

Discussion paper

EUROPEAN EMPLOYMENT OBSERVATORY  
GERMANY

New government continues labour market reforms

Quarterly review of labour market trends and policies  
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by

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## Glossary

Agenda 2010	Principal economic and social reform programme of the SPD-Bündnis90/Die Grünen government coalition passed in March 2003
Hartz reform	<p>Reform of unemployment insurance under the Federal Employment Service (<i>Bundesagentur für Arbeit</i>) and active labour market policies, named after Peter Hartz, principal staff manager of Volkswagen and the president of “Hartz Commission” established by the German government in 2002.</p> <p>The reform has four parts:</p> <p>Hartz I (2002): introduction of public temporary work agencies (Personnel Service Agencies – PSA)</p> <p>Hartz II (2002): reorganisation of public employment services; mini-jobs, ICH-AG</p> <p>Hartz III (2004): restructuring of public employment services to the Federal Employment Agency</p> <p>Hartz IV (2005): merging of unemployment aid and social assistance to UB-II</p>
ICH-AG	Business foundation grant ( <i>Existenzgründungszuschuss</i> ; § 421 I SGB III) for UB-I recipients, which supports unemployed becoming self-employed for up to three years (1 <sup>st</sup> year: 600 € per month, 2 <sup>nd</sup> year 360 €, 3 <sup>rd</sup> year 240 €)
Job Summit	Agreement between red-green government and CDU/CSU opposition from 17 March 2005 on the principles of further labour market reforms.
Mini Jobs	<i>Geringfügige Beschäftigung</i> : Jobs with monthly incomes up to 400 €. These can be regular or occasional jobs and jobs in addition to regular employment. Employers pay 25 % of wages to social insurance.
Midi-Jobs	Registered employment with monthly wages between 401 and 800 € and reduced social insurance premiums.
National Training Pact	Agreement between the Federal Government and the employers associations to offer 60,000 additional dual training places in 2004, and another 30,000 in 2005.
1 € Jobs	Jobs in the area of social and public services for UB-II recipients. They are remunerated by 1 or 2 € in addition to UB-II benefits. Jobs need to be additional to jobs in the premier labour market and to normal activities of the institutions.
Rehabilitation benefit	<i>Eingliederungszuschuss</i> : a wage subsidy for employers who employ long-term or disabled unemployed. Subsidies are limited to 50 % of wages for 12 months. For disabled or older workers the limits are 70 % of wages for a maximum period of 24 months.
UB-I	<i>Arbeitslosengeld I</i> : Regular unemployment benefit
UB-II	<i>Arbeitslosengeld II</i> : Means-tested basic income for job seekers, paid after expiration of regular unemployment benefit

## Executive Summary

While the German economy shows clear signs of a recovery, the labour market is still waiting for positive impacts. Following the official macro-forecasts, employment will stagnate in 2006 and the reduction of registered employment will come to an end. This is more than in previous years but certainly no real improvement. The lasting unemployment situation has triggered an emigration trend of German people who see better economic alternatives in other countries of the world.

After signing the coalition treaty, the German Federal Government started a series of legislative projects: A cyclical investment programme of 25 billion € was initiated. The “Hartz” labour market reform was amended with regulatory adjustments (Mini-Jobs, Personnel Service Agencies etc.) and will be continued with a comprehensive approach for low-wage employment. The concept will be developed by a governmental working group in autumn 2006. Moreover, family benefits will be introduced and the base-lines of the pension reform will be newly defined.

Industrial relations in Germany are in “strike time” again. Facing job cuts and the deterioration of working conditions, union workers are not willing to accept further cutbacks. The closure of the AEG plant in Nürnberg and the unwillingness of the Länder Governments to accept the Federal collective agreement for public workers are reasons to go on strike.

Most importantly, however, more information on the evaluation of German labour market policies was published in the last three months than during the last ten years. The Federal Ministry for Labour and Social Affairs (*Bundesministerium für Arbeit und Soziales, BMAS*) published the interim results of the Hartz evaluation and the Institute for Labour Market and Occupational Research (*Institut für Arbeitsmarkt- und Berufsforschung, IAB*) submitted an evaluation report on “Labour Market Institutions and Employment”.

