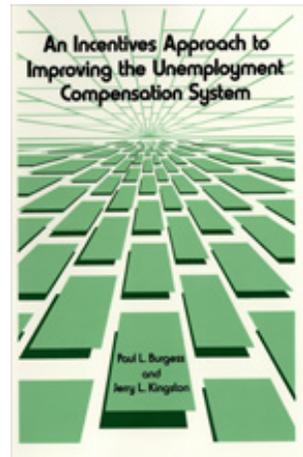

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Introduction

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Introduction

August 14, 1985 marked the golden anniversary of the federal-state unemployment compensation (UC) program. Such a milestone in the evolution of the employment security system invites both reflection on past successes and consideration of how the system might be improved to meet present and future challenges. Both UC benefit provisions and the labor market within which the program operates have changed significantly since the inception of the UC system. Increased coverage of unemployed workers, higher weekly benefits, and the introduction of various extended benefit programs have tended to increase UC program outlays for any given level of aggregate demand.¹ Substantial changes also have occurred in the composition of both the insured and total labor forces. The conceptual distinction between voluntary and involuntary unemployment—once thought to be quite clear—has become increasingly blurred. Furthermore, cyclical fluctuations have become more pronounced, with the two deepest recessions since the Great Depression recorded within the past 13 years.

In spite of the diverse challenges it has confronted, however, the UC system has retained many of its basic goals and organizational/operational features. Perhaps the most apparent impacts of the above changes have been reflected in the overall volume of UC benefit payments and in the consequent pressures on UC system solvency. In addition, there has been increased emphasis on assessing the labor market impacts of UC benefits

1. Over the past few years the proportion of all unemployed persons receiving UC support has declined, and the divergence between the total and insured unemployment rates has been a topic of increased attention. For a recent survey of this issue, see National Foundation for Unemployment Compensation & Workers' Compensation (1986b).

and on determining the extent to which UC claimants are eligible for the support they actually receive.²

This study focuses on a number of issues related to UC eligibility criteria and the extent to which compliance with them has been and can be enforced. In addition to the program's 50th anniversary, several other events also suggest that a major reconsideration of UC eligibility criteria, enforcement provisions and administrative practices may be appropriate. For example, a number of UC reform proposals have been suggested within the past few years.³ Beginning in 1984, the U.S. Department of Labor (USDOL) initiated an intensive effort to design a Quality Control (QC) program for the UC system; the core or initial component of this recently implemented program specifically relates to ascertaining the extent to which UC claimants are entitled to the benefits they receive.⁴ Proposals for restructuring federal-state administrative funding relationships within the UC program also have been advanced recently, including the Reagan administration's 1985 "devolution" proposal that would place much greater responsibility on the states for the administrative financing of their UC systems.⁵ The analysis in this study is intended to contribute to these already ongoing efforts to improve the UC system.

Study Background/Overview

As background for this investigation, it first is useful to clarify some terminology. *Payment errors* occur in the UC system when claimants receive benefit amounts that differ from those to which they are entitled, given the provisions of employment security

2. For example, see the following for three very recent analyses of claimant eligibility issues: Kingston and Burgess (1986); Kingston, Burgess and St. Louis (1986); and St. Louis, Burgess and Kingston (1986).

3. See for example Blaustein (1981).

4. The planning for this program was announced by USDOL to state UC agencies in March 1984. See U.S. Department of Labor (1984e).

5. Deborah L. Steelman, Special Assistant to the President, Office of Intergovernmental Affairs, announced this UC reform proposal at the 1985 national conference of the National Foundation for Unemployment Compensation & Workers' Compensation. See National Foundation for Unemployment Compensation & Workers' Compensation (1985a). For more recent details, see Cogan (1985).

law and policy. Consequently, payment errors include both overpayments and underpayments. UC overpayments are the focus of this study because of the availability of much better data on this type of payment error and because the available data suggest that overpayments are a more serious problem than underpayments. Nonetheless, this emphasis should not be interpreted to imply that underpayments are unimportant. As explained in more detail below, relatively little is known about the extent to which UC claimants are underpaid, although some research directed towards this issue is now underway. Finally, it should be emphasized that UC system overpayments are not synonymous with “fraud” or “abuse” of the UC program. Available evidence suggests that overpayments occur for a variety of reasons, many of which do not entail deliberate efforts by claimants to obtain benefits to which they are not entitled. Indeed, a central theme of this study is that many features of the present day UC system contribute to the erroneous payment of benefits, apart from any deliberate efforts claimants may make to obtain benefits to which they are not entitled.

