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The German Labour Markets – The Case for More Flexibility

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resumo

résumé / abstract

Com base num modelo com diversos segmentos do mercado de trabalho, este artigo tenta descrever as características do mercado de trabalho alemão. Destacam-se dois processos que têm vindo a deteriorar a situação, anteriormente favorável, desse mercado: a subcontratação (*outsourcing*) da produção à Europa central e oriental, e a deslocação de mão-de-obra para a economia subterrânea. Afirma-se que a economia subterrânea não pode substituir a economia formal quando esta enfrenta grandes pressões e se exige maior flexibilidade. O modelo utilizado parece confirmar, em termos gerais, as actuais características do mercado de trabalho alemão, revelando que o processo de ajustamento resultou mais em alterações do emprego e do PIB (oficial) do que em alterações salariais. Por último, o artigo analisa o que pode vir a acontecer se as recentes concessões salariais isoladas se transformarem numa redução geral dos níveis salariais.

Cet article utilise un modèle qui comprend plusieurs secteurs du marché du travail pour essayer de décrire les particularités du marché du travail en Allemagne. Deux caractéristiques sont mises en relief: la sous-traitance de la production aux pays de l'Europe centrale et orientale et le transfert de main-d'œuvre à l'économie parallèle. On affirme que l'économie parallèle ne peut pas remplacer l'économie formelle lorsque celle-ci subit des pressions qui demandent une plus grande flexibilité. Le modèle utilisé semble, d'une manière générale, confirmer les caractéristiques du marché allemand, montrant que le processus d'ajustement a eu comme résultat des changements de l'emploi et du PIB (officiel) plutôt que des salaires. Finalement, cet article analyse ce qui peut arriver si les récentes concessions salariales isolées deviennent une baisse générale des salaires.

A framework of different labour market segments is introduced to describe the stylised facts of the German labour market. Two processes, the outsourcing of production to Middle and Eastern Europe and the transfer of jobs to the shadow economy, are distinguished, which are eroding the formerly favourable labour market situation in Germany. It is argued that the shadow economy cannot operate as a substitute for the regular economy if the latter is put under strain and more flexibility is required. The framework used here seems to be in broad agreement with the stylised facts, showing that the process of adjustment has resulted mainly in changes to employment and the (official) GDP rather than to wages. Finally, the paper deals with the consequences that may arise if the recent emergence of selective wage concessions turns into a reduction in overall wage levels.





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1. The Demand for More Flexibility

In the words of Hans-Werner Sinn, president of the Munich Ifo Institute, "Germany is the sick man of Europe, ranks lowest in growth and is unable to keep up with its neighbours" (Sinn, 2003: 1). Even if we focus our attention on the level of the GDP (per inhabitant) rather than on growth, Germany now (2003) ranks only seventh in the EU-12 (Statistisches Bundesamt, 2004a: Table 15.2). Moreover, an insidious process of outsourcing production to Middle and Eastern Europe is taking place. However, not all of Germany's economic performance criteria are looking bleak. Within the group of euro area members, Germany's share of exports has increased slightly from 28.5% (1999) to 29.6% (2002) (Sachverständigenrat, 2003: Table 7*, 1995 prices) and German companies seem to be gaining in intra-euro area price competitiveness (Compare ECB, 2004: Box 5). Nevertheless, doubts remain as to whether Germany will overcome its economic difficulties within the foreseeable future.

Looking at the causes of unsatisfactory performance, there is some agreement on the fact that the labour market is at the heart of Germany's economic difficulties. Unemployment is now stagnating at a comparatively high rate, with long-term unemployment representing about one third of the total (Bundesanstalt für Arbeit, 2003). Moreover, since the social security system is financed to a large extent by a pay-as-you-earn scheme, its sustainability is threatened. Based on these observations, many German economists have declared that the German labour markets are overregulated in all respects, including employment protection, labour standards, a rigid system of collective wage bargaining which is backed by law and a generous welfare system (see, for instance, Franz, 2002). The inability of firms to adapt, a spread of wages that is too small to effectively combat unemployment amongst lower qualified workers and wage levels that are not compatible with a sustainable position in the international product markets are consequences which the authors deplore.

