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Unemployment benefits and activation in federal welfare states: An institutional moral hazard perspective

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ABSTRACT

Subnational governments have become more involved in the 'regulation of unemployment' (the design, implementation and financing of unemployment-related benefits and activation), partly because they are thought to be better placed to activate the unemployed than federal governments. However, depending on its specific design, decentralization can reduce the incentives subnational governments have to implement effective activation. Such 'institutional moral hazard' is not yet systematically theorized. We examine how and to what extent it affects three federal countries. We distinguish three factors that influence whether institutional moral hazard is perceived as a problem and how it can be resolved. We identify two types of subnational challenges to federal control.

KEYWORDS Institutional moral hazard; multi-tiered welfare states; intergovernmental relations; federalism; unemployment insurance; social assistance; active labour market policies

Introduction

Since the 1990s, subnational¹ governments have become more involved in the 'regulation of unemployment', i.e. the design, implementation and financing of unemployment-related benefits and activation policies. This trend is related to the reorientation towards 'active' welfare states, specifically the adoption of Active Labor Market Policies (ALMPs) (Finn 2000; Sabatinelli 2010). There is a growing literature on intergovernmental relations in social policy (Kazepov 2010; Obinger, Leibfried, and Castles 2005; Van Berkel, De Graaf, and Sirovátka 2011a). Intergovernmental tensions over burden-sharing in the regulation of unemployment (Bonoli and Trein 2016; Bonoli, Natili, and Trein 2019) and related coordination challenges (Øverbye et al. 2010) are well-documented. We analyze how decentralization can weaken the incentives for subnational governments to minimize the risk of unemployment either through lax subnational activation policies for federally financed

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benefit schemes or through shifting caseloads from subnational to federal schemes. Such ‘institutional moral hazard’ goes beyond conflicts about ‘which government pays for what’; it can have profound effects on solidarity, the functioning of unemployment-related policies and intergovernmental relations.

In Section one, we hypothesize that institutional moral hazard (IMH) affects multi-tiered welfare states. This hypothesis is confirmed in three case studies: Switzerland, Belgium and the United States (US) (Section three). IMH affects the regulation of unemployment in these federations, but its form and the remedies applied differ.

Section four develops general propositions about factors influencing the perception of IMH as a problem and the actual policy remedies: the generosity of the insurance, the constitutional context of subnational autonomy and interregional unemployment differences. Also, we distinguish two types of challenges by subnational governments to federal control over the regulation of unemployment: those that concern the interpretation of intergovernmental ‘insurance contracts’ and more fundamental challenges regarding the legitimacy of federal control. We conclude by formulating a research agenda.

Institutional moral hazard

Federal financing of unemployment benefits can be conceptualized as a federal-subnational insurance against costs associated with the risk of unemployment. If subnational governments have policy responsibilities in the regulation of unemployment, such federal financing can negatively affect subnational incentives to reduce the risk of unemployment, i.e. ‘institutional’ moral hazard emerges. Our hypothesis is that IMH (A) *affects multi-tiered welfare states* and (B) *is consequential for the intergovernmental division of responsibilities*, especially in federations. However, this issue has not been systematically theorized. Beyond deductively testing the presence of and concern for IMH, our primary aim is inductive theory-building: to develop general propositions that can explain the variation in how IMH affects intergovernmental relations and how governments respond to it.

IMH is the by-product of decentralization of responsibilities in the regulation of unemployment. While in the past research focused on the *substance* of social policies, a growing body of literature addresses *governance aspects* of social policy, including multilevel governance (Kazepov 2010; Obinger, Leibfried, and Castles 2005; Van Berkel, De Graaf, and Sirovátka 2011a). The substance and governance of social policies affect each other (Van Berkel and Borghi 2007); specifically for the regulation of unemployment, the substantive reorientation away from passive income-replacement benefits and towards activation went hand-in-hand with a tendency to decentralize such policies (Finn 2000; Sabatinelli 2010).