The interim evaluation of the Hartz reforms (I to III) states that the German labour market reform activated unemployed people in a significant way. Independently from the volume of measures, the share of net exits from unemployment into a regular job increased. The benchmarking studies for individual policy measures and the macro-evaluation came to the same positive results regarding the promotion of self-employment and continuing training. The results are however contradictory for wage subsidies and job creation schemes. In particular, job creation schemes and Personnel Service Agencies had a lock-in effect extending unemployment periods rather than shortening them.

In addition, the IAB publication provides scientific evaluation of the German collective bargaining system, co-determination and dismissals protection. Following these studies, collective bargaining had significant impacts on wage structures and employment. In particular in eastern Germany the unfavourable employment situation was also caused by collective agreements. Co-determination is associated with positive performance effects on companies. Dismissals protection improves incentives for workers and companies to invest into firm-specific knowledge and improves the matching efficiency of recruitment. However, it is associated with negative employment and job turnover effects.

## 1. Introduction

This report gives a short review of present labour market trends and the plans of the German Federal Government after the creation of the black-red coalition. These parts are kept brief as there is much to report on new evaluation studies, in particular on the first interim evaluation of the “Hartz” labour market reform. This evaluation study was published a few days before the deadline for this report. Further details will therefore be provided on future occasions.

## 2. Update on economic and labour market trends

The Annual Economic Report of the Federal Government, presented on January 25 2006, expects GDP growth of 1.4 % in 2006 and stable employment ( $\pm 0$  %). Economic growth will be supported by export growth (+ 6.5 %) while domestic demand will continue to increase slowly (+ 0.7 %). Average gross wages are expected to increase at the same rate. Nevertheless, consumer sentiments improved in December 2005 for the first time since four years (GfK 29/12/2006).

The economic research institutes raised their 2006 GDP forecasts by 0.2 to 0.5 percentage points to growth rates between 1.4 to 1.7 %. This includes the positive effects of the announced increase of VAT by January 2007 and of the football world championship. There are clear signals that the slump of the last five years is overcome. This is confirmed by recent statistics on incoming orders in manufacturing which grew by 4.3 % in the two-months-comparison October/November against August/September 2005. In particular, large orders contributed to this increase.

Unemployment increased by 75,000 to 4.6 million in December 2006. This however was the lowest November/December increase and therefore resulted in a decrease by 110,000 if figures are seasonally adjusted. The number of people employed remained unchanged. Unemployment rate was 11.1 % (8.2 % according to ILO standards). The number of long-term unemployed people increased to 1.83 million after 1.8 million in November 2005. (04/01/2006)

In January 2006, however, unemployment increased again by 408,000 to 5,012 million. This was due to the cold winter and the rising amount of older workers who entered unemployment. The shortening of unemployment benefit periods which will be legally effective in February initiated part of this rise. The volume of registered vacancies was about 30 % higher than in the previous year.

Following official statistics, 150,000 Germans left the country in 2004 – the highest level ever since the statistics were recorded in the nineteen-fifties. People emigrated to the USA, Switzerland, Austria and other EU countries. This was caused by the lack of jobs in Germany and better income opportunities in the target countries.

## 3. Labour market policy developments

### 3.1. Policy actions

After signing the coalition treaty, the German Federal Government started a series of legislative projects:

### Employment policies

A 25 billion EURO business cycle programme was decided by the government, including tax preferences for environmental protection. A tax allowance up to 1,200 EURO will be granted for private expenditure on repair and maintenance in the household. This is expected to create additional jobs in the crafts business.

	Expenditure 2006-2009 (billion EURO)
Parent benefit	3.0
Households as employers (child care benefits, social care, repair and maintenance)	2.5
Research and development	6.0
Business promotion (degressive depreciation, CO2-related housing modernisation, investment benefits, VAT-reform)	9.3
Traffic infrastructure	4.3
Total	25.1

Source: German Federal Government 2006.