Prior to 1980, accurate and substantive evidence on the extent of overpayments in the UC system was not available. Although concerns about overpayments frequently were expressed in the public press prior to 1980, the first valid estimates of UC system overpayments were produced by a study conducted by the authors for the National Commission on Unemployment Compensation during 1979 and 1980.⁶ The overpayment estimates in that (Kingston-Burgess) study were developed for six major metropolitan areas on the basis of intensive eligibility verifications that were conducted for samples selected to represent the vast majority of UC payments made in those areas. The major findings of that initial study—that UC overpayment rates were much higher than even informed observers had expected, and that most overpayments were not likely to be detected by conventional program procedures—led USDOL to pilot test a modified, “operational” version of the Kingston-Burgess study in five statewide UC programs. An analysis of the results of this

6. See Kingston and Burgess (1981).

second study by Burgess, Kingston and St. Louis reinforced the earlier findings about the existence of a potentially serious overpayment problem in the UC program.⁷ This evidence and subsequent findings produced by the Random Audit (RA) system prompted USDOL to expand the RA program to a total of 46 states by FY 1984, and to design an even more comprehensive Quality Control program which was implemented in 1986.⁸

This sequence of events has focused both official and broader public attention on the problem of overpayments in the UC system. Such a focus may be somewhat appropriate because high overpayment rates may, of themselves, be a major problem in some state UC programs. However, a major theme of this study is that high overpayment rates per se are not necessarily the most fundamental issue requiring attention by policymakers and UC program administrators. Rather, these rates may be symptomatic of more basic problems that very likely represent important issues for states with both low and high payment error rates. Although the basis for this contention may not be immediately obvious, the analysis in chapters 2-7 clearly indicates that three fundamental problems confront the UC system: (1) adverse incentives; (2) program complexity; and (3) partly because of the first two problems, ineffective monitoring of claimant compliance with weekly UC eligibility criteria. These considerations also indicate that the overall quality of state programs clearly cannot be judged on the basis of overpayment rates alone. In fact, it is quite conceivable that overall program quality could be higher in certain states with high overpayment rates than in certain other ones with low overpayment rates.

Economists emphasize how individuals, business firms and government agencies respond to incentives in making various decisions under whatever constraints apply. Accordingly, the basic focus of this study is on how UC system participants are likely to respond to the incentives they confront in that system. In fact, the analysis indicates that adverse incentives characterize

7. See Burgess, Kingston and St. Louis (1982).

8. See U.S. Department of Labor (1984f) and U.S. Department of Labor (1984g). Even though planning for the QC program began in 1984, implementation was delayed until April of 1986.

the decision environments of all major UC system participants. Adverse incentives include: (1) incentives in federal administrative funding procedures and performance criteria that adversely affect entire state UC systems; (2) incentives in individual state systems that fail to discourage and may even encourage claimant noncompliance with stated UC eligibility criteria; (3) very limited incentives for employers to monitor claimant compliance with eligibility criteria, especially those that must be satisfied on a weekly basis; and (4) limited incentives for state agency personnel either to monitor claimant compliance with eligibility criteria or to prevent/detect payment errors.⁹

The other two fundamental problems stressed in this study—program complexity and ineffective monitoring of claimant compliance with UC eligibility criteria—are interrelated issues which also affect and are affected by adverse incentives. Program complexity creates numerous undesirable impacts, including the possibilities of relatively high payment error rates, high administrative costs and substantial administrative discretion in applying UC eligibility criteria which may result in the inequitable treatment of claimants. Program complexity also creates a situation in which adverse incentives represent a more serious problem than would be the case in a less complex program. In turn, program complexity and adverse incentives contribute substantially to the difficulties of monitoring claimant compliance with the weekly eligibility criteria (e.g., nonrefusal of suitable work, availability for work and active job search). These monitoring problems imply that adverse incentives and program complexity are more serious issues than would be the case in a system in which claimant compliance with weekly eligibility criteria could be more easily and less expensively enforced.

