

Discussion paper

EUROPEAN EMPLOYMENT OBSERVATORY  
GERMANY

Undeclared Work

by

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## 1. Introduction

Undeclared work is part of the shadow economy for which a legal obligation exists to provide administrative evidence on economic activities to public authorities. This can be tax avoidance, the non-payment of social contribution rates, illegal employment or – particularly in Germany – the execution of a crafts business without professional entitlement. Little is known about this specific part of the shadow economy as statistical records by the prosecution authorities in general do not provide useful figures.

This article tries to approach the problem from a wider perspective of the shadow economy, presenting the statistical estimates presently available and the measures undertaken by public authorities to combat black activities and illegal work. The new legislation from 2004 in this area seems to show some effects but the problems nevertheless exists.

## 2. Prevalence of undeclared work in the economy

For the estimates of undeclared work basically two methods can be used:

- The macro-economic method which is based on the consideration that activities in the black economy are paid by cash. The velocity of money therefore gives an indication of the size of the shadow economy. It includes all forms of hidden activities. A second macro-approach uses the econometric estimates in which the size of the black economy is given through indicators like tax burden, density of regulations, working times, cash flows etc. (Schneider 2004). As these methods can hardly identify the type of activity or its sector, their definition goes beyond the term of undeclared work including e.g. neighbourhood help or do-it-yourself activities. There is a tendency to overestimate the size of the hidden economy.
- Survey or statistical approaches which either use population surveys or statistical evidence about employment, working hours, wages etc. to estimate the scope of undeclared work. These estimates tend to underestimate the size of the black economy, however, they allow for a series of differentiations as regards the persons involved, the occupations, sectors and regions (Feld, Larsen 2005).

### *Macro-estimates*

The latest macro-calculations published by the Institut für Angewandte Wirtschaftsforschung, Tübingen, estimates the size of the German hidden economy in 2007 to 349 billion EURO (IAW 2007). This will be 14.7 % of the official GDP. Since 2003 the hidden economy in Germany was declining by 6.6 % until 2006. In 2007 the trend is expected to be terminated with an increase by 1 % against the previous year.

The main reason for this increase is identified in the rise of VAT from 16 to 19 % at the beginning of 2007. The rise of mini-job taxation, the abolition of housing allowances, the additional tax on top incomes, and the increase of contribution rates to pension and health insurance are also expected to contribute to the growth of the hidden economy. A negative impact on its size is addressed to lower unemployment insurance rates, tax allowances for private housing maintenance and child care.

38 % of the hidden economy is located in the construction industry. Manufacturing industries contribute 17 % as the hotel and catering sector. Other services – mainly private help like baby sitting, private lessons or hairdressing – contribute 15 %.

By international comparisons, Germany's shadow economy takes a middle range with

Greece and Italy at the top and Austria, Switzerland, Japan and the USA at the end.

The study underlines that great parts of the money earned in the shadow economy return to the official economy and thus is lost only partly. The reduction of the hidden activities requires the reduction of taxes and social insurance premiums. The tax wedge is seen as the major determinant of the volume of the shadow economy. The government should take the responsibility to re-establish the balance between taxation and the supply of public services.

### *Survey-based estimates*

An approach used for the estimation of black activities in Denmark, Norway and Sweden was applied to Germany by the Rockwool Foundation (Feld, Larsen 2005). This approach interviewed a representative sample of the population aged 18 to 74 in 2004 and used a similar survey in 2001 for comparison.

Black activities are defined as productive economic activities which are legal and taxable, but on which income tax, social security contributions, VAT, etc., are not paid, because they are not reported to the tax or customs authorities. This is rather close to the definition of undeclared work. Prices and wages therefore can be kept below what should have been paid at the formal market. Buyer and seller are both aware of this, and both obtain an extra economic advantage in this way.

Directly asking persons about their involvement in the black economy reveals surprisingly great openness of interviewees to report about such activities. However, it can be assumed that only "peccadilloes" are reported. Serious violations of the law and activities of bigger volume can hardly be measured by this method. However, it provides a detailed insight into the "smaller" activities.

Following the Rockwool Foundation study for Germany, the number of people involved in black activities during the last 12 months declined from 10.4 % in 2001 to 8.8 % in 2004. This trend is more or less in line with the macro-estimates. The participation rate for men (14.5 %) was more than twice that for women (6.5 %). Young persons were also overrepresented, in particular the age group of the 20-29 year olds. Increases were also found in the age groups from 18-19 year and 70-74. The group between 30 and 50 years however, showed lower "shadow" participation rates. Black activities are widespread among unemployed, skilled workers, and people undergoing education and training.