Decentralizing activation policies is thought to increase their efficiency vis-à-vis a central one-size-fits-all approach (López-Santana 2015, 11). This fits within a broader trend of introducing New Public Management (NPM) in the governance of activation (Weishaupt 2010). NPM tools – such as performance management – help policy-makers coordinate between the standardized logic of benefit administration and the individualized and flexible logic of delivering activation services (Karjalainen 2010). However, multilevel governance can also result in clashes of interests. Fiscal federalism literature shows that governments sometimes engage in opportunistic behaviour in an attempt to shift costs of social policies to another level of government (Bonoli and Trein 2016; Bonoli, Natili, and Trein 2019). This is premised on the assumption that governments are, *ceteris paribus*, motivated by the desire to relax their own budget constraints (Weingast 2009, 283). NPM-tools can be used by federal governments to steer subnational behaviour through changing subnational incentives.

Importantly, decentralization is not a zero-sum game; the downward transfer of responsibilities can counterintuitively result in stronger – albeit indirect – central control (Minas, Wright, and Van Berkel 2012). Because of this inherent ambiguity in decentralization processes, we will define the conditions under which IMH can occur. But before we do that, we must define IMH itself.

Moral hazard is the ability of the insured party to influence the probability of the insured risk and loss at a cost to the insured party that is lower than the expected gain (Barr 2012, 92–93). We frame our analysis in terms of ‘moral hazard’ because the regulation of unemployment is characterized by the *insurance of risks*. Rather than seeing unemployment as mostly influenced by macroeconomic factors, the activation paradigm emphasizes the individual’s responsibility to find work (Dean 2007). From this perspective, ALMPs mitigate the individual-level moral hazard associated with the insurance provided by unemployment-related benefits. When subnational governments are responsible for activation, the risk of unemployment is also influenced by subnational policy. If subnational governments do not bear the fiscal consequences of their behaviour, and if subnational policy is (partly) influenced by financial incentives, moral hazard is also situated at the institutional level. We focus on two forms of IMH.² First, ‘ineffective activation’, whereby subnational governments do not meet federal expectations about the reduction of unemployment through ALMPs. The second form is ‘dumping’, whereby subnational governments shift beneficiaries from subnationally financed schemes to federally financed schemes.

For IMH to occur it is necessary that subnational governments are tasked with particular responsibilities.³ The literature distinguishes between administrative, political and fiscal responsibilities (López-Santana 2015, 14–16). Incentives for ineffective activation arise when the federal government (partly)

finances individual benefits of a particular scheme while subnational governments have political responsibility for activating the beneficiaries of that scheme. For instance, subnational governments can ‘park’ beneficiaries in programs that do little to help them get back to work. Incentives for dumping arise when the federal government finances one benefit scheme and subnational governments fund a related benefit scheme. For instance, subnational governments can encourage applicants to subnational schemes to apply for a federally financed benefit instead. Dumping caseloads is a way for subnational governments to balance their objectives of ‘owning’ social policies, which enhances their legitimacy, while avoiding the related budgetary costs (Bonoli, Natili, and Trein 2019).

The literature discusses ways in which central governments try to ensure subnational compliance with central goals (Braun and Trein 2014, 806; Van Berkel and Borghi 2008, 396). Inspired by this we identify two remedies to IMH: financial remedies and minimum requirements regarding subnational policies. *Insurance implies the existence of a contract that regulates pay-outs and the conditions under which those pay-outs occur.* Financial remedies affect subnational incentives by changing the level and/or the structure of pay-outs. For instance, federal governments can make subnational governments finance a part of a benefit scheme for which subnational governments design ALMPs, to make them sensitive to the outcomes of ALMPs. Federal governments might also stop financing individual benefits and instead provide lump-sum block grants to subnational governments; this decouples the level of federal financing and the number of beneficiaries. Minimum requirements codify the conditions for federal financing and the responsibilities of subnational governments through regulation and/or performance management. For example, federal governments can oblige subnational government to use certain types of ALMPs and/or to achieve performance targets. The degree to which the ‘contract’ is codified determines the level of subnational autonomy. Admittedly, the insurance metaphor has its limitations: subnational entities do not pay a specific, identifiable ‘insurance premium’ to the federal government in return for its coverage of unemployment risks.