These arguments concentrate on the highly regulated and relatively well-protected area of the German labour market. However, if we look more carefully at developments in Germany, it is possible to find indications of considerable flexibility in several areas. Paralleled by a drop in union membership from one third to one quarter during the nineties (Nickell, 2003: Table 9), collective bargaining agreements have declined from over 80% in the eighties to about 70% at the end of the century. Correspondingly, the percentage of employees integrated into the social security system ("Sozialversicherungspflichtig Beschäftigte") dropped from 90% in 1993 to 84% in 2003 (calculated from Statistisches Bundesamt, 1997 and 2004b: Tables 3 and 3.10), whilst various forms of atypical work have developed. On the other hand, even within the range of collective bargaining, the so-called "opening" clauses allow for deviations from the provisions of industry-wide collective arrangements (see OECD, 2004: 145, 154-155).

After describing the main features of the highly regulated standard employment practices in Germany and contrasting them with the various forms of employment that have developed alongside them, this paper will present a graphical interpretation of the labour market situation (Section B). This interpretation distinguishes several types of labour markets in order to allow for employment relationships that range beyond the standard employment practices that remain highly regulated and fully integrated into the social security system. Subsequently, based on this

analysis, the process of outsourcing, which challenges the traditional system of wage bargaining in Germany (Section C), will be investigated.



2. The German Labour Markets

2.1. Main Features

We begin our analysis of how the German labour markets function by describing the *Tarifautonomie* (the system for the free determination of wages and terms of employment by employers' associations and unions; for details see Franz, 1999: 233-237). Typically but not exclusively, such collective labour contracts are negotiated between unions and employers' associations within the industry. Despite a fall in collective bargaining and union membership, it seems safe to say that up to the present day the unions have had a considerable influence on labour contracts – at least in western Germany, where collective bargaining is considerably more widespread than in eastern Germany.

Generally, within the framework of collective bargaining, entrants' wages are bound to the wages of the incumbents. Even if some collective labour contracts contain clauses which allow lower entrants' wages, these clauses are more of an exception than a rule (Sachverständigenrat, 2001: 232).

The influence of the unions is backed by *labour market regulations*, especially by the institution of works councils (*Betriebsräte*) (for details, see Addison et al., 2001). At present, these must be established in any company that employs more than five people (full-time). Members are elected by the company employees and, in the bigger companies at least, a large number of them are union members.

By law, the works councils possess certain rights in relation to firms, especially with regard to both individual and collective dismissals. For instance, in case of collective dismissals the companies have to negotiate a social plan which settles severance pay and/or contains special arrangements for early retirement programmes. Moreover, the social plan may provide for programmes to help dismissed workers find new employment, by improving their qualifications, for instance. These activities work in the interests of the incumbents, either by increasing the costs of their dismissal and thereby making it less likely or by determining the financial (and other) assistance to be provided by the company if dismissals cannot be avoided. Moreover, in the latter case the social security system offers financial support, not only through the usual unemployment benefits but also in the form of certain early retirement programmes introduced in the seventies and eighties. However, these generous arrangements in favour of insiders have had to be financed, meaning that they have driven an increasing wedge between producer and consumer wages and have been detrimental to employment. Furthermore, the position of employees with regular contracts is strengthened by employment protection legislation that is considered to be comparatively strict in Germany, with only the Netherlands, Portugal and Sweden ranking higher within the EU-15 (OECD, 2004: Table 2.A2.4). Nevertheless, it should be borne in mind that – with some provisions – small companies with no more than ten employees are exempt from the most trenchant aspects of employment protection.

Recently, faced with the threat of companies shifting production abroad, employers and employees have agreed to deviations from the provisions of the industry-wide collective wage contracts. Notable examples have involved the car manufactures DaimlerChrysler and Volkswagen. Typically, employees have accepted concessions in wages and working hours in exchange for a promise from the company not to shift production to Eastern Europe and to avoid dismissals.