### Labour market reform

- The government plans to introduce a seasonal short-time work regulation (*Saison-Kurzarbeitergeld*) which substitutes the existing winter unemployment benefits (*Winterausfallgeld*). The new regulation will be eligible for all seasonally unemployed (agriculture, construction finishing in addition to construction industries). The main reason for the reform is the fact that – under the present regulation – companies have to pay social insurance premiums for 80 % of the last wage. As this means costs of 16 % of the last wage during the period of seasonal inactivity, companies prefer to dismiss workers.
- Based on the recent evaluation of the Hartz reform, Personnel Service Agencies (PSA) are no more obligatory for the regional labour agencies and the ICH-AG will only be valid until mid 2006.
- The tax rate on mini-jobs will be raised from 25 to 30 %, following government plans. This is strongly objected to by parts of the CDU and employers' associations. Actually 6.7 million people are engaged in mini-jobs.
- New concepts are expected from the governmental working group on low-wage employment which will present its report in autumn 2006. One of the suggestions might result in the substitution of the mini-job regulation in favour of a general social tax allowance for all labour contracts. The so-called Kombi-Lohn and the introduction of a minimum-wage regulation will be other issues.
- A debate on the combination of low-income jobs with tax preferences (*Kombi-Lohn-Modell*) was discussed without taking a final decision. Following the CDU suggestions, such a programme should be offered by January 1 2007. The coalition partners CSU and SPD expressed caveats.

### Families

- The government decided a new regulation supporting families and the reconciliation of family and work. The programme provides tax allowances for the cost of child care for all parents. Up to the age of 14, two thirds of the costs of child care can be deducted

form incomes up the amount of 4,000 EURO. In total 460 million EURO are planned for this support programme.

- From January 2007 onwards the governments pays a means-tested parent benefit for parents who reduce their employment or give it up. The benefit will compensate income losses up to 67 % of the previous income and the maximum of 1800 € per month.

### *Pension reform*

A new law restricting the decline of average pension payments in the future was announced by the government on January 18 2006. This will include:

- The compensation of the negative effects of declining average wages on pensions as this decline is attributed to the rising number of 1-EURO-jobs. In addition, automatic adjustments in the pension formula which reduce the level of new pensions (called “Ri-ester” and “Rürup” factors) will be avoided.
- In 2007 the contribution rate to public pension insurance will rise from 19.5 to 19.9 % of gross wages. This was already fixed in the coalition treaty.
- As both declining pensions and an additional rise of contribution rates should be avoided, tax transfers to pension insurance will be required. This means the reversal of the initial plan to freeze tax transfers.
- The rise of the pension entry age from 65 in 2011 to 67 in 2035 will now be shortened by six years to 2029.
- The Association of German Pension Insurance expects a long-term rise of contribution rates from 19.5 to 24.5 % in 2030.
- The well-known pension system expert Bert Rürup (Technical University Darmstadt; Chairman of the Council of Economic Advisors) brought the reform of the surviving dependants’ pensions into the debate. As the actions presently planned to restrict the rise of contribution rates cannot be expected to work sufficiently, a reduction of pension entitlements seems necessary which is oriented at financial needs of survivors rather than the descendent pension level.

### *Industrial relations*

- Strike at AEG Nürnberg after the announcement of the management to close the 1700 employee plant (19/01/2006)
- The services sector trade union Ver.di prepares a country-wide strike to force Länder governments to adopt the collective agreement concluded with the Federal Government in 2005.
- The metal workers union (IG-Metall) presented a 5% claim for the coming negotiation round. This is justified with the negative experience from moderate wage policies which led into the “most severe consumption crisis of the after-war period” (Institute for macro-economy and business cycle research, IMK; 16/01/2006).
- In the retail trade sector the social partners concluded an agreement after a difficult nine months’ negotiations. For the first time, companies are allowed to fall below collective wages to avoid “economic emergency”. The agreement of the social partners is required. Moreover, a 1 % increase of collective wages was concluded together with a single payment in 2006 up to 400 EURO (200 EURO on average). These single payments are used to share rising profits with employees in the course of the business cycle.