Institutional moral hazard in three cases

We test our hypothesis that IMH affects the intergovernmental division of responsibilities in multi-tiered welfare states by analyzing three federations where relevant political and/or fiscal responsibilities are devolved to subnational governments: Switzerland, Belgium and the US. Our primary aim is theory-building: developing general propositions about factors affecting the salience of IMH and the way in which federal governments mitigate it. While we think IMH can occur in decentralized unitary countries, we expect that its dynamic is most pronounced in federations, for two reasons. First, in

federations it is more likely that subnational governments have significant political and fiscal responsibilities. Second, in contrast to unitary countries, subnational competencies are often constitutionally guaranteed and federal governments cannot decentralize and recentralize in a discretionary manner (Minas and Øverbye 2010).

In Belgium and Switzerland, the federal government finances and regulates unemployment insurance (UI) while for American UI political and fiscal responsibilities are shared between the federal and state level. In all three cases, subnational governments have fiscal and political responsibilities in social assistance (SA) and in activation policies. We therefore expect IMH to be present. In short, we focus on ‘most likely cases’. However, our cases differ with regard to the generosity of unemployment-related benefits, number and heterogeneity of constituent units, methods and degree of burden-sharing, and the constitutional context of subnational autonomy.⁴ These factors could influence the salience of IMH, the possibility to remedy it and the extent to which subnational governments will challenge proposed remedies. Our cases represent a North-American country, a non-EU European country and an EU Member State. By applying a most likely case-design we test whether the IMH perspective holds in different contexts and we maximize the range of policy-experiences from which we can draw lessons and develop general claims. This design fits our theory-building aim (Rohlfing 2012, 84–90).

Switzerland

In this section, we explain that federal attempts at centralizing UI activation and cantonal SA schemes were relatively unsuccessful. The federal government limited the extent to which cantons were able to ‘dump’ SA beneficiaries in federally financed programs. We discuss federal concerns about ineffective UI activation, about the differences between cantonal SA programs, and about perverse interactions between cantonal and federal schemes.

UI benefits are federally designed and financed (or ‘insured’). Activation is also federally financed, while administrative and political responsibilities over ALMPs have historically been mostly cantonal and/or municipal. Hence, those subnational governments have no financial incentive to activate UI beneficiaries effectively. In 1995, following an unemployment crisis, the federal government started to emphasize activation and transferred the political responsibility for activation from municipalities to the cantons, which had to create new activation offices. The federal government assumed financial responsibility for activation policies. The intention was to centralize the management of these new offices by federal performance standards for the number of enrollments in ALMPs, but this was seen as too rigid and suboptimal (Duell et al. 2010, 51). Other proposals to strengthen federal control through the imposition of output-based targets were unsuccessful (Ehrler

and Sager 2011, 162). Instead the federal government introduced a more relaxed performance measurement backed up by a (cantonal) peer-review system (Bertozzi, Bonoli, and Ross 2008, 146). Originally, the performance measurement system was paired with a bonus/malus system, but several cantons questioned the validity of indicators underpinning it and the bonus/malus element was quietly dropped (Duell et al. 2010, 15). In short, attempts to increase federal control over UI activation were not very successful. Currently, federal legislation prescribes a number of minimum requirements for cantonal policy-behaviour but in general, the cantons have broad political responsibility over ALMPs, and as a result, stark differences in strategies and performance persist (Bertozzi, Bonoli, and Ross 2008, 146–148; Duell et al. 2010, 49). Federal control over cantonal activation policies lacks bite as it relies mostly on publishing performance reviews.

Unlike UI, SA is in every respect a cantonal responsibility. Cantonal SA schemes were, and still are, very diverse. The federal government was concerned about the fragmented nature of SA, which is not necessarily the same as being concerned about IMH. However, the cantonal autonomy that generated fragmentation also led to several perverse interactions with federal schemes. The cantonal activation offices could serve both UI and SA beneficiaries. Therefore, the cantons had incentives to prioritize activation of their own SA caseload. Furthermore, the federal government also grew concerned over the ‘dumping’ of SA caseloads in two federal schemes (Bonoli and Champion 2014, 9–11). First, since the 1990s, several cantons used job creation programs as ALMPs to requalify SA beneficiaries for UI. Second, several cantons actively assisted SA beneficiaries in filing for disability insurance and sometimes even paid legal fees to appeal the dismissal of claims (Bonoli and Champion 2014, 10). Between 1990 and 2003 the disability insurance caseload nearly doubled in size (Champion 2011, 124), which the federal government interpreted as the result of dumping. Cantons perceived this as the correct application of the law.

