

with Special Stock Option Watch

Reduced VAT Rates Unsuitable as Instrument of Redistribution Policy



The abolition of reduced rates of VAT in Germany, particularly on food, books and newspapers, would increase the expenditure burden of all households. Removing reduced rates would only have minor redistribution effects, however. These negative redistribution effects are slightly detrimental to households on low incomes but could be compensated for if the exchequer were to redirect the ensuing additional tax receipts to households via transfers or other forms of tax relief. This is the key finding of a study completed by the ZEW on behalf of the Federal Ministry of Finance.

The ZEW study confirms that households on low incomes spend an above average share of their disposable income on goods on which the reduced VAT rate is levied and would therefore register the abolition of reduced rates more sensi-

tively than other groups. The difference in the spending structure between this group and high-income households is minor, however, and reduced VAT rates are not therefore justified by the degree of relief they ostensibly provide to low-income families. High-income families profit to much the same degree. Reduced VAT rates thus represent an inaccurate tool for redistribution purposes.

If reduced rates of VAT were abolished, what could be done to prevent households, and particularly low-income households, suffering from the financial consequences? Given that the European Union (EU) envisages a lower rate of 15 percent as part of the process of tax harmonisation, it would not be possible to replace the differentiated rates applicable in Germany at present by a standard rate somewhere between the current rates of 7 and 16 percent. The ZEW stu-

dy therefore investigates scenarios in which additional tax receipts are generated by the abolition of reduced rates of VAT as part of a revenue-neutral tax reform designed to increase transfers and reduce rates of income tax or social security contributions. A deft choice of compensatory measures would enable scenarios to be created in which all households would be better off after such a reform. The impact of such a comprehensive overall tax reform would be most positively felt if the additional revenues generated were used to reduce social security contributions. A reduction in marginal rates of income tax would also prove to be an appropriate method of tax revenue recycling; increasing the tax-free personal allowance, in contrast, would be significantly less effective.

The ZEW analysis shows that because it is so inaccurate in its effects, VAT is a poor tool of redistribution policy. Differentiated rates of VAT are not therefore justified by redistribution objectives.

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RESEARCH FINDINGS

Direct transfers or changes in personal income tax rates promise to be far more effective in this respect.

Much more significant than the redistribution effects is the impact which different VAT rates have on different branches of business and industry. A

revenue-neutral abolition of the reduced rate of VAT would diminish demand for lower-taxed goods and bring about a corresponding increase in demand for goods previously subject to higher rates of VAT. In reality, therefore, reduced rates of VAT in fact represent subsidies to par-

ticular sectors of business and industry – subsidies which, while they are dressed up as redistributive measures, should be seen for what they are and subject to policy debate accordingly.

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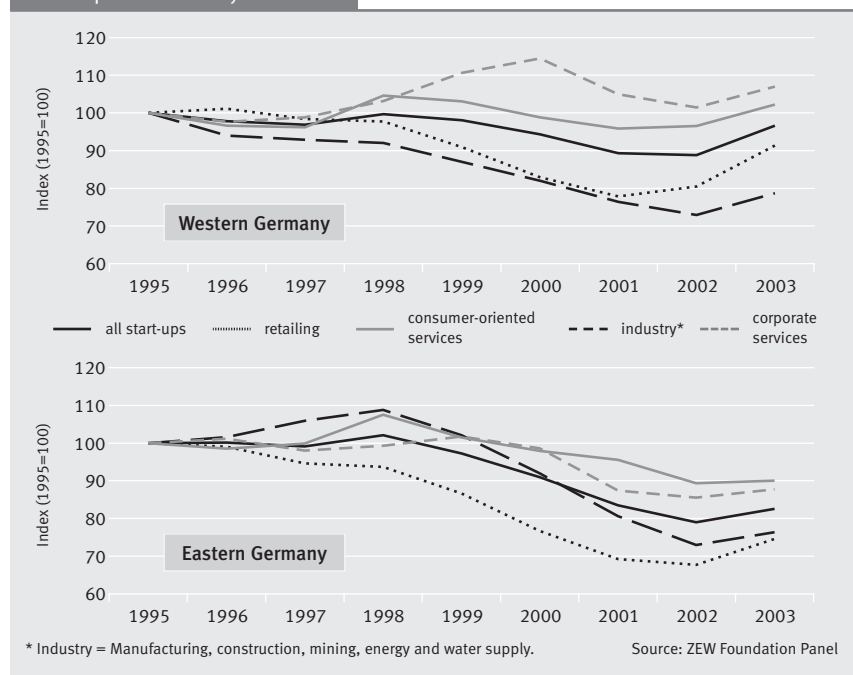
New Business Start-Ups in Germany: “Me, Incs.” Flash in the Pan?