## **3.2. Public and scientific debate**

During the last three months, more on evaluation of German labour market policies was published than during the last ten years. The Federal Ministry for Labour and Social Affairs

published the interim results of the Hartz evaluation, covering components I to III. This evaluation – consisting of a multitude of single studies – gives the first indication on the effects of the institutional reform of the Federal Labour Office and parts of German labour market policies. Moreover, the Institute for Labour Market and Occupational Research (*Institut für Arbeitsmarkt- und Berufsforschung, IAB*) submitted a 340 pages volume of its Journal for Labour Market Research focussing on “Labour Market Institutions and Employment”. This volume contains a broad range of evaluation studies, starting with collective bargaining, and covering the issues of co-determination, dismissals protection, labour participation of women, and labour market policies in general.

### 3.2.1. Hartz evaluation

The Federal Government published the interim results of the “Hartz Evaluation” on February 1 2006 (“*Hartz I bis III auf dem Prüfstand*”). This evaluation was initiated with the introduction of the reform programme in 2002 and involves 20 research organisations. The interim report covers the reform steps I to III. Hartz IV which started in 2005 is evaluated separately.

The summary by the Federal Ministry for Labour and Social Affairs (BMAS) is structured into three analytical chapters, preceded by an extensive discussion of the limitations of the evaluation. It is criticised that the evaluation took labour market integration as the central effectiveness indicator rather than taking a combination of economic and social targets as reference. In particular, the compensation of disadvantages in cyclical and structural change through labour market policies will have to be considered as an important target in the final report.

#### *New organisation and the acceptance of the Federal Labour Agency*

The new organisation of labour offices as “Service Centres” is principally accepted by the evaluation. However, various shortcomings are indicated which prevented a significant improvement of services until now:

- The functional re-organisation has become more complicated and more sensitive to failures.
- IT-services, the new online (“virtual”) labour market in particular, did not function sufficiently.
- The decentralisation of competences to local labour agencies is still dominated by a top-down approach.
- The differentiation of “clients” into four target groups is too crude. Better profiling will help to improve this.
- The new rationale of economic efficiency includes the risk that target groups with the lowest integration prospects will receive little support.

Following the commercial newspaper HANDELSBLATT, the interim report by INFAS revealed a further deterioration of the Federal Labour Agency’s public image: 52 % of the Germans expressed their opinion that the BA is not a modern service provider. In 2004 the comparative share was 42 %. The report concludes: “During the last five years the labour agencies significantly lost trust. While in 2000 still one third of the West-Germans expressed confidence, in 2005 it was only one fifth.” (Handelsblatt 25/12/2005, p.3). From the clients’ perspective, the most important need for improvements are in the areas of “pace of work”, “availability”, and “understanding of clients’ needs”. Moreover, 53 % of the companies did not involve public labour agencies in recruitment. In 2004 these were only 41 %. The survey was undertaken among 9,000 German workers, unemployed people and employers. In its summary the Federal Government considers the results as

strongly influenced by the recent Hartz IV reform and its negative effects on the position of unemployed people.

### *New orientation of labour market policies*

For different ALMP instruments the evaluation came to the following (interim) results:

- The newly introduced target planning for *continuing training*, which is now also directed by short-term labour markets needs, and the specified placement rate of 70 % has initiated a creaming process among unemployed people. This was amplified by training vouchers which were used by qualified rather than unqualified persons. Continuing training leads to shortened unemployment periods, however, the probability to get a registered job did not increase.
- *Training markets* were significantly affected by the reform, giving more autonomy to the management of local labour agencies and introducing an assessment process for all training institutions. While this is still objected to by the majority of training providers, the re-organisation is endorsed by the agencies' managers.
- *Rehabilitation benefits* were already used for many years. The evaluation confirmed that this type of wage subsidies for long-term unemployed people, disabled people or older workers significantly raised the probability to enter registered employment. Other wage subsidies (reduction of social insurance premiums) were largely unknown. *Rehabilitation measures* in general seem to be effective as unemployment periods are shortened.
- The *promotion of self-employment* among the unemployed was successful, even if many unemployed people entered self-employment due to lack of alternatives, and professional consulting for the business foundations was very rare. The evaluation states that after 16 months the share of beneficiaries not being unemployed or in labour market policy measures was significantly lower than for comparable unemployed persons. However, dead-weight losses are very probable. This will lead to a reform of the "ICH-AG" during the year.
- *Private or non-profit placement services* – which play a marginal role in the German labour market – could not improve placement probabilities for unemployed people. Less than 10 % of the placement vouchers given to unemployed people were used.
- Employment by Personnel Service Agencies (*PSA*) or job creation schemes (*Arbeitsbeschaffungsmaßnahmen, ABM*) was associated with lock-in effects, which means that people employed in these measures were entering employment significantly later than unemployed people outside of these schemes. Agency work in general had positive employment effects.
- Marginal employment ("*Mini-Jobs*") grew by 1.8 million since 2003. In general, it is no bridge to registered employment. The "Midi-Job" regulation has created or safeguarded 120,000 jobs.