The fragmentation in SA prompted federal centralization attempts in the mid-2000s (Bonoli and Champion 2014, 14–15), which were met by cantonal resistance. Centralization ultimately proved unsuccessful because the political risks of limiting cantonal autonomy were seen as too high; also, SA caseloads eventually stopped rising which diminished the urgency to centralize (Bonoli and Champion 2014, 16). Instead, governments opted for intergovernmental collaboration. For instance, cantons themselves produced non-binding inter-cantonal SA guidelines, which did something to harmonize SA schemes but did not increase federal control. The federal government was able to limit perverse interactions. First, it utilized financial remedies to mitigate the moral hazard of cantons using UI activation-funds for their own SA caseload. In 2008 it was decided that cantons must co-finance ALMPs provided to SA beneficiaries and federal contributions to cantonal offices were capped (Duell

et al. 2010, 53–55). Second, the federal government changed the eligibility criteria for disability insurance in 2004 and 2008, largely preventing caseload transfers from SA (Bonoli and Trein 2016, 609). Third, the federal government also tightened eligibility criteria for UI in 2011.

While we find support for our starting hypothesis that IMH affected the Swiss regulation of unemployment and that this worried federal policy-makers, we also find that cantonal autonomy limited the degree to which the federal government could address its concerns. Despite strong intergovernmental tensions over IMH, cantons are relatively successful in protecting their political autonomy against centralization attempts. Moreover, because SA is cantonal, the potential for financial remedies to affect cantonal SA policies is limited. The federal government was, however, more successful in closing off interactions between cantonal SA and federally insured schemes.

Belgium

In Belgium, political conflict over federal solidarity in UI led to a strengthening of minimum requirements for UI activation in 2004. However, no major changes occurred in SA. In this section, we discuss the tensions over UI activation, the most recent constitutional reform and the relative lack of concern for IMH in SA.

UI benefits are federally financed, while political and administrative responsibilities over activation have been mostly regional since the 1980s; yet, the federal level was in charge of monitoring job-search behaviour and sanctioning UI beneficiaries. The regions wanted to develop ‘positive’ ALMPs, largely disconnected from sanctions. In 1999, the Verhofstadt government launched the ‘active welfare state’, and regional UI activation became a salient issue. There were significant disparities between both the employment performance of the regions and the activation strategies they adopted. Regional governments had little financial incentive to activate effectively. The challenge was deeply political. Flemish nationalism increasingly focused on fiscal transfers to Wallonia (Béland and Lecours 2005, 273). Wallonia and Brussels were associated with ‘a culture of dependency’ (Béland and Lecours 2005, 273); for the Flemish nationalists this could only be ended by splitting social security. Walloon and Brussels policy-makers argued that their comparatively high unemployment rates were due to exogenous circumstances such as deindustrialization and migration. In 2004, the Verhofstadt II government negotiated a federal-regional cooperation agreement, based on detailed minimum requirements for regional activation. This resulted in a consistent activation effort, intensified federal-regional cooperation, and regional convergence regarding the organization of ALMPs (Vandenbroucke et al. 2016, 60). The 2004 agreement explicitly addressed IMH via strict minimum requirements. It codified

requirements, and established a close-monitoring and gradual sanctioning system for the individuals concerned.

Although the federal-regional cooperation agreement was successful, it could be considered as a 'second-best solution' (Dean 2007): ideally, all the instruments of activation, including punitive ones, had to be concentrated at one level of government. Between 2009 and 2011 a new constitutional reform was negotiated, which went into effect in 2015. The reform decentralized more political responsibilities for UI activation: all activation, monitoring and sanctioning instruments were transferred to the regions, but within a federal normative framework. This included the transfer of fiscal responsibility for activation, which until then was partly federal. This reform did not include specific financial incentives for the regions to mitigate IMH, which could be expected to increase again; but it was accompanied by new minimum requirements for regional activation. Although regions gained more competencies, their autonomy in the treatment of unemployed people remained limited by federal regulation.