The three fundamental problems—adverse incentives, program complexity and ineffective compliance monitoring—represent the building blocks around which the subsequent analysis is organized. The approach taken is to analyze the three problems

9. A related issue revolves around incentives for and detection of internal agency fraud, but that issue is not addressed in this study. However, it should be noted that this problem may represent a potentially important issue in some states, as perhaps is indicated by the increased emphasis by USDOL on this issue in recent years.

in separate chapters and then to provide some possible responses for dealing with the specific problems analyzed in those same chapters. The responses suggested typically are quite general in nature; in most cases, the specific details of these approaches would have to be formulated by state or federal policy-makers/program administrators. Furthermore, although a number of responses are suggested for the particular problems identified in individual chapters, it is important to emphasize that a systems approach should be taken in devising any overall set of reform proposals, either for federal-state relationships or for those within individual states. Because of the interactive nature of system components, apparently plausible responses to specific problems might well generate unintended and unacceptable side effects in terms of other program aspects. Consequently, it would be difficult even to evaluate the desirability of certain changes, except in the context of whatever overall changes might be implemented. Moreover, because of uncertainty about the exact impacts that most suggested changes would have, it is important to emphasize the need for further research and experimental pilot studies to fully evaluate many of the changes suggested by the analysis in this study.

Qualifications and Limitations of the Analysis

The UC system is an extremely complex one, with a variety of philosophical, social, legal and economic dimensions that merit study. Moreover, even the limited issues raised in this study could be approached in a number of different ways. Accordingly, it is important to emphasize the limited scope of this inquiry. Some fairly specific qualifications or limitations that apply to this study include, but certainly are not limited to, the following: (1) the problem of UC underpayments is not addressed in any substantive way; (2) little attention is directed to tracing the evolution of most of the system deficiencies analyzed, and no attempt is made to pinpoint responsibility for those deficiencies; (3) only within-system reform approaches that would maintain the fundamental features of the existing UC system are emphasized; (4) benefit financing and trust fund

solvency issues are virtually ignored; (5) in many cases, indirect (v. direct) evidence is provided to support the analysis; (6) the specific applicability of particular aspects of the analysis to individual states varies with state-specific circumstances; (7) the most recent overpayment statistics from the Quality Control program were not available for this analysis; (8) the interstate benefit system is not analyzed; and (9) a general knowledge of UC system features is assumed.

Underpayments Not Emphasized

This study emphasizes overpayment errors and treats underpayments only in a tangential manner. This asymmetry reflects the absence of substantive evidence about the frequency or extent of total underpayment errors, the difficulties encountered in designing experiments to produce underpayment evidence, and the generally greater concerns that have been expressed about overpayments in the UC system. This emphasis on overpayments, however, should not be interpreted to imply that underpayments are unimportant. Some information on underpayments recently has become available as a result of the Random Audit programs which operated in as many as 46 states; evidence related to UC underpayments is summarized in the appendix to chapter 2. Unfortunately, however, this evidence reflects only underpayments in *benefits actually paid*, and excludes underpayments due to erroneous denials of UC claims for which no payments were made. Consequently, no comprehensive evidence is available to assess the magnitude of all types of underpayment errors in the UC system.

Evolution of and Responsibility for Existing Deficiencies

Virtually no attempt is made to trace the emergence or evolution of the existing UC system deficiencies analyzed in this study. There also is no attempt to pinpoint responsibility for these system deficiencies, since it is assumed that federal and state policymakers/program administrators did not deliberately set out to create a system with the adverse incentives and other problems emphasized in this study. In fact, at least some of these

individuals probably still do not recognize the existence of a number of these adverse features. The very explicit analysis of adverse UC program characteristics is provided to clarify these issues, and is not intended as a criticism of those who have shaped or managed various parts of the federal-state UC system over the years. Given the interactive nature of the relationships among all system participants—including not only federal/state UC program personnel, covered employers and claimants, but also federal/state legislators, the federal/state judicial system, private sector firms that specialize in handling UC program matters for employers, organized labor, the academic community and yet other groups—it would be both futile and unproductive to attempt to place responsibility for existing system problems on certain groups.