The number of new companies set up in German in 2003 rose by eight percent compared with the previous year. The key reason for this significant increase in new company formations is the introduction of a special business start-up subsidy for unemployed (“Me, Incs.”) and the extensive use made of bridging allowance. This employment policy measure can be assumed to have had an especially significant impact in the retailing and consumer-oriented service sectors (such as gastronomy) and construction. These are the findings of the latest six-monthly study published by the ZEW on company start-up behaviour in Germany.

The number of new business start-ups has not dropped for the first time since 1999. More firms have been established across all branches of business and industry. At nine percent more new companies have been established in western Germany than in eastern Germany where there has been a 4.5 percent increase. Owing to the significant rise in start-ups directly benefiting from labour market policies there has been a discernible structural shift towards small, non-technological and knowledge-intensive formations in the legal form of unincorporated partnerships.

At 13 percent, the biggest increase in the number of start-ups has taken place in retailing. This trend is largely due to the mail-order sector where there has been an increase of almost 60 percent in the

Start-ups in Germany



number of new companies. In absolute figures, the largest increase in the number of newly formed companies is among specialised retailers of goods such as photographic products and computers.

In the consumer-oriented service sector, around five percent more firms were set up in 2003 compared with the previous year. An above-average increase in the number of new firms was recorded in the real estate and housing sectors. Start-up conditions also appear to have improved in the adult education sector over the last twelve months.

The number of new providers of corporate services increased by about five percent with the focus in this sector falling in particular on data-processing services and related activities. The number of new companies in the manufacturing sector rose by around seven percent. This sector is typically extremely capital intensive which is why – with the exception of certain parts of the construction trade – very few “Me, Incs.” have been set up in this area.

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RESEARCH FINDINGS

Will China Break the Yuan-Dollar Link?

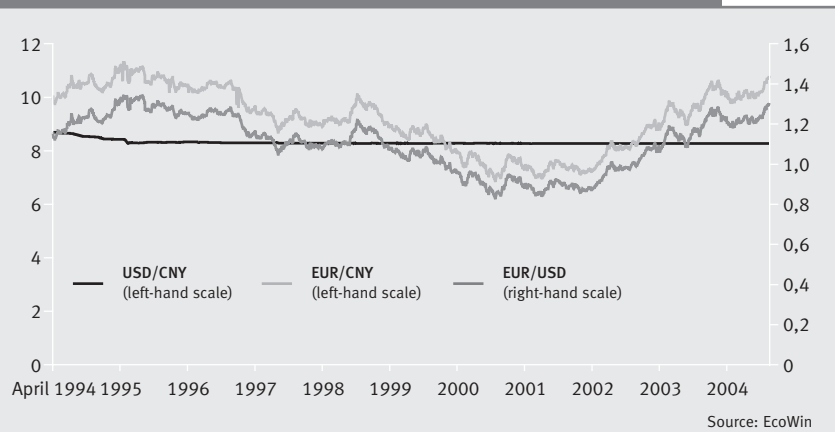
According to a survey undertaken by the ZEW, the current link between the Chinese currency and the US dollar is expected to be loosened if not abandoned altogether in the future. This article sheds light on the background to the present currency regime and the potential impact of its demise.

The monetary perspective of exchange rate theory regards two currencies as “assets” with the exchange rate between the two expressing their relative scarcity. If, *ceteris paribus*, the demand for one currency increases in comparison with another, the currency in greater demand rises in value; if, in contrast, the supply of this currency increases, it will decrease in value. Under a system of flexible exchange rates this theory predicts that an expansive monetary policy would lead to downward pressure on the value of the relevant currency.