The constitutional reform also affected SA activation. Because UI can be prolonged indefinitely, SA used to play a marginal role in Belgium. SA benefits were, and still are, federally co-insured for at least 50–65 percent and municipalities finance the rest. The federal government organized and funded SA activation instruments, but left considerable political autonomy to municipalities. Traditionally, municipalities focused on their clients' well-being. In 2002 new federal legislation shifted the discourse on SA policy more towards activation (De Bie and Vandenbussche 2016). Nevertheless, federal minimum requirements remained vague and municipal autonomy was largely untouched. Municipalities applied different activation strategies (Bogaerts et al. 2010; Hermans 2005). Notwithstanding the federal and municipal co-financing of benefits, there was no structural federal-municipal transmission of information concerning SA activation. With the constitutional reform, the regions took over the former federal political responsibilities in regulating and financing all activation responsibilities, including SA. The municipal role remained unchanged, i.e. municipalities still implement benefits and ALMPs and retain their partial financial responsibility for SA benefits. Even though the regions may be better equipped to integrate the municipal policies in their overall activation effort (compared to the federal government), they have no financial incentive to do so effectively. Additionally, it is common practice in Belgium to use work programs to shift persons from SA to UI. This is explicitly allowed, and at times even promoted, by the federal government and not regarded as dumping – contrary to Switzerland.

While we find that concerns about ineffective UI activation polarized the public debate, IMH in SA is, so far, not a salient issue. The combination of municipal autonomy and inter-municipal solidarity (via federal and regional

funding) is deeply entrenched in the political fabric, whilst inter-regional solidarity has been controversial for many years. The Belgian case demonstrates the importance of subnational differences in unemployment performance but also differences in the perception of IMH in UI versus SA.

United States

The US federal government is reluctant to restrict state autonomy; it relies more on financial incentives to steer state behaviour. We first discuss UI and the impact of the recent crisis, and next the 1996 reform of SA and the interactions between the different state and federal SA programs.

Political responsibility for UI is based on federal-state cooperation. The federal government imposes administrative minimum requirements for state UI programs, but important parameters (e.g. eligibility and generosity) are set by states. The federal government finances the administration costs through a payroll tax on employers. States finance benefits from their UI trust funds through their own payroll taxes. Hence, states have incentives to keep UI caseloads as low as possible and to reduce their tax pressure on employers. When state trust funds are depleted, the federal government steps in to finance UI. To prevent states from relying on federal fiscal support, the federal backstop is a loan which has to be repaid. Moreover, if a state continues to borrow for over a year, the federal government will increase its tax pressure by applying ‘penalty rates’ on employers in that state, putting political pressure on the state government to refill its trust fund. So, in principle, the design of the UI system mitigates that moral hazard.

The federal penalty rates are meant to pressure states to maintain adequate trust fund solvency. However, because federal financing requirements and penalties for state borrowing have not been adapted since 1983, the system became ineffective. Subsequently, before the crisis, the vast majority of state trust funds did not meet (non-binding) federal solvency targets (GAO 2010, 10–12); during the Great Recession 36 state trust funds had to borrow. Additionally, when unemployment levels rise extraordinarily fast, the federal government extends state UI benefits. During the previous crisis, federally financed benefits extended the maximum duration of state UI benefits from 26 up to 99 weeks.⁵ Thus, the federal government financed both depleted state trust funds and extended benefits. To regain solvency, some states increased their UI payroll taxes, but many states also restricted eligibility and reduced UI generosity. While this might be opportunistic state-level behaviour, it is not IMH as it does not increase the risk of unemployment. The Obama administration wanted states to maintain the generosity of state UI programs and defined minimum requirements for state UI programs as a condition for federally funded extended benefits. But these minimum requirements could be circumvented and were limited to the duration of

the extended programs ending in 2014, after which the states were free to reduce both generosity and coverage – which many states did.

Also, states had no financial incentives to effectively activate beneficiaries of federally financed extended benefits. Again, this was addressed through some federal minimum requirements aimed at state activation efforts for beneficiaries of extended benefits (Klerman 2013). But the Obama administration was more concerned about state trust fund solvency and the generosity and coverage of state UI benefits than about ineffective activation. In short, federal concerns focused on the economic stabilization function of state UI programs and state reliance on federal funding. The Great Recession and all the federal dollars flowing into the UI system legitimated the imposition of stricter minimum requirements, but when the crisis subsided that consensus quickly dissipated.