Within-System Reform Emphasized The reforms or policy responses to the problems analyzed in this study are ones that could be implemented within the basic institutional framework and traditions of the existing UC system without fundamentally altering its basic features and assumptions. In this sense, the responses considered necessarily are somewhat limited. Less conventional reform approaches are not considered in this study.

The decision to limit reform approaches and policy responses to those that could be carried out within the existing system reflects two basic considerations. First, it reflects a consensus of opinion among many informed observers that such proposals would be much more likely to receive serious consideration than less conventional responses. Second, the research undertaken for this study now has convinced us that, contrary to our opinion at the outset, very significant improvements actually could be made without altering the basic philosophical approach and institutional framework of the existing UC system. Although many of the changes suggested in subsequent chapters likely will be considered to be very major ones (particularly by many federal and state UC program administrators), our view is that these proposals actually involve relatively minor changes, especially relative to proposals that would alter the foundations of the system itself.

From the perspective of within-system reform, it appears that emphasis should be placed on: (1) reducing the complexity of the existing UC system and also finding ways to improve the administration of existing (or less complex) provisions; (2) improving both federal administrative funding procedures and other federal incentives for state UC agencies; (3) improving claimant incentives for increased self-compliance with UC eligibility criteria; (4) improving the incentives of state UC agency personnel and, to a lesser extent, of covered employers to prevent and detect payment errors; and (5) improving the procedures used to monitor claimant compliance with weekly UC eligibility criteria. Many might question the political feasibility of taking effective action in some of these areas, but the subsequent discussion of the specific within-system responses analyzed in this study has not been limited by any attempt to consider only proposals likely to be politically popular. Apart from whatever may be the political feasibility of the suggestions, it is hoped the analysis of system deficiencies and policy options presented may serve to stimulate interest in UC system reform.

It very well could be that society's long-run interests ultimately might be better served by completely replacing the existing UC system with one that would be quite different from even a reformed version of the present system. However, a serious analysis of the many issues that would be involved in designing an optimal replacement for the existing system is completely beyond the scope of this study.

Benefit Financing and Trust Fund Solvency Issues Not Analyzed

The UC program experienced a financial crisis during the past 13 years which began with the 1974-1975 recession and became even more severe with the onset of back-to-back recessions in 1980 and 1982. By January 1, 1985, state UC systems had obtained loans from the federal government that totalled \$23.5 billion.¹⁰ As a result of these and other considerations, trust fund

10. Vroman (1985).

solvency and benefit financing issues recently have received substantial attention.¹¹ This study, however, was not motivated by these considerations. It is the case, of course, that the overall volume of UC benefit payments (for a given level of aggregate demand) can be set at whatever level policymakers choose by simply altering eligibility criteria and benefit levels. Hence, some of the proposals considered in this study could have some implications for benefit financing issues because they could impact on the overall volume of UC program outlays (for a given level of aggregate demand). These impacts, however, are viewed primarily as side effects of policies intended to address the incentives or other issues that do constitute the focal point of this study. This approach reflects both the emphasis of our previous research and also our view that an analysis of the benefit payment side of the UC program ledger can make an important contribution in terms of improving the existing UC system.

Indirect v. Direct Evidence

In many cases, it is necessary to provide indirect evidence for the existence of some of the adverse features analyzed in this study. For example, there is no accepted basis for proving that the UC program is too complex, especially since certain features of existing complexity were specifically introduced by policymakers in the hopes of achieving certain goals. Furthermore, merely documenting the existence of adverse incentives does not indicate the extent to which system participants actually respond to them. Nevertheless, even though much of the evidence offered in this study is indirect in nature, our opinion is that it provides a sufficient basis for the conclusions reached; others, however, will have to make such assessments for themselves. At several places throughout this study, we offer suggestions for additional research in areas in which more direct or substantive evidence may be useful.

11. Two recent studies by Vroman provide an excellent overview of the issues involved. See Vroman (1985) and (1986).

Applicability of Analysis to Individual States

The federal-state UC system includes 53 individual UC jurisdictions (the 50 states plus the District of Columbia, Puerto Rico and the Virgin Islands). The specific eligibility criteria applicable in each jurisdiction are determined by that jurisdiction, subject to conformity with broad federal guidelines. Administrative practices and operational procedures vary considerably among the states. Accordingly, the assessment of the UC system provided in this study is a generalization that may apply to varying degrees to individual UC jurisdictions. Because of the diversity of state UC systems, no attempt is made to indicate how each portion of the analysis applies to specific states. It is our view that the general thrust of most of the analysis would be applicable, at least to some degree, to nearly all state UC programs.