China linked its exchange rate to the US dollar in April 1994, initially as a “managed float” and later as a “pegged” currency within defined fluctuation margins. When currencies are pegged in this way, the central bank constantly strives to maintain a stable scarcity relationship to the US dollar. The Chinese central bank manages this by purchasing US dollars on the market in order to build up dollar-denominated foreign currency reserves. Capital inflows of this type lead to an inexorable expansion in the money supply in the long run despite the Chinese central bank’s endeavours to withdraw liquidity by a number of means, including sterilisations on the foreign exchange markets. However, as these are rather classified as short-term measures, the USA’s expansive monetary policy will be “imported” in the long term.

As a result, the link between the yuan and the US dollar not only has significant implications for China’s monetary policy, it also prevents the yuan rising in value and thus strengthens the country’s export business.

US dollar and euro exchange rate with the Chinese yuan; and the euro compared with the US dollar



Bearing in mind that the Chinese economy shows signs of overheating, it is doubtful whether this monetary policy will continue to be pursued in the future.

Future Chinese exchange rate policy more flexible?

In addition to these domestic issues, China is facing increasing pressure from other countries to loosen exchange rates. Eurozone countries believe that the yuan-dollar peg has a number of disadvantageous effects on their competitive position. To begin with, the link prevents the yuan appreciating relative to the US dollar, and Chinese goods thus remain relatively cheaper for the USA than European goods. Also the euro’s rise in value against the US dollar means an increase in value against the yuan.

There is also a danger that the growth in the US current account deficit will be exacerbated by the present conditions. In his time Charles de Gaulle noted that the use of the dollar as an international means of exchange and reserve currency “enabled the US to be indebted to foreign countries free of charge by paying what they owe other countries in dollars that they themselves issue as they wish.” (Cf. Niall Ferguson, “The end of the dollar’s reign?”, NZZ Online, 20.06.2004).

However, two reasons in particular are likely to figure in China’s reluctance to loosen its exchange rates in the near future. On the one hand, the competitive position of the People’s Republic would deteriorate vis-à-vis other Asian countries whose currencies are pegged to the US dollar. Secondly, a more flexible exchange rate would not be without risks given the instability of financial markets. In this context the International Monetary Fund recommends action to improve the competitiveness and risk management of banks and the legal framework in which financial markets operate.

More than 90 percent of experts surveyed as part of the monthly ZEW financial market test believe that China could loosen or entirely float its currency within the next five years. More than 70 percent believe that if this was the case, the US dollar would drop in value against the yuan as the Chinese central bank would cease purchasing US dollars and demand from this source would begin to dwindle.

While a more flexible yuan exchange rate policy is on the Chinese government’s agenda, the latter believes as well that the banking system first needs to be tackled before any moves can be made in this direction. It remains to be seen how urgently both issues are addressed.

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RESEARCH FINDINGS

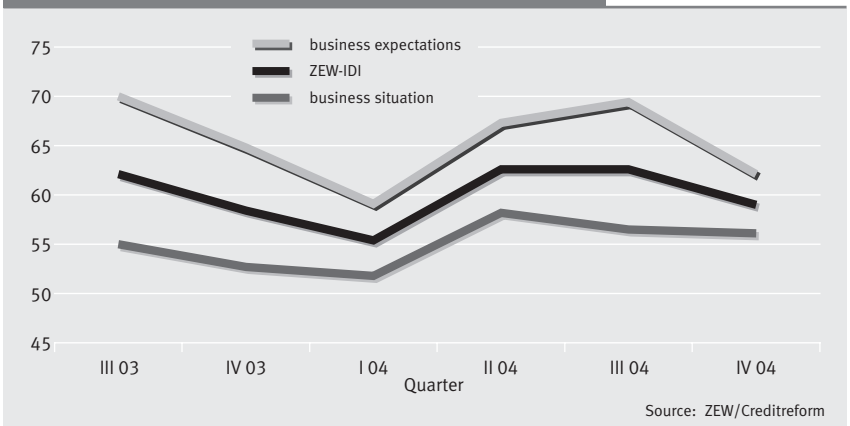
German IT-Related Service Providers: Upward Trend Contained

The ZEW-IDI, sentiment indicator for the German IT-related service providers, rates with 59.0 points in the fourth quarter of 2004 clearly below the previous quarter's value of 62.6 points. This may for the most part be attributed to the clear drawback of the partial indicator which reflects the firms' business expectations for the first quarter of 2005. The indicator value regarding the assessment of the present economic situation has however only slightly decreased. After continuous increases of the ZEW-IDI over the second and third quarter of 2004, the values for the fourth quarter of 2004 reflect the dampened growth prospects for the German economy as a whole. The balance of positive and negative turnover development in the fourth quarter is only at a slight plus. This does not match the IT-related service providers' previous quarter's expectations, when on balance still more than 36 percent of the firms were anticipating increasing turnovers for the fourth quarter of 2004.