SA in the US is more residual and targeted than in our other cases. Before 1996, the main SA program (Aid for Families with Dependent Children, AFDC) was implemented by the states within a federal regulatory framework that left relatively little political responsibility for states. This scheme focused on families with children, notably single mothers. Benefits were federally co-insured for 50 up to almost 85 percent, depending on the state. In the 1990s, federal actors grew increasingly concerned about growing AFDC-caseloads and ineffective activation efforts. At the same time, state agitation for more autonomy in SA resonated with federal policy-makers (Haskins 2006, 35). The 1996 reform addressed both federal concerns about growing caseloads and state concerns about constraining federal legislation via financial remedies. AFDC funding was transformed to a block grant: Temporary Assistance for Needy Families (TANF), still mostly focused on single mothers. The federal government legislated mandatory time-limits for TANF benefit duration to reduce individual-level moral hazard. Because of the block grants, states no longer had ‘the promise of increased federal funds as an incentive for greater outlays of state dollars’ (Hoke 1998, 120). In return, while TANF included some minimum requirements regarding activation, state-level political responsibility regarding SA was greatly expanded. Initially, caseloads shrunk enormously. But as those reductions levelled off by 2000, states easily circumvented the limited federal activation requirements through loopholes (Germanis 2016). Moreover, their newfound autonomy enabled states to redirect their block grant funds away from SA benefits and towards supplanting existing state expenditures (Germanis 2015, 32). Although states argued they operated within their legal prerogative, in 2001 the Bush administration proposed to substantially strengthen federal minimum requirements for state TANF programs. States perceived this move as federal overreach. The debate waged until 2005, when a watered-down version of the initial proposal was finally passed (Allard 2007). These minimum requirements had a lot of loopholes and states are still able to use TANF as a ‘slush fund’ (Germanis 2015,

40, 53). Thus, the federal government's ability to regain control over TANF has been very limited.

State-run TANF programs interact with several federal SA-adjacent programs. States have fiscal incentives to move people from AFDC/TANF to Supplemental Security Income (SSI), a federal disability scheme. In the early 1990s, SSI caseloads exploded (Berkowitz and DeWitt 2013, 181–183). Caseload transfers from AFDC to SSI were a contributing factor (Kubik 2003). The 1996 reform included measures to restrict access to SSI (Rogowski et al. 2002), making transfers more difficult. Over time, the fiscal gains for states to shift a beneficiary from TANF to SSI have increased and evidence suggests that transfers continued after 1996 (Wamhoff and Wiseman 2006). TANF also interacts with food stamps (Supplemental Nutrition Assistance Program, SNAP), which are almost completely federally regulated and financed, with only administrative state-level responsibilities (Moffitt 2015). A recent study finds that a significant portion of state savings on TANF cash benefits are replaced by federal expenditures on SNAP and SSI (Parolin and Luigjes 2019). Some of these issues have been noted in federal reports (GAO 2012) but after the 2005 reform, there has been little federal appetite to reform TANF.

In the US, as in the European cases, IMH is both present and a concern. However, the US emphasize financial remedies rather than minimum requirements to resolve it. UI involves a sophisticated financial design and the AFDC-TANF transformation combines more autonomy with a switch from co-insurance to block grants. In general, the federal government seems very reluctant or unable to address IMH through limiting state autonomy. The US case, therefore, suggests a link between how closely guarded subnational autonomy is and the way in which IMH is addressed.

Discussion

Our hypothesis is confirmed: in the three cases IMH (A) affected the regulation of unemployment and (B) led to intergovernmental tensions and ultimately to reforms. However, the guise it took, the degree of federal concern and the way in which it was remedied, differed between the cases. We first summarize such similarities and differences. We then formulate three propositions to explain the variation and distinguish two types of potential intergovernmental conflict.

Similarities and variation between the cases

In Switzerland and Belgium, UI is relatively generous (Table 1); here, a dominant concern was ineffective UI activation. In the US, worries about activation concerned SA rather than UI because under normal circumstances states

Table 1. Overview of generosity and government expenditures on UI and SA in the three cases during the time periods discussed.

