement the economic legitimacy of a firm's management with a social one. This setup gives workers more leverage over factory decisions, boardroom decisions and employment policies-including wages. Codetermination is therefore about a democratic decision making process at company level and the equality of capital and work. According to Mitbestimmung (1998), the primary point of codetermination is about making investments in human capital profitable and rewarding employees' loyalty with participation rights. Employees have two paths through which they receive participation rights: work council or "shop floor", where the company workforce elects members for a four-year term (Betriebsrat) and supervisory board, company level (Aufsichsrat). The work council is established in companies with more than 5 employees, not necessarily union members and employers must negotiate with them policies affecting the workforce, such as lay-offs etc. Germany was one of the first countries to implement a two-tier system where by law companies are required to have a board comprised of executives and chaired by a CEO and a supervisory board consisting of shareholder and employee representatives. The number of employee representatives varies depending on the size and legal form of the company-from one-third up to half of the members of the supervisory board. It is involved in appointment of the management board members, overseeing their activities, monitoring of business operations etc. With the power of approving crucial strategic decisions, the ultimate corporate power resides with the supervisory board and respectively the employee representatives (Fitz Roy and Kraft 2004).

4.1. Effects of codetermination and multiplication potential. Employees share a similar objective as the shareholders, namely the long-term survival of the company. In this context managers would be discouraged to pursue risky projects or expansions by mergers or acquisitions with the aim of short-term profits. Dyballa and Kraft (2016) also find evidence that employee representation is beneficial in case shareholders, as members of the supervisory board, change managers' compensation to incentivize them to act to their short-term interest. Due to their knowledge of the firm's specific operations and processes, employees are great at monitoring the performance of the managers and contributing first hand knowledge to the board's decision making (Edwards et al 2009, Fauver and Fuerst 2006). The latter concluded that codetermination could increase efficiency and thus market value of the company. On the empirical side, findings are mixed: Vitols (2005) established that out of 25 EU states, countries with stronger worker participation show better labor productivity, research and development intensity and lower strike rates, but performed worse in terms of GDP growth. Hörisch (2012) on the other hand, using the Gini index, concludes that there is lower income inequality in countries with codetermination. Mentioning the system of codetermination as an inclusive framework in the context of "democratic capitalism" brings the question whether it could be applied in principle to Bulgaria for example. It would be hard to simply transfer Germany's labor-relations infrastructure and replace the existing one overnight. For instance, unions have a big role in the German model and in Bulgaria they are just not that strong. One of the measures is to increase the role of the unions or make them reasonable and cooperative like in Germany, where both at the company level and sector unions are happy to prioritize competitiveness over wage increases, thus making the success on the export market and all the jobs depending on it a national prerogative. Staring down the threats of globalization becomes a lot easier when there's collaborative culture in place and institutions that prize flexibility.

5. CONCLUSION

The conclusions derived from the *Mittelstand* experience are straightforward:

At the meta-level, there is no specific recipe for success, since it is not a consequence of one specific factor, but rather the accumulation and the implementation of many small steps, slowly and consistently to improve performance. It is impossible to replicate a cultural identity and instill social trust- an important, but often overlooked element of successful societies. Germany is a stakeholder economy in that sense, where all actors try to come to a common goal and perhaps that's the reason why *Mittelstand* companies enjoy a relatively harmonious relationship with their workers.

At the macro-level is necessary to promote a business-friendly environment and strengthen the elements that foster entrepreneurship. It is not sufficient to only have rhetoric; consistence between rhetoric and practice is essential.

At the meso-level is vital to implement the dual vocational training system. The education, characterized by the acquiring of the essential professional experience connected with the transfer of knowledge and skills, guarantees the flow of future specialists while minimizing youth unemployment.

Still at the meso-level, codetermination's explicit idea to ensure equal participation of shareholders and employees in a company's decision making, is worth further attention. Establishing work council organizations is key, because in essence they can be intermediaries between unions and firms anywhere. Therefore, codetermination is an institutional disposition that theoretically can be multiplicated in other countries.

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