This is the result of a business survey among German IT-related service providers that the ZEW and the credit reference agency Creditreform, Neuss, conducted in November and December 2004. About 1,000 firms participated in this survey. The sector of the IT-related service providers is comprised of the Information and Communication Technology (ICT) service providers (firms in the branches of computer service and leasing, ICT-specialised trade as well as telecommunication services) and knowledge intensive service providers (firms in the branches of tax consultancy and accounting, management consultancy, architecture, technical consultancy and planning, research and development as well as advertising).

While firms in western Germany on balance report of stagnating turnover development in the fourth quarter of 2004

Development of ZEW-IDI between III 03 and IV 04



compared to the previous quarter, the turnover of firms in eastern Germany has moderately increased. Due to the markedly decelerated drawback in prices, the earnings situation of firms in eastern Germany has improved despite a decrease in demand compared to the previous quarter. In the fourth quarter of 2004 only 18.7 percent of eastern German firms report on balance of a worsened earnings situation. In western Germany on balance 15.5 percent of firms report of an improved earnings situation. Regarding the first quarter of 2005, still a majority of firms anticipates an increase in demand rather than a decrease, despite lowered business expectations. Turnover and earnings are on balance also expected to increase for the first quarter of 2005.

Employment figures remain volatile

Employment figures among the IT-related service providers continue to remain volatile. Expectations in the third quarter of 2004 to retain the number of employees in the fourth quarter of 2004 have not been met. On balance more than 23 percent of firms release staff. In eastern Germany the number of firms releasing staff exceeds the number of

firms hiring new staff by 14.6 percent. In western Germany this balance amounts to nearly 24 percent of firms. Thus, for the first time since the third quarter of 2003, more western than eastern German firms report of a decrease in staff.

Just as in the third quarter of 2004 the ratio of firms reporting an increase in turnover compared to the previous quarter is highest among tax consultants and accountants as well as research and development firms. The proportion of architects with a decrease in turnover is striking at 71 percent. Thus architects had to absorb the greatest decline in turnover of all branches. Among the factors influencing this decline is the decrease in demand in the main construction trade.

Regarding the demand for their services most branches are confident for the year 2005. Solely the architects and technical consulting firms expect a decrease in demand in the first quarter of 2005. Such positive demand expectations will however, according to the firms' expectations, only afford additional staff for tax consultants and accountants, in the ICT-specialised trade and for the business consultants.

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ZEW CONFERENCE

ZEW Evaluation Conference

More than 60 researchers from nine countries discussed current issues in treatment evaluation at the second international ZEW Evaluation Conference on 22nd and 23rd October 2004. The four plenary lectures were given by leading international academics. 20 papers were selected for the series of parallel lectures from a large number of submissions. The scientific committee consisted of Bernd Fitzenberger, Reinhard Hujer (both University of Frankfurt am Main and ZEW), Michael Lechner (University of St. Gallen and ZEW), Jeff Smith (University of Maryland) and Alexander Spemann (ZEW and University of Freiburg).

The conference focused on the latest developments in causal analysis of treatment effects. The key issue at the heart of this topic is the solution of the fundamental evaluation problem represented by the fact that a participant in any action cannot be observed simultaneously in a status of non-participation. The aim, therefore, is to find comparable persons among non-participants. A number of problems arise in this context. In particular, the treatment and outcome variable being investigated must be precisely defined in its institutional context. The invited speakers and selected lecturers presented a mix of methodologically innovative papers relating in particular to issues of heterogeneous and dynamic treatment effects in evaluation research as well as applied research results based on natural and social experiments.

