

# What hides behind the German labor market miracle?\*

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## Abstract

A fundamental economic questions regarding the functioning of labor markets is the effect of the unemployment insurance (UI) system on labor market dynamics and unemployment rates. Existing research focuses on the changes in job finding rates resulting from incentive effects for workers to accept jobs and for firms to open vacancies. This paper draws attention to separations into unemployment as a third channel that –while known in theory– remained understudied in empirical and quantitative work. If job finding or separation rates adjust after a reform matters for the distribution of gains and losses and the political feasibility of a reform. We study the arguably largest reform of a UI system in industrialized countries in recent years: The so-called *Hartz reforms* in Germany in the mid-2000s. We provide empirical evidence that lower separation rates are responsible for the German labor market miracle with unemployment rates cut by half within a decade. Separation rate changes are strongly heterogeneous within the workforce and concentrated among long-term employed, high-wage workers. We develop a labor market search model with worker heterogeneity to causally link the reform of the UI system to changes in labor market dynamics and unemployment rates. We match heterogeneous reform effects with long-term employed, high-wage workers being most adversely affected. In a counterfactual analysis, we trace the good performance of the German labor market during the financial crisis back to the reform. Without the reform, unemployment rates would have been 50% higher in 2015 and had closely tracked the labor market experience of Germany’s neighbors. We argue that ignoring changing separation rates will for typical European labor markets likely lead to biased conclusions regarding changes in labor market dynamics and the distributional consequences from UI reforms.

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