UI				
Country	Time period	Gross replacement rate ^a	Maximum duration	Expenditure as % of GDP ^b
Switzerland	Introduction cantonal activation (1995)	30%	104 weeks	0.9%
	Reform of activation (1999–2008)	29–37%	104 weeks	0.4–1.0%
Belgium	Cooperation agreement (2003–2004)	42%	Unlimited*	2.8%
	Sixth constitutional reform (2009–2011)	37–38%	Unlimited*	3–3.1%
US	Extended and emergency UI benefits (2008–2014)	23%**	99 weeks	0.4%
SA				
Country	Time period	Benefit as % of average wage ^c	Maximum duration	Expenditure as % of GDP ^d
Switzerland	Reform of activation (1999–2008)	21–28.6%**	Unlimited	0.2–0.4%
	Debate on SA centralization (2004–2008)	21–22.2%**	Unlimited	0.3–0.4%
Belgium	Constitutional reform (2009–2011)	26.8%**	Unlimited	0.5%
US	AFDC-TANF (1995–1996)	Not available	No federal limit	0.3%
	TANF reauthorization (2005)	2.8%	Federal limit: 60 months	0.1%

^aOECD tax-benefit database: (summary measure of benefit entitlements) average of the gross unemployment benefit replacement rates for two earnings levels, three family situations and three durations of unemployment, 2001, 2003, 2005, 2007, 2009, 2011.

^bSOCX database: unemployment benefits (10-7-1-1-1), 1990–2013.

^cOECD tax-benefit database: maximum amounts of SA benefits for head of household + spouse in percentage of average wage, 2002, 2005, 2007, 2010. US: maximum amounts of family benefits (TANF) for a household with one child aged 3–12, in percentage of average wage, based on Michigan, 2002, 2005, 2007, 2010.

^dSOCX database: income maintenance (10-9-1-1-1/2/3/4, includes other spending than SA cash benefits, for USA 1995: 10-5-1-1-1 + 10-7-1-1-2, USA 1997-2012: 10-5-1-1-2 + 10-7-1-1-3, 19, USA 1996 = missing), 1990–2012.

*Contingent on renewal by authorities.

**Nearest available years.

finance UI benefits themselves. When the US federal government financed extended UI benefits, there were some federal concerns about ineffective state activation efforts.⁶ The Belgian case is interesting in this regard because UI activation was fiercely politicized, while possibly ineffective activation of federally co-insured SA received little attention. In part, this can be explained by the difference in generosity between UI and SA. Another explanation is that regional unemployment is structurally very unequal in Belgium: the concomitant interregional redistribution is controversial.

Swiss cantons resisted centralization of both UI activation and SA. Especially SA has long been a cantonal prerogative: attempts to centralize it were seen as unconstitutional, but even federal attempts to increase control over cantonal UI activation were largely thwarted in the name of

cantonal autonomy. In the US, state-led agitation against federal SA regulations resulted in expanded state autonomy during the 1996 reform, and the federal government applied financial remedies to address concerns about activation.⁷ A subsequent modest federal attempt to regain more control over TANF led to a very drawn-out political struggle which resulted in ineffective watered-down minimum requirements. And in Belgium, strong concerns about ineffective UI activation were addressed through cooperation agreements – not unilateral federal dictates.

In our cases, benefit schemes interact but the degree to which this is problematized varies. Interactions between benefit schemes were a prominent subject of disputes in Switzerland and the Swiss federal government closed off pathways for interactions between cantonal SA and federal schemes. Similar interactions in the US were addressed in 1996 but have gone relatively uncontested since. In Belgium, transfers from SA to UI were explicitly allowed and even promoted by the federal government. This relatively unusual feature can be explained by the fact that, historically, SA was seen as only a marginal instrument in Belgian social protection: it was generally accepted that coverage by social insurance proper had to be universal

Factors influencing IMH

We identify three factors influencing the salience of IMH and the way in which it is remedied (or not). First, the generosity of benefits affects the level of spending and the political sensitivity to the risk of unemployment (Table 1).⁸ Moreover, high individual generosity implies more individual moral hazard and increases the urgency of effective activation by subnational governments responsible for ALMPs. And, the more generous the federal financing is, the higher the salience of IMH (Table 2).

