

## THE SHADOW ECONOMY IN GERMANY – CAUSES AND CONSEQUENCES<sup>1</sup>

Enno Langfeldt  
Fachhochschule Kiel/University of Applied Sciences

In this paper, the shadow economy is seen as a reaction to excessive constraints created by public institutions and bureaucracy. While large companies can shift production abroad in order to avoid these constraints, illicit work and do-it-yourself activities are the only exit options for individuals and small companies. Under the present high tax and social security contributions and tight labour market regulations the existence of the shadow economy is increasing welfare as many activities otherwise would not have occurred. However, due to control and concealment costs in the underground economy, the overall efficiency could be further increased if by a reform of economic and social policy incentives are given to shift back activities to the official sector voluntarily. In order to draw some policy conclusions at the end of the paper at first the available empirical evidence on the shadow economy is provided and then its main causes and consequences are analysed.

In general, the shadow economy incorporates all kinds of economic activity that are unobserved by the official statistics. Some activities are hidden in order to avoid taxation and regulation (underground economy). Other activities are not officially measured because they are non-market activities (household and volunteer work) and thus are not included in the definitions of the national income accounts. The size of the underground sector in Germany is estimated to be in the order of 15% of official GDP, the respective rate for household activities and volunteer work is likely to amount to about one third. In the last three decades before the end of the century, the shadow economy seems to have increased more rapidly than the official sector. Since then the shadow economy is shrinking relative to the official sector.

The key problem of the official sector is the huge wedge between take-home pay of workers and the official hourly wage costs, which have to be paid by the customers of these services. Currently the net wage of a qualified painter is 9.14 € per hour, while the amount of the respective hourly wage costs (including VAT) to be paid by customers is 50.56 €. The services of an illicit worker are available at a price of about 15–20 € per hour. With such large price differences is not surprising that illicit work is not only widely used in the population but also seen as only a minor violation of law.

The single most important cause for the existence of the shadow economy is the high level of social security contributions and taxes in relation to gross wages. In the case of an employee with an average income, the respective rate is slightly above 50%, marginal rates are even higher. Indirect taxation (current VAT rate: 19%) gives an additional stimulus to work off the records. Another serious problem is

---

<sup>1</sup> Den vollständigen Text des Artikels “Die schattenwirtschaft in der Bundesrepublik Deutschland und ihre ursachen” findet der Leser auf der beigefügten CD.

social transfer payments. For low qualified workers in the service sector and in eastern Germany there is almost no incentive to take up official work as official wages hardly exceed transfer payments. Even in case of additional small earnings in the official sector, the implicit taxation is in the order of 90%. Regarding these incentives, illicit work and do-it-yourself activities seem to be the only reasonable forms to take up work voluntarily.

Unemployment and related welfare benefits have a strong influence on the incentive to work in the shadow economy. Most of the public transfer payments do not include an obligation to work. Incentives to take up regular work are very weak. If recipients of welfare benefits earn small additional incomes in the official sector, benefits are by an amount of about 85% of the additional incomes earned. Thus for many of those who have fallen into poverty the shadow economy is the only reasonable alternative to improve the financial situation.

The intensity of regulation is another important factor for the size of the shadow economy. For small and medium-sized companies the annual costs of the different bureaucratic obligations amount to about 4400 € per employee. The most severe regulations refer to the labour market. Law fixes the maximum amount of working hours and health and safety standards. There is also a legal dismissal protection of workers and the obligation for compensations in the case of mass layoffs. In addition, the government protects workers against competition from foreign workers. In some sectors, they have to be paid according to German standards. Foreigners will receive a job allowance only if German workers are not available for the job. Although there are no legal minimum wages, the government is interfering into the formation of wages. For some sectors, minimum wages agreed upon by unions and employers associations are declared compulsory for all firms and workers. Because of all these regulations, the size of long-term unemployment and the unemployment of low-skilled workers is significantly higher than in other industrial countries.

Surveys indicate that the readiness to undertake illicit employment as well as its acceptance is high in Germany. Three quarter of the population expect that their neighbours employ illicit workers. Asked whether illicit work is “an activity which should not be done under any circumstances”, only 25% of the persons asked answered “yes”. As a comparison, 75% condemn fraud in line with different kinds of welfare benefits. To sum up, for a wide majority of the population illicit work is not a criminal activity but a widely accepted social norm.

So far, it has been argued that the shadow economy and the official economy are substitutes, higher incomes in one sector mean lower incomes in the other. However, there are good reasons to assume that the shadow economy is also supporting the regular sector. Illicit work and do-it-yourself activities are increasing the official demand for materials. To a large part, the incomes of illicit workers will be spent in the official sector. Thus fears that the existence of the shadow economy leads to large losses of tax revenues seem to be exaggerated. With respect to income distribution, the shadow economy is likely to level off income inequalities as low-income earners participate more actively.

With respect to policy conclusions it has already become evident that that the tax wedge has to be reduced and the labour market has to be deregulated. In order to prevent that the aging of the population will put additional pressure on non-wage labour costs in the future, social security contributions should no longer be fixed to wages solely. In order to increase official work incentives for people receiving social transfer payments new schemes are needed which reduce the high implicit taxation in the case that official work is taken up.

The German Council of Economic Advisers favours a model were recipients of welfare benefits are taxed only at a rate at 50% if they have additional incomes from the official sector. In addition, the efforts to take up regular work are increased by a 30% reduction in welfare benefits.