Validity of social experiments in duration analyses

Gerard J. van den Berg, Free University of Amsterdam and Tinbergen Institute, discussed the validity of social experiments for the purpose of duration analysis. Social experiments are usually regarded the best setting for analysing the average impact of policy measures. If the observed target variables represent transitions from one economic status to another, however, the mix of people assigned a particular status will vary over time. Even if groups of participants and control groups are, on average, comparable immediately after the policy measure has been assigned, or not, for experimental purposes, the comparability of the groups generally declines in the en-

suing period. If the policy measure has positive effects, the composition of the group of people of a particular status can change in the period after the measure has been applied. Participants with “good” unobserved characteristics leave the participant group relatively soon leaving people behind in the group who



Gerard J. van den Berg

have “bad” characteristics. While the effect on the probability of retaining a particular status can be estimated, sorting processes can mean that transition rates can only be estimated for people whose status has not changed up to this particular point in time.

If not all the randomly-selected participants take part in the measure, or if their actual participation is delayed, the probability of retaining a specified status can no longer be estimated without making further structural assumptions. Bearing these constraints in mind Gerard van den Berg argued that duration analyses should be based on a semi-parametric model and the chronological sequence of events should be used to accumulate information and identifica-

tion. His talk continued by outlining how such methodological strategies can be made to work in practice.

Working family tax credit in UK

Richard Blundell, Institute for Fiscal Studies and University College London, compared the results of ex ante and ex post-evaluations of support for low-



Richard Blundell

income families in the form of tax credits (Working Family Tax Credit, WFTC) in the United Kingdom. The impact appears to be minor. The employment effects of the WFTC are small because the interaction of the tax credit with the tax and transfer system has been neglected such that if families enter employment, their net incomes only rise by a small margin. Blundell also discussed the shape the best of all possible welfare states might take. His findings: In an optimum tax and transfer system every additional hour of work should lead to a rise in net income – this condition will finally be more or less met in the British system with the introduction of the new tax credit system in 2004/2005.

Negative selection in medical intervention

Ed Vytlačil, Stanford University, presented the first application of the newly developed Shaikh-Vytlačil estimator for use in the evaluation of medical inter-

ZEW CONFERENCE



Ed Vytlačil

ventions. The effect, for example, of heart catheters in intensive medicine and patient mortality in the 1990s was examined using a matching method which largely eliminated the selection bias resulting from the observed characteristics of patients. This revealed a higher mortality among patients in receipt of treatment than in a control group that was not given heart catheter treatment. Vytlačil criticised the fact that these studies took too little account of negative selection when choosing patients undergoing treatment. In reality, unobserved personal characteristics of the patients play a role in doctors' decisions whether or not to go ahead with treatment. By selecting an appropriate instrument – the week day of hospital admission –

Vytlačil was able to take account of selection bias based on unobserved characteristics when estimating the impact of the measure. It was apparent that patient mortality dropped significantly in the first seven day period following admission and that this could also be observed by doctors. However, patient mortality increased after 30 days. This effect remained unobserved by doctors because the patients had already been discharged from the clinic. Vytlačil has not yet drawn any health policy conclusions from his analysis.

Impact of school vouchers

Josh Angrist, MIT and Hebrew University Jerusalem, focused on the long term impact of secondary school vouchers. State schools offering a high standard of education are often not available to students from poor households in developing countries – and the cost of attendance at a qualitatively better private school is usually prohibitive. One frequently discussed alternative to the expensive policy of improving the quality of state schools is to subsidise attendance at private schools. This idea was implemented in Columbia in the 1990s through the PACES programme. Vouchers were issued to students from low-income families enabling them to attend

private schools. Some of the vouchers were distributed by means of a lottery; the annual extension of the voucher depended on the student's academic performance at the school. The analysis examined the long-term effects of the voucher on performance on the key ICES university entrance examination



Josh Angrist

after 11 years of schooling. This in itself is remarkable as most studies in the realm of education research tend to focus only on the short-term effects on school performance.

Despite the lottery character of the voucher issue system, it is not at all easy to make simple comparisons between the test performance of voucher holders and non-holders because not all students take part in the test. Josh Angrist argues that the vouchers improve school performance and that more people therefore take part in the university entrance examinations. These additional participants generally achieve below-average test results, however. Direct comparisons thus show that the voucher exerts a distorting downward effect on test results. Once this bias is taken into account, however, the voucher can be shown to have a significantly positive effect on later education achievement to the order of around 15 to 20 percent of achieved test scores. The study shows that the positive impact of the voucher is not restricted to weaker students.