Unavailability of Recent Overpayment Evidence

Information on overpayment rates in as many as 46 statewide jurisdictions is available for FY 1983, FY 1984, FY 1985 and for a portion of FY 1986, but is not summarized or discussed in this study because the data had not been publicly released at the time this study was undertaken. Our judgment, however, is that this limitation does not significantly impact on the substance of the study. In fact, evidence released in 1987 for more recent periods is entirely consistent with the evidence analyzed in this study. Furthermore, the dominant themes of this study are related to issues, circumstances or relationships of which high UC overpayment rates are primarily symptomatic. In the absence of convincing evidence that fundamental changes have recently occurred with respect to the complexity, incentive and monitoring issues, there seems to be no strong basis for assuming the analysis would have been significantly altered by the availability of more recent data.

Interstate Benefit System Not Analyzed

About 5 percent of the UC benefits paid in the United States in recent years have been paid on an interstate basis.¹² Cooperative agreements among the UC jurisdictions permit the interstate payment of benefits. Claimants receive interstate benefits from the (liable) state in which they had worked and earned their qualifying wage credits, but file for those benefits from another (agent) state in which they have temporarily or permanently relocated.

The present study does not provide for a separate analysis of the interstate benefit (IB) payment system. No meaningful evidence currently is available on overpayment rates in the IB system, although USDOL apparently plans to encompass the interstate system in an expanded version of its recently implemented Quality Control program.¹³ However, the fundamental problems that contribute to payment errors and reduced UC program quality with regard to intrastate benefits—adverse incentives, program complexity, and an inability to effectively monitor claimant compliance with UC eligibility criteria—almost certainly are even more pronounced problems in the IB system. In addition, shared administration of an IB claim between the liable (paying) state and the agent state clearly would be expected to introduce additional complexities and to provide for even more adverse incentives for payment accuracy than those which exist for intrastate payments.¹⁴

UC Program Knowledge Assumed

As is perhaps already apparent, it is assumed that the reader has at least a general understanding of the UC system. No attempt is made to provide any detailed description of the UC

12. This estimate was provided during 1985 by the Interstate Benefits unit in the National Office of the Unemployment Insurance Service of the U.S. Department of Labor.

13. See U.S. Department of Labor (1985e: I-C-4 through I-C-6).

14. For example, neither covered employers nor UC agency personnel in agent states would have strong incentives to deny IB claims because the benefits received by interstate claimants: (1) would be charged to out-of-state employers; and (2) likely would account for some increased spending within agent states, thereby creating additional sales, profits and employment opportunities.

system as it presently operates, although some background is provided in selected portions of the study for particularly complicated features of the system. It probably still is the case that even those with little general knowledge of the system can evaluate many of the adverse UC system features stressed in this study. In any case, a number of good sources are available for those who wish to supplement their UC system knowledge before considering the subsequent analysis.¹⁵

Organization of the Study

This investigation is organized in the following manner. Evidence of overpayments and some information on underpayments in the UC system are summarized in chapter 2. The sources and extent of complexities that characterize the UC program, especially those related to UC eligibility criteria, are documented in chapter 3. The major theme of this study—the importance of adverse incentives in affecting the behavior of UC system participants—is developed primarily in chapters 4, 5 and 6. The adverse incentives confronted by state UC agencies with respect to federal-state administrative funding issues are discussed in chapter 4, whereas issues related to state compliance with federal performance criteria are considered in chapter 5. In chapter 6, the incentives faced by UC claimants, covered employers and state UC agency personnel are examined, especially as they relate to the extent of claimant compliance with UC eligibility criteria. In chapter 7, the difficulties of monitoring claimant compliance with weekly UC eligibility criteria, particularly worksearch requirements, are analyzed in detail. Possible responses to the problems identified in chapters 3–7 are analyzed in each chapter. The final chapter contains principal findings, policy recommendations and a brief summary of the entire study.

15. See for example Haber and Murray (1966) and Hamermesh (1977).