7 ½ hours per week were spent on black activities on average per person engaged in such activities. Men spent more (almost 8 hours) than women (6 ¾ hours). The average remuneration per hour amounted to 10.40 EURO in 2004, more or less the same like in 2001. For men the hourly rate was 11.00 EURO and 8.70 for women. 12 EURO were paid to skilled workers, and 9.20 EURO to unskilled.

Using these information bits, the Rockwool Foundation estimated the total size of the black economy to 3.1 % of the 2004 GDP. This was a 24 % decline since 2001. In full-time equivalents, 1.3 million jobs could be found in the informal economy. Similar to the macro-estimates the construction sector was the biggest part of the black economy, followed by agriculture and the hotel and catering sector. Transport and communication is also among the "big" sectors.

### *Undeclared work in view of the population*

A population survey undertaken by the Allensbach Institute revealed that 55 % of the

population considered more severe punishment of undeclared work to be necessary (BMF 2006). However, in 2004, only 40 % of the population perceived the risk of detection as very or fairly high, while 50 % thought it might be fairly or very small. 10 % did not know how to assess the risk (Feld, Larsen 2005). Compared to 2001 the risk awareness seems to have risen. This might be the effect of the new legal regulation which was in the public debate at that time. The knowledge about sanctions remained limited: 20 % of the interviewees expected that only taxes would have to be paid, 50 % expected additional punishment in form of a fine imposed together with taxes, and 5 % expected a prison sentence. All others could not give an answer.

In comparison to other types of cheating behaviour, black activities appear to be more or less accepted by the population. While 73 % deemed it totally unacceptable to receive welfare benefits without being entitled, and 52 won't accept a free ride on a bus or train, only 33 % thought of carrying out black activities was absolutely unacceptable (Feld, Larsen 2005). The rejection is even less in the case of activities for private households.

### *The economic interpretation of the shadow economy*

The analysis of the shadow economy in Germany undertaken by researchers of the IFO Institute in 1987 provided a principal economic view on this sector and its relation to the official economy (Heinze, Schedl, Vogler-Ludwig 1987). The shadow economy was structured into three areas: tax-free activities (e.g. neighbourhood help), self-production by private households (do-it-yourself activities, child care, elderly care etc.), and the underground economy (black activities, contracts without invoice). A declining productivity profile was identified starting from highly productive professional activities in the official economy over black activities to the low-productive self-production by households. Market prices on the one hand and time budgets of private households are the main determinants of the decisions where services and products are produced. The higher the market prices and the more "leisure" time the higher is the volume of self-production. New technologies for household appliances raise the productivity of self-production.

As market prices include taxation, tax avoidance provides a considerable advantage to suppliers in the black economy. Higher taxes raise the "earnings from angst" but stronger control raises the risks.

With an approach using the occupational structure of the work force, time budgets of households and income levels, the number of suppliers in the black economy was estimated between 6 and 7 % of the total work force. In relation to GDP the volume of black activities was estimated around 4 %, and in addition a similar volume of contracts without invoice. This sums up to 8 % of undeclared work or tax evasion – an estimate which was at the lower border of the spectrum of estimates at that time.

Following the study, the size of the shadow economy depends not only on the level of tax rates but on job opportunities in the official labour market. Shadow activities also emerge if unemployment is high and income perspectives are poor. The growth of the shadow economy therefore was also attributed to the rise and persistence of unemployment in Germany.

### *Illegal employment*

This is mainly an issue related to illegal immigration. The incentives to get even a low-paid job in a high-wage country are very strong for potential workers from many non-EU countries. Therefore illegal employment is a fact which can hardly be avoided. Nevertheless, administrative control and the policy of deterrence followed in Germany create high risks for both immigrants and employers. This might be the reason why the latest migration

report of the Federal Government from 2005 doesn't even mention the notion of illegal work or black activities. The estimates of the volume of illegal employment range between 0.5 and 1.5 million, however, none of them is scientifically based.