Besides the standard employment relationship that is classified as an unlimited full-time job with all the usual labour and social rights, different kinds of atypical work have also developed (Buch and Rühmann, 1998). These include temporary work, fixed-term contracts, part-time work, *mini-jobs* and dependent self-employment. In 1995 more than one third of all employment



relationships belonged to this category. So far, the most important of these atypical employment relationships have been the *mini-jobs* (formerly *Geringfügige Beschäftigung*), amounting in 2004 to about seven million jobs and representing, at present, maximum monthly earnings of 400 EUR. Obligations and rights in relation to the social security system and taxation have been changed several times but have always been limited, in comparison with regular employment where the usual labour market regulations apply (Buch, 1999: 138-147). *Mini-jobs* are attractive in combination with shadow economy activities, since it is difficult to control whether individuals who declare they are working under the *mini-job* rule earn more than the 400 EUR allowance and evade taxes and contributions for the extra they are paid. Even discounting illegal activities, it is significant that it is possible to reduce taxes and social security contributions by hiving off part of one's occupation as a *mini-job*.

Finally, the shadow economy, which has expanded in Germany during recent decades, must also be taken into account when considering the various segments of the labour market. According to estimates by Schneider and Enste (2000), its labour force amounted to more than 20% of the total labour force in the late nineties, producing goods and services totalling about 15% of the GDP. Compared with its size in the late eighties (about 12% of the GDP), shadow economy activities have increased markedly faster than the regular economy. Including the estimates of Enste and Schneider, it may be surmised that, at present, about six out of ten employment relationships are covered by collective bargaining contracts, about one quarter of all contracts belong to the regular economy but are not covered by collective bargaining agreements, and the rest (about one sixth) are located within the shadow economy.

2.2. An Interpretation of the Labour Market Situation

Referring to section 2.1., the assumption that a homogeneous labour market exists is inadequate in any proper discussion of the German labour market and the need for flexibilization. Instead, this interpretation will follow the lines of the insider-outsider approach.

The highly regulated and collectively organized area of the labour market is treated as the insider market, whilst the segments of atypical but formal employment and of shadow activities form two types of outsider market. In fact, the various segments of the labour market are heterogeneous in terms of the wages to be earned in them. For example, collectively negotiated wages can drop to less than five euros per hour (WSI Tarifarchiv, quotation from SZ, 2004). On the other hand, the jobs of high-wage earners may be fully integrated into the social security system without being covered by collective bargaining agreements. However, to simplify the following considerations it will be assumed that the insider market is the high-wage segment of the labour market, whilst the wages of outsiders are considerably lower.

We will start with the *insider* labour market segment. In principle, the bargaining position of the insiders is contestable. According to the insider-outsider approach, the upper limit for insider wages is to be found in the reservation wage of the outsiders *plus* the turnover costs due to the replacement of insiders by outsiders, i.e. in the relative profitability constraint (Lindbeck and Snower, 1988: 5). But it is doubtful whether the latent competition of outsiders is effective in those sectors within western Germany where collective wage arrangements prevail. With the exceptions mentioned above, entrants' wages in these sectors are tied to insider wages. Therefore, the effective underbidding of wages by outsiders is prevented.

After the fall of the Iron Curtain and the reintegration of the former Communist countries within the world economy, the position of western Germany's insiders has been contested by workers from both eastern Germany and Middle and Eastern Europe. But for reasons that will not be discussed here in detail, it seems that the pressure exerted by eastern Germany's labour market is not as strong as might have been expected. The labour markets of both Germanies were mainly composed of commuters from East to West Germany, with a balance of 440 thousand in 2001 (Ragnitz, 2002). In general, these commuters were bound to existing collective labour contracts in West Germany. Of course, competition by the East German labour force was



perceptible when firms outsourced their production to East Germany or when East German companies could underbid their western competitors. However, wages and productivity are both, on average, lower in eastern than western Germany, with the result that unit labour costs in manufacturing are only slightly lower in eastern than western Germany (Sachverständigenrat, 2002: 186). Thus, it is no surprise that nowadays production outsourced not to eastern Germany but to Middle and Eastern Europe appears to be the most effective threat to the position of western German insiders.

