GERMANY'S LABOUR MARKET MIRACLE: Improved job centre performance was key to the big fall in unemployment

Germany's unemployment rate almost halved between 2005 and 2010 in part because of the upturn in the business cycle but largely because the country's employment agencies became much more effective at getting jobseekers into work. That is the main finding of research by **Moritz Kuhn** and colleagues, to be presented at the annual congress of the European Economic Association in Mannheim in August 2015.

Although Germany's 'labour market miracle' has been widely discussed, surprisingly little is known about what workers and employers actually experienced. The new study looks at over one million German workers between 2000 and 2010 to test whether or not the 'miracle' was the result of unemployment benefits being cut as part of the Hartz IV reform of 2005. Because a similar reform has been proposed for other European countries, it is important to test whether or not it was actually responsible.

The researchers find that the fall in unemployment was half the result of unemployed workers finding jobs quicker and half the result of employed workers becoming less likely to lose their jobs – a lower 'separation rate'. While the consistently higher job-finding rate was linked to the Hartz reforms, the lower separation rate was just part of the regular German business cycle.

Because the separation rate has not fallen permanently, this suggests that the main effect of the reform was actually the fact that employment agencies became better at linking unemployed workers with job vacancies. This contradicts the widespread belief that unemployment fell because benefits fell. The authors conclude:

> 'The carrot and stick policy of the reform – '*Fördern und Fordern*' – with lower benefits in the long run and better services in the short run, is the key behind Germany's labour market miracle.'

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The German unemployment rate almost halved between 2005 and 2010. This development is surprising because first, Germany had a weak labour market performance for decades, and second, the Great Recession in 2008 has been the largest economic crisis for decades.

This is why observers refer to these developments as the German labour market miracle. Although the extraordinary performance of the German labour market in terms of unemployment rates has been widely recognised, surprisingly little is known about what happened in terms of workers' prospects of finding jobs and employers' decisions to lay off workers.

The paper by Benjamin Hartung, Philip Jung, and Moritz Kuhn fills this gap. They use a large representative sample of work histories from German social security records to study changes in the underlying worker flows between employment and unemployment from 2000 to 2010.

Using the leading model on the existence of unemployment, they scrutinise the claim of most observers that the cut in unemployment benefits as part of the Hartz IV reform package has been the key reason for the success of the Hartz reforms and the reason behind Germany's labour market miracle.

Understanding the reason is of highest policy relevance as the reform has already been suggested as the role model for other European countries. In their empirical analysis, the authors explore over one million individual employment histories. Based on this data, the authors compare the share of workers finding and losing jobs each month before and after 2005. Two key empirical results emerge:

- First, 50% of the decline in unemployment results from more unemployed workers finding jobs (8% per month in 2010 compared with 6% per month before 2005).

- Second, the remaining 50% of the reduction in unemployment results from fewer workers losing their jobs (separations).

The authors provide additional evidence to argue that the higher job finding rates are a permanent effect due to the Hartz reforms, while the lower separation rates are cyclical and Germany's standard reaction to the business cycle. Given that this second effect accounts for 50% of the reduction in unemployment, they partly undermine Germany's labour market miracle.

In a second step, the authors contrast the results of their empirical analysis with predictions from leading models of unemployment. Once adapted to the German labour market, they show that their empirical findings are in contrast to the leading explanation that the decrease in unemployment benefits accounts for the strong reduction in unemployment rates.

The authors show that a decrease in benefits is consistent with workers finding jobs more quickly but that it would also imply a permanent reduction in separation rates; a prediction in stark contrast to their empirical results.

An improvement in the workings of the employment agencies is the likely missing ingredient for a consistent explanation. A low efficiency in bringing together unemployed workers and open positions has already been pointed out as a reason for the poor performance of the German labour market in earlier work and this was the prominent weakness identified by the Hartz committee.

Without understanding the causes behind and the changes underlying the German labour market miracle, it is premature to recommend it as a role model for other European countries. This new paper contributes along two dimensions to a better understanding.

First, it partly undermines the German labour market miracle and shows that 50% is due to lower separation rates during good economic conditions — an ordinary business cycle effect. The remaining 50% of the decrease constitute a seminal change for Germany's unemployed as their job finding rates increased by 25%.

Second, the authors use economic theory to investigate the causes behind these changes in the labour market. Their results can be summarised that the carrot and stick policy of the reform ('Fördern und Fordern') consisting of lower benefits in the long run and better services in the short run is the key behind Germany's labour market miracle.

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What hides behind the German labour market miracle? A macroeconomic analysis
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