### 3. Measures taken to combat undeclared work

#### *The 2004 act to combat undeclared work and tax fraud*

The German government passed the "Act to Intensify the Combat against Undeclared Work and Tax Fraud"<sup>1</sup> in 2004. This new law changed the prevailing legal regulations in a series of points:

- Undeclared work (*Schwarzarbeit*) was defined as the violation of notification requirements, accounting obligations or tax payments according to tax legislation or the Social Code. In addition, the violation of regulations for crafts and industrial business is included. This definition excludes large parts of neighbourhood help and do-it-yourself activities as far they are not profit-oriented.
- The competences of customs authorities were extended in order to have sufficient legal power to combat undeclared work. In particular, customs authorities were authorised to control tax and social contributions payments, to enter production sites and control workers, and to check trucks and cars. Moreover, a central databank was established which allowed custom and police authorities to exchange information.
- The non-payment of social contribution rates was made an element of crime, while tax fraud by private households in the area of mini-jobs was made an administrative offence.
- Construction and maintenance services for private households have to be documented by an invoice which the private household has to keep available for two years.
- Penalties against undeclared work were raised considerably up to 300,000 EURO in the case of illegal employment, and non-payment of social contribution rates. Violence of business or crafts business registration duties can be penalised up to 50,000 EURO.

Meanwhile 6,200 civil servants of the customs authorities are engaged in combating undeclared work and tax fraud. 355,900 cases were investigated in 2005 and 81,300 criminal procedures were started. Financial losses were estimated to 563 million EURO. The total sum of penalties amounted to 88 million EURO.

The adoption of the law was accompanied by a broad consensus among social partners and scientist. The German Trade Union Association (DGB) demanded for common EU standards for self-employment and regular jobs. It agreed to the intensification of administrative control, the introduction of forgery-proof identification cards for registered jobs, and the extension of works councils' rights (DGB 2004).

In its 10<sup>th</sup> report on the impact of the new act on combating illegal employment - published in 2005 – the Federal Government stated that the efforts of public authorities were intensified considerably and showed first success (Bundesregierung 2005). The activities will be further extended.

#### *Alliances against undeclared work*

In parallel, a public initiative against undeclared work was started which led to alliances against undeclared work in two sectors, the construction industry and transport business. The treaties were signed by the social partners and the Federal Ministry of Finance. Regional alliances followed the activities at the federal level. They included a general declara-

<sup>1</sup> Gesetz zur Intensivierung der Bekämpfung der Schwarzarbeit und damit zusammenhängende Steuerhinterziehung vom 23. Juli 2004. BGBl. I 2004, S. 1842 ff. < [Internet Access](#) >

tion against undeclared work and specific measures to be undertaken by the partners.

As common targets the treaties defined

- raising the awareness of the consequences of undeclared work and illegal employment
- creating fair competition and avoiding ruinous pricing
- establish rules for regular tax payments by all companies
- enforce legal regulations and minimum standards on the labour market

The partners agreed to denounce undeclared work and illegal employment in the public and to inform the population about the negative impacts. Moreover, information flows between social partners and financial control should be improved at the local level. Working groups were established in the sectors to develop specific measures.

The Länder governments were included in the initiatives and created their own instruments to combat illegal work. The Berlin government e.g. established an information centre which provided information to the public and coordinated activities against the black economy ([Senat von Berlin](#)).

## 4. Conclusions

The debate on undeclared work has to be conducted in a differentiated way. The budgetary problem of tax losses is only one side of the problem. The economic effects are on the other side and these are quite different as regards the impacts on growth and employment.

Tax evasion by larger employers and big contracts appears to distort price competition among companies in a negative way. The unfair winner of a contract – due to tax evasion or illegal employment – attracts value added and employment from the competitors. This is to the advantage of customers but the disadvantage of competitors and legal workers. As all competitors are able to provide the same type of products or services, the market is not extended, at least not in the first round. In the second round the price advantage given to the customer might extend demand, however, public demand is restricted simultaneously. Thus the macro-effects can be assumed to be minor.

The case is different for small contracts often executed as private crafts services and demanded by private households. In many cases regular companies would not supply such small-scale services in maintenance, repair, personal care etc., and if they would, these contracts would not be concluded at the price level of official contracts. This means that through enforcing taxation these services would largely disappear from the markets. The involuntary tax preference which in fact the government gives to such activities “involuntarily” finally extends GDP. If these activities should be made legal, a substantial tax reduction would be necessary at this lower end of productivity. Only this could avoid negative effects on private incomes, employment, and economic growth.

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