In contrast to the replacement of insiders by domestic outsiders, outsourcing means a shift in the location of jobs and requires advance preparation in order to adapt to differences in administrative regulations and culture, as well as the building up of new plants. In general, this alternative not only requires more time but is also associated with greater imponderability in comparison with the replacement of insiders by domestic outsiders. Therefore, outsourcing production abroad is proceeding slowly. The implications of this process will be considered in section 3.

The graphical interpretation of the insider labour market contains a wage demand (WD_i) curve and an aggregate labour supply (LS_i) curve. The WD_i curve implies that individual firms are wage takers on the labour market. Referring to the arguments in section 2.1., at least until recently the German unions possessed sufficient bargaining power to influence insider wages effectively. The efforts of companies to outsource production abroad indicate that in many cases companies estimate the marginal product of labour as being lower than the wage they have to pay for it. This situation is marked by point A in Figure 1, which means that the unions have realized the maximum insider wage (W_i) that is compatible with the maintenance of insider employment at the moment.

As argued above, competition from domestic outsiders is likely to be ineffective in Germany, which means that only the *absolute* rather than the relative profitability constraint is relevant in relation to insider wages. Since dismissal costs exist, the absolute profitability constraint expressed by the APC curve, is not identical to the WD_i curve, but is shifted upwards by d which represents the (annuity of the) costs involved in dismissing insiders. Apart from other influences, d increases in relation to the demands of employment protection.

According to the interpretation of Figure 1, the reservation wage of foreign outsiders *plus* the turnover costs due to the replacement of insiders (R_i^+) lies well below the insider wage in Germany, giving rise to a steady process of outsourcing. However, until recently R_i^+ was not perceived as a strict restriction by unions when defining their wage demands in industry-level negotiations. Foreign competition seemed to be too far away geographically and outsourcing too dispersed with respect to time and companies to merit serious consideration in the process of wage bargaining at industry level. This situation, which has changed recently (See Section 2.1.), is illustrated by Figure 1, whereas the following section 3 will deal with the changes in wage bargaining that are evolving at the moment.

The starting point A represents a kind of momentary equilibrium for insider employment N_i and a level of unemployment determined by the difference LS_i minus N_i . Since human capital will depreciate gradually during unemployment, former insiders who have become unemployed lose their status after some time, and the pool of insiders will decrease gradually, shifting the LS_i curve to the left. Accordingly, the excess of supply over demand tends to be small in the insider market.

The market for *outsider* employment comprises atypical work and low-wage employment. This latter aspect of the outsider market is characterized by little union influence and rather insignificant employment protection (for instance in small companies with no more than ten employees, see Section 2.1.), but it is integrated into the social security system. Atypical work comprises several different kinds of participants on the supply side, ranging from insiders who earn an additional salary with a *mini-job*, to the registered unemployed who supplement their unemployment benefits in this way. The common feature in all these employment relationships is



the lack of union influence on wage-setting and, to a certain extent, less employment protection than in the insider labour market. For the sake of simplicity, this market is specified as a competitive market. Wages are subject to the pressures of the reservation wages of those who would like to participate in this market but have not yet succeeded. In Figure 2 it is assumed that this reservation wage is the same for everyone involved in the supply side of the market (R_O). Turnover costs are neglected, since they are much lower than those in the well-protected insider market. In fact, R_O is mainly determined by the level of unemployment benefits.