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INSIDE ZEW

New ZEW Online Taxation Platform

As a new element of its homepage the ZEW has set up a comprehensive taxation platform at:

www.zew.de/en/publikationen/taxation

The taxation platform compiles press releases, studies, project reports, and publications resulting from projects and analyses on taxation done at the ZEW. The new ZEW taxation platform also provides information about the European Tax Analyzer, a computer simulation tool developed in close co-operation with the University of Mannheim which can be applied to measure and analyse national

and international tax company taxation. The current version of the European Tax Analyzer covers the tax systems of most EU member states as well as of Switzerland and the United States. Additionally, the website presents analytical instruments such as a simulation model for the measurement of effective tax burdens on highly qualified employees developed by the ZEW, or the simulation tool modeling the analysis of investments according to their fiscal attractiveness.

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ZEW FINANCIAL MARKET SURVEY

Results of the Survey in March 2005

The Financial Market Test conducted by the ZEW is a monthly business survey of German financial market experts which started in December 1991. The survey asks for the predominant expectations about the development in six international financial markets.

As a whole around 350 experts take part in the survey. 280 of them work in banks, 50 in insurance companies and

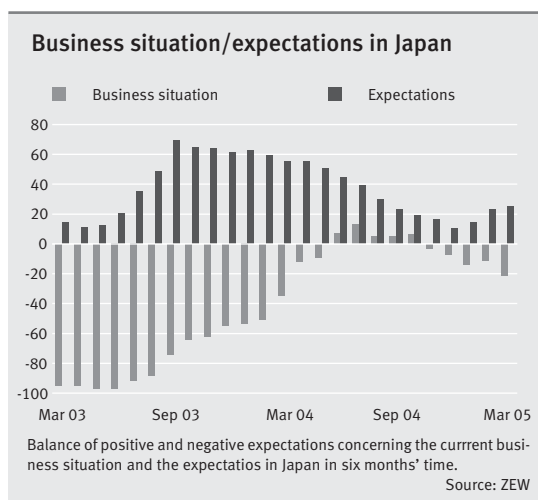
investment companies and 20 in other industries. Participants in the survey are financial experts of the finance departments, the research departments and the economic departments as well as the investment and securities departments of the firms. The experts are questioned on their medium term expectations about the development of important international financial markets with respect

to the business cycle, the inflation rate, short term and long term interest rates, the exchange rate and share prices.

Information to the applied procedure is available as an abridged version published by the ZEW. The present survey was conducted between February 28, 2005 and March 14, 2005. All calculations are termed to March 18, 2005.

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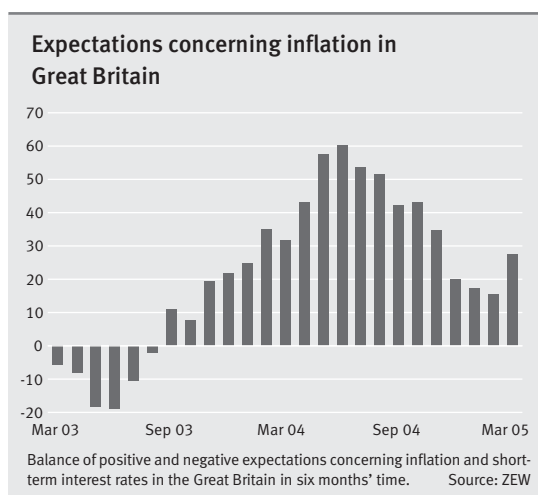
Japan: Ambiguous picture



The assessment of the current business situation in Japan drops unusually harsh from -11.4 points to -21.0 points. The expectations component however continues its upward trend of the past four months and results at 25.2 points slightly improved as compared to February (22.8 points). These numbers reflect the inconsistent picture currently provided by the Japanese economy. On the one hand the past three quarters were characterised by clearly weakened growth, owing in part to a decrease in private consumption. On the other hand several factors indicate that economic recovery may again resume this year. For example, reasonable hope exists that deflation can be abated. Thereby the incentive for private households to defer larger purchases to future periods, as provoked by decreasing prices, and accordingly an obstruction to the strengthening of domestic demand would be dismantled. A further stimulus for consumers' demand stems from the fact that real wages per hour have again attained a level that keeps up with the growth of productivity.