### *Macro-effects and general assessment of ALMP*

The evaluation states that the German labour market reform activated unemployed people in a significant way. Independently from the volume of measures, the share of net exits from unemployment into a regular job increased. However, the absolute level of net exits did not rise.

The benchmarking studies for individual measures and the macro-evaluation came to the same positive results regarding the promotion of self-employment and continuing training. The results are however contradictory for wage subsidies and job creation schemes.

While women profited from self-employment promotion and agency work, men were more represented in continuing training and rehabilitation measures. Eastern Germany was able

to shorten the performance distance to the west as regards placement rates and the organisation of ALMP.

### 3.2.2. The IAB collection of evaluation studies

The broad set of papers published by Franz, Gerlach, Sadowski and Walwei (2005) evaluates the effects of labour market institutions on employment in Germany. Five major themes are addressed: collective bargaining and wage policies, co-determination, dismissals protection, employment participation of women, and active and passive labour market policies. Most of the papers were written by university professors linked to the Centre for European Economic Research, *Zentrum für europäische Wirtschaftsforschung, ZEW*, the Institute Future of Work (*Institut Zukunft der Arbeit, IZA*), the German Economic Research Institute (*Deutsches Institut für Wirtschaftsforschung, DIW*), and the publishing Institute for Labour Market and Occupational Research (*Institut für Arbeitsmarkt- und Berufsforschung, IAB*).

#### *Collective bargaining*

The empirical analysis by Fritzenberger and Kohn shows that higher degrees of union density in different branches are associated with lower skills-related wage dispersion but also with lower average wages. Wage bargaining therefore is determined by insurance-related considerations through which lower wages are exchanged for higher job and income security. Wage dispersion is squeezed at the lower end as expected by many preceding publications. It is also restricted over the life cycle of workers. No clear change of collective wage bargaining can be observed during the period between 1985 to 1997 which means that social partners did not significantly change their wage policies. In parallel, the paper by Möller identified (weakly) significant insider behaviour of German workers: periods of stronger employment growth were used by insiders to raise wages.

The West German type of collective bargaining could not be successfully transferred to eastern Germany. The analysis by Bonin characterises the wage policy after unification as a launch failure. Both trade unions and western employers' associations followed the target to rapidly adjust collective wages in eastern Germany to western levels. The strong wage increase contributed to the negative employment balance and thus passed into a decade of stagnating wage differentials to the West. Only six out of 18 branches classified by wage statistics could achieve western wage levels. Union density decreased continuously such that in 2003 only 10 % of East German companies were members of an employers' association authorised for collective bargaining, and only 20 % of the workers were union members. As a result, wage flexibility in eastern Germany is higher than in the western part.

#### *Co-determination*

The review of analytical studies of co-determination in Germany is summarised by Jirjahn with a positive result: the majority of empirical studies show positive effects of co-determination and works councils on economic performance of companies. In particular, the introduction of performance based wages, financing of continuing training, working time accounts, shift work and process innovation, and environmental protection is determined by workers' representatives in a way which contributes to economic performance. Based on trustful relationships with the management, the cooperation of workers in restructuring processes is supported. Works councils use their mandate for a much broader range of issues than codified in the works constitution act. Positive effects from co-determination can be expected if works councils use their competences to identify com-

pany-related solutions rather than redistributing economic returns. As co-determination is based on long-run industrial relations, the rise of short-term economic management principles might not only limit the functionality of co-determination but also lead to a self-selection of capital owners. Short-term business concepts avoid Germany as a location.