As far as *shadow activities* are concerned, two types of activity may be identified, depending on the origins of the workers (domestic or foreign) involved in these markets. Both areas of the market are specified as competitive, but they differ in terms of supply. While domestic supply is restricted in this market, as it is in the other labour markets, the supply offered by foreign workers seems to be highly elastic, or even indefinitely elastic. Moreover, due to the German welfare system, the reservation wage of domestic suppliers is assumed to be higher than that of the foreign workers. On the other hand, it tends to be lower than the outsider market, which is subject to taxation and contributions, even though they are distinctly lower than those levied on the insider market. Figure 3a) reflects excess supply because at the moment it seems to be easy to hire a domestic worker for a shadow activity.

3. The Process of Erosion and its Consequences

3.1. The Process of Erosion

The system of different labour market segments is similar to a system of communicating pipes with barriers which impede any equalizing processes. As argued above, the process of outsourcing will require time. The same is true in relation to the decision to transfer an outsider job to the shadow economy, since the participants have to overcome the social norms. As a result, the equilibration processes will take full effect only after a long period of time, if at all. As long as these effects work, momentary equilibria will emerge which will be investigated here.

In the first instance, the process of erosion affects the insider segment of the labour market. In Figure 1, the initial position A will be eroded by *outsourcing* production abroad, shifting the WD_1 (and with it the APC) curve inwards. This process reduces insider employment due to the assumption that the competition of foreign outsiders is too dispersed to be taken into account by unions in their wage demands. Consequently, insider unemployment will rise temporarily. It is certain that in the case of outsourcing abroad, the drop in demand for insider employment will not be compensated by an increase in the demand for domestic labour in one of the two other segments of the labour market. As argued in section 2, unemployed insiders lose their status over time and will join the supply side of the two other areas of the labour market. However, elastic supplies tend to prevent wage reductions and the rise in employment in these market segments. Consequently, within the framework presented here, the decrease in insider employment and the increase in *overall* unemployment will be the sole effects on employment and unemployment. As a result, shadow activities do not compensate for the loss of insider employment.

If an insider job is *transferred to the outsider segment* or an outsider job to the *shadow economy* these shifts of demand have no effect on wages but only on employment. As the combined result of both operations, the official GDP will be depressed while the extended GDP (including the outcome of shadow activities) will remain unchanged as long as productivity in all the labour market segments remains the same. If, on the other hand, productivity in the shadow economy is lower than in the other segments, the reduction in the GDP will not be fully compensated by shadow activities and the extended GDP will be depressed as well. To the extent that activities which have been transferred to the shadow economy were formerly undertaken by low-wage workers integrated into the welfare system, (registered), unemployment will rise.

In all cases the transfer of jobs will put the welfare state under strain. Given the way the German pay-as-you-earn system functions, the loss of jobs that had been integrated into the social

security system will tend to raise contributions in the short term. As long as the increase in contributions is not fully compensated by decreasing the net wages of employees, gross wages, which are relevant to the employers, will rise and once more will provide an incentive for reducing those jobs which are integrated into the social security system. A vicious circle may emerge, which will make the labour market situation deteriorate even further.

According to the preceding analysis, the process of erosion of highly regulated employment takes place without changes to wages and affects the GDP negatively. This corresponds broadly to the stylised facts. In the nineties there was a low growth rate in the GDP and (registered) unemployment increased in general, whilst the share of employees integrated into the social security system dropped. On the other hand, wage dispersion remained almost unchanged from the eighties to the nineties of the last century (Compare OECD, 2004: 141). This seems to be compatible with the preceding analysis where the adjustment process resulted in changes in employment but not in wages. Finally, the process of outsourcing leads to a comparatively high net loss of jobs in Germany, contrary to the situation in the United States (McKinsey, quotation from Economist, 2004). This is probably due to the German labour market institutions. Doubtless the interpretation presented here is just a first approximation towards explaining this phenomenon, since it predicts that the rate of loss amounts to 100% instead of 60%, as estimated by McKinsey.

