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15. December 2023

Unemployment in Germany rises with generous social benefits

- **EPOS Economic Research Center analyses German social security data**

Bonn, Mannheim, Germany, 15.12.2023 – **Interactions between generous unemployment insurance and retirement rules can lead to higher unemployment particularly for older workers close to retirement. The reason: The joint effect of both schemes creates an incentive to build a “bridge-to-retirement”. This is the main finding of the discussion paper “When Institutions Interact: How the Effects of Unemployment Insurance are Shaped by Retirement Policies” by the EPOS Economic Research Center at the Universities of Bonn and Mannheim.**

Concerns about the sustainability of pension schemes grow. In response, governments often choose to reform retirement systems. “As they alter retirement rules, governments should be aware of interactions with unemployment policies,” says Han Ye from the EPOS Economic Research Center. “For older workers in particular, different pension schemes will alter the effects of unemployment insurance – making it more or less attractive to build a ‘bridge-to-retirement’.”

In the mid-nineties over 50% of unemployment benefits paid to older workers

Using German social security data between 1975 and 2017, the authors start with documenting a puzzling fact about the unemployment rate of older German workers: In the mid-nineties, the unemployment rates for older workers increased dramatically, diverging from those of younger workers. At its peak, over 50 percent of total West German unemployment insurance benefits were paid out to workers aged between 55 and 64. In other countries, such as the U.S., the different age groups largely moved together over the same period.

When more generous unemployment insurance interacts with retirement rules

The authors show that the unique German trend can be well explained by unemployment insurance extensions over that period that interacted with the retirement system: They show sharp increases in entries into unemployment insurance at precisely the age that allows workers to claim their pension right after the expiration of benefits. When unemployment insurance was extended, this increased the period over which workers received benefits before retirement and led to more workers above the new and lower age threshold claiming unemployment benefits.

To quantify the role of both retirement and unemployment insurance, the paper develops a model that captures labor supply incentives under both of these systems. Based on simulations of the model, the peak unemployment rate of workers aged 55 to 59 in the early 1990s would have been 5.7 percentage points (pp) lower had the potential benefit duration of unemployment insurance remained at 12 months instead of rising to 32 months. This large response is a result of the interaction between retirement and unemployment insurance. The same extension has much smaller effects for younger workers further away from potential retirement.

More generally, the generosity of retirement policies can alter the effects of an otherwise identical unemployment insurance extension. For example, extending the potential benefit duration by 12 months increases the unemployment rate of older workers by less than 1 pp under the 2014 retirement institutions

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which are largely still in place today. However, when re-instituting more generous retirement rules, the same 12-month extension would have increased unemployment more than three times to close to 3 pp.

“Changes to both, the unemployment insurance and the retirement system, played an important and so far underappreciated role in the German ‘labor market miracle’ after 2005 when the country’s unemployment rate fell from around 12 to 5 percent,” says Han Ye. “As to future policies, governments need to be aware of the interactions between different institutional schemes and consider the trade-offs for workers.”

The presented discussion paper is a publication without peer review of the Collaborative Research Center Transregio 224 EPoS. Access the full discussion paper here: <https://www.crctr224.de/research/discussion-papers/archive/dp481>

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Authors

Matthew Gudgeon, Assistant Professor in Economics, Tufts University

Pablo Guzman-Pinto, Economist, Amazon

Johannes F. Schmieder, Professor in Economics, Boston University

Simon Trenkle, Research Associate, Ph.D. Economics, IZA, IAB

Han Ye, Assistant Professor in Economics, University of Mannheim and member of EPoS Economic Research Center

The Collaborative Research Center (CRC) Transregio 224 EPoS

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Press Contact

Sonja Heer

Rothenbaumchaussee 185

20149 Hamburg, Germany

Telefon + 49 (0) 40 82244284

Sonja.Heer@econ-news.de

Contact

Prof. Han Ye

University of Mannheim

han.ye@uni-mannheim.de

CRC TR 224 Office, Marja Eisheuer

phone | +49 228 737926

email | crctr224@uni-bonn.de

www.crctr224.de