Franz, however, disputes the positive results presented by Jirjahn and urges for the liberalisation of co-determination. As positive and negative experience is available, the introduction (or continuation) of co-determination should be liberalised in a process of negotiation between workers and management. As far as positive economic effects are associated with co-determination, companies will continue but nobody will be forced to use it.

### *Dismissals protection*

The article by Jahn provides a comprehensive and well structured review of national and international research evidence:

- Dismissals protection reduces the entries into but also the exit from unemployment. In this way the share of long-term unemployed and the average duration of unemployment increase.
- It empowers job owners with the effect that real wages rise.
- Aggregated employment levels are reduced.
- Employment of male workers in middle working ages are profiting from dismissals protection while other groups (new entrants, women, youth) are losing. The probability of entrance into a job is negatively affected.
- The velocity of employment adjustment is lowered with the effect that productivity is growing slower.
- Dismissals protection improves the incentives for workers and companies to invest into firm-specific knowledge, while high risks of unemployment raise investment into general knowledge.
- It improves the matching efficiency of recruitment as staff management scrutinises new workers more accurately.

Nevertheless, for the explanation of employment trends in Europe dismissals protection is classified as a minor drag. Much more important are the duration of unemployment benefits, the increase of labour costs, and the influence of trade unions. The combination of institutional settings therefore, is very important to describe the impact of single regulatory elements.

The majority of fixed-term contracts in Germany is (or was) used as an extension of probationary periods. 40 % of fixed-term contracts are continued by a regular non-terminated contract. In contrast to other EU countries, there is no indication that fixed-term contracts are used in Germany to extend the exchange of workers on the same job (Boockmann, Hagen).

### *Womens' participation*

As maternity protection is part of non-wage labour costs, negative effects on female employment are discerned by Alewell and Pull. The article therefore urges not only for a broader financial basis but also for regulations which reduce the reorganisation costs in companies through longer announcement periods for maternity leave.

Bohla et al. calculate the labour participation effects of different full-time schooling models. The present Federal Investment Programme for the creation of full-time schools – which targets at 30 places per 100 children – is expected to raise participation of mothers

by 1 % and 4 % in working hours. Full-time schooling for all children would increase female employment by 16 % in western and 5 % in eastern Germany.

#### *Active and passive labour market policies*

Mayer and Gerlach expect positive effects of the Hartz-IV reform on unemployment if the instruments are used appropriately. In particular, individual coaching, entry contracts and training instruments should be used.

## 4. Recent labour market reports

*Bundesministerium für Wirtschaft und Technologie (2006):  
Jahreswirtschaftsbericht 2006. Annual Economic Report.* Berlin

The Annual Economic Report is the presentation of the Federal Government's economic policy approach and its forecast of short-term trends. It includes the reaction to the policy recommendations of the Council of Economic Advisors. The policy outline covers the areas of

- fiscal and tax policies
- education, research and development
- labour market and employment
- social security
- competition, SMEs and services
- restructuring in eastern Germany and regional policies
- infrastructure
- energy
- ecological modernisation and consumer protection
- European and international economic policies.

Supporting the new Lisbon strategy, the German Government concentrates on further reforms, innovation and investment. The prospects are based on the strength of German manufacturing and its technological competitiveness. The main policy tasks are therefore in domestic areas of fiscal policy with further cuts in public expenditure, the reform of German federalism, the continuation of labour market reforms, and innovation in education and training.

As these reforms need longer time horizons, the short-term prospects are reluctant. With a GDP growth rate of 1.4 % and stagnating employment in 2006, the Federal Government remained less optimistic than the economic advisors.

*Franz W., Gerlach K., Sadowski D., Walwei U. (Eds.) (2005):  
Arbeitsmarktinstitutionen und Beschäftigung. Labour Market Institutions and Employment.  
Themenheft der Zeitschrift für ArbeitsmarktForschung. Journal for Labour Market Research.* 2 und 3 2005. Kohlhammer Verlag, Stuttgart.

See Section 3.2.2.