3.2. The Trend towards Flexibilization in the Labour Market

The process of erosion which has taken place since at least the nineties may have changed its character recently to a certain extent. As mentioned in Section 1, within the framework of collective bargaining opening clauses are increasingly used due to the threat of outsourcing on the part of the companies. The resulting concessions made by employees probably do not prevent outsourcing completely, but the process will continue at a lower rate. Consequently, wages are reduced selectively (and not generally), depending on the credibility of the threat to outsource production, and the impact on the overall wage level may be limited. In principle, the development which is described in the preceding section could continue for some time, at the price of steadily shrinking employment in the insider segment of the labour market.

The consequences of a permanent worsening of employment opportunities depend on the reaction of the participants in this market segment, especially the employees. In the course of time, the system of industry-wide collective bargaining could break down. Such a fundamental institutional change may result in overall (instead of selective) wage reductions. This would provoke a dilemma: It seems unlikely that reductions in the overall wage level in the insider labour market segment will prevent further outsourcing or give rise to growth in the workforce as long as they are moderate (Compare Figure 1). Only a wage reduction that is large enough to reach the lower part of the WD_1 curve could contribute towards increasing insider employment, if at all, or at least towards preventing further decreases. However, such a substantial reduction in the overall wage level is likely to improve the international competitiveness of companies considerably and to increase the already existing trade surplus of Germany even more. This might provoke wage reductions in other countries and, in the final analysis, the emergence of a deflationary spiral cannot be discounted.





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Appendix



Figure 1 – German Labour Markets: Insider

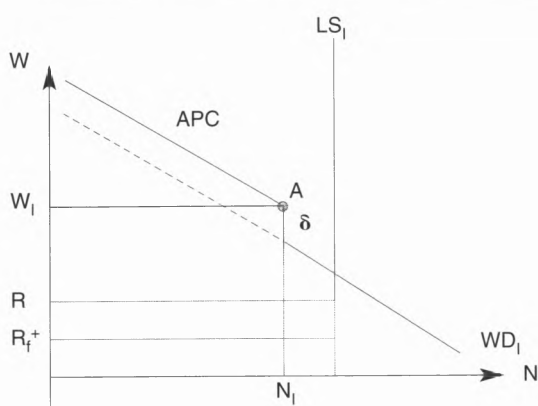
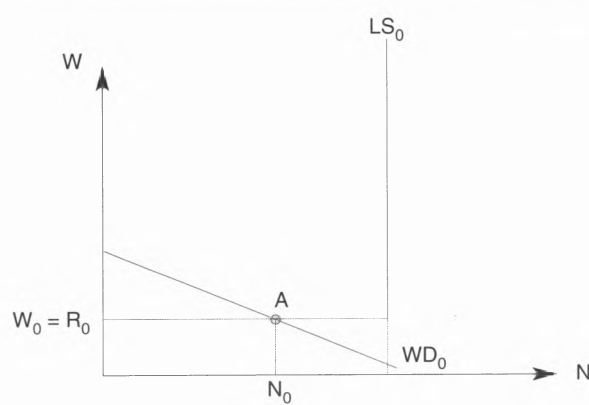


Figure 2 – German Labour Markets: Outsider



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Figure 3a – Shadow Economy: Domestic Workers

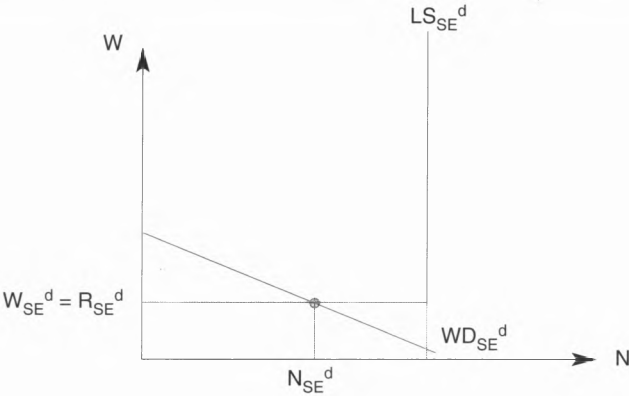


Figure 3b – Shadow Economy: Foreign Workers