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Great Britain: Turnaround of inflation expectations



After the steady decrease of inflation expectations for Great Britain over the past three months the respective indicator undergoes a surprisingly sharp turnaround in March rising from 15.5 points to 27.4 points. This may be attributed primarily to the circumstance that the price of oil seems to level off higher than used to be the case to date. Increased energy costs in January for private households, for example, have thus contributed significantly to the increase in the consumer price index. Real estate prices should be however less relevant for their increase has markedly shallowed over the fairly recent past. Neither by the Bank of England do the surveyed financial experts expect an inflation driving policy. Thus, 26.1 percent of the analysts take an increase in the targeted interest rate into consideration, and even 68.5 percent suppose that the Bank of England will leave its monetary policy unchanged. The latter could be backed by the assumption that the present key interest rate, currently at 4.75 percent, already reflects the economy's neutral interest level.

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PUBLICATIONS

■ ZEW Economic Studies

Klaus Jacob, Marian Beise, Jürgen Blazejczak, Dietmar Edler, Rüdiger Haum, Martin Jänicke, Thomas Löw, Ulrich Petschow, Klaus Rennings

Lead Markets for Environmental Innovations

Some countries are earlier than others in the development and introduction of environmental innovations. Often, the leadership in technological development is accompanied by a leadership in environmental policy. The book provides an analysis of lead markets for innovations such as fuel cells, photovoltaic, and others. Contributions of innovation economics, policy analysis and environmental economics are assessed regarding their potentials to explain the leadership of single countries. The policy frameworks that are favourable for the creation of such lead markets are depicted on the basis of theoretical considerations and case studies. Finally, recommendations for R&D policies, environmental and industrial policies are derived.

Volume 27, Physica Verlag, Heidelberg/New York, 2005, ISBN 3-7908-0164-X

Christina Elschner, Robert Schwager

The Effective Tax Burden on Highly Qualified Employees – An International Comparison

Taxes on the highly skilled are an important cost factor for companies competing internationally for talent. This book provides an international comparison of the effective level of taxes and social security charges imposed on highly qualified employees. Based on a newly developed inter-temporal simulation model, the attractiveness of seven EU Member States, twelve Swiss cantons, and the United States is assessed. Several compensation packages including old age provision, fringe benefits, and long-term incentives as well as various income levels and family situations are considered in the analysis. The book also contains a comprehensive survey of social security and tax systems in the countries studied.

Vol. 29, Physica Verlag, Heidelberg/New York, 2005, ISBN 3-7908-1568-3

■ ZEW Discussion Papers

No. 05-01, Martin Schüler, Friedrich Heinemann: The Costs of Supervisory Fragmentation in Europe.

No. 05-02, Michael Lechner, Ruth Miquel, Conny Wunsch: Long-Run Effects of Public Sector Sponsored Training in West Germany.

No. 05-03, Michaela Niefert: Patenting Behaviour and Employment Growth in German Start-up Firms. A Panel Data Analysis.

No. 05-04, Bernd Fitzenberger, Alfred Garloff: Unemployment, Labor Market Transitions, and Residual Wage Dispersion.

No. 05-05, Ralf Wilke, Martin Biewen: Unemployment Duration and the Length of Entitlement Periods for Unemploy-

ment Benefits: Do the IAB Employment Subsample and the German Socio-Economic Panel Yield the Same Results?

No. 05-06, Christoph Böhringer, Tim Hoffmann, Casiano Manrique, Lara Peñate: The Efficiency Costs of Separating Carbon Markets Under the EU Emissions Trading Scheme: A Quantitative Assessment for Germany.

No. 05-08, Johannes Rincke: Policy Innovation in Local Jurisdictions: Testing the Neighborhood Influence Against the Free-Riding Hypothesis.

No. 05-10, Bernd Fitzenberger, Adronke Osikominu, Robert Völter: Imputation Rules to Improve the Education Variable in the IAB Employment Subsample.

No. 05-11, Johannes Rincke: Yardstick Competition and Policy Innovation.

No. 05-12, Friedrich Heinemann: Planning or Propaganda? An Evaluation of Germany's Medium-term Budgetary Planning.

No. 05-13, Thomas Zwick, Christoph Rappe: Workers into Managers – Developing Leadership Competence of Production Unit Managers.

No. 05-14, Elisabeth Müller: How Does Owners' Exposure to Idiosyncratic Risk Influence the Capital Structure of Private Companies?

No. 05-15, Nicole Gürtzgen: Rent-Sharing: Does the Bargaining Regime Make a Difference? Theory and Empirical Evidence.



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I M P R I N T

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