Second, our cases demonstrate the importance of the constitutional context of subnational autonomy. ‘Owning’ social policies enhances the legitimacy of subnational governments, which is why centralization triggers inter-governmental conflict (Bonoli, Natili, and Trein 2019). Since concerns about institutional moral hazard have to be balanced against the political sensitivity of subnational autonomy, federal governments must tread lightly. Partly, this

Table 2. Generosity of benefit schemes and federal insurance and the salience of IMH.

	Ungenerous federal insurance	Generous federal insurance
Ungenerous benefits	Low salience: due to a low potential for IMH.	Moderate salience: while there is some potential for IMH, it is limited by low individual-level moral hazard.
Generous benefits	Moderate salience: while there is some potential for IMH, it is limited by high subnational sensitivity to the risk of unemployment.	High salience: due to a high potential for IMH.

reflects the political realities of federations, where central governments are more constrained in using hard measures to overcome coordination challenges vis-à-vis unitary countries (Øverbye et al. 2010). The more subnational autonomy is constitutionally entrenched, the more difficult and contentious minimum requirements are. This is a matter of degree, however, because even federal governments do not shy away from minimum requirements, as we illustrated. Overall, our contention is that the more subnational autonomy is entrenched, the less federal governments rely on minimum requirements.

Third, the Belgian experience suggests that regional differences in employment performance contribute to the salience of IMH. If such differences are structural, benefits are perceived as permanent, redistributive transfers; this undermines the very notion of insurance-based solidarity. This chimes with Trein's expectation that in countries with heterogeneous collective identities such as Belgium, clear distinctions between net-payers and net-receivers negatively affect solidarity (Trein 2019, 6–7). Furthermore, interregional differences easily convey the idea that policy differences are the causal factor, regardless of whether this is accurate. The heightened salience, in turn, can push governments to confront IMH. We therefore posit that clear structural differences in subnational employment rates increase the concern for IMH.

It seems that the dynamic of SA differs from that of UI for reasons applying to many countries. In our cases, federal governments were either less concerned about SA-related moral hazard or less inclined to limit subnational political responsibilities. The first two factors identified above explain this. SA is not only often less generous than UI benefits; SA beneficiaries are seen as having more complex needs than UI beneficiaries which is why many countries allow more subnational autonomy and less codified work requirements in dealing with SA caseloads (Minas, Wright, and Van Berkel 2012, 288; Van Berkel, De Graaf, and Sirovátka 2011b, 241). Moreover, local autonomy in SA often has a long historical pedigree. These factors limit both concern about and initiatives against IMH. And when federal governments partially finance SA, they seem to prefer financial remedies over limits to subnational autonomy.

Our analysis allows to distinguish two types of challenges to federal control. First, challenges can arise over the interpretation of the 'insurance contract'. Disentangling the manifestation of true risks from the impact of behaviour is difficult and inevitably liable to perception, which fuels conflict. For instance, while Flemish nationalists argued that the poor employment record in Wallonia and Brussels was mostly due to IMH, Walloon and Brussels policy-makers emphasized exogenous circumstances. Similar issues emerge about performance measures that federal governments use to monitor or influence subnational behaviour. Specifically, subnational governments can argue that (proposed) targets are not valid indicators to gauge or steer their

performance, as illustrated by the Swiss bonus/malus system for UI activation. Whether or not transfers of caseloads from subnationally financed schemes to federally financed schemes constitute 'dumping' is another example of such 'interpretation' challenge. When Swiss cantons shifted caseloads from SA to both UI and disability insurance, the federal government perceived this as cantons dumping caseloads in federal schemes, while cantons argued that they were acting in the spirit and the letter of the law.

The second, more fundamental, type of challenge arises when minimum requirements imposed by a federal government as part of the 'insurance contract' are perceived subnational governments as federal 'overreach'. We saw this in Switzerland during the initial federal attempts to dictate UI activation policies and in debates over centralizing SA. We find another example of this in the US during debate over stricter minimum requirements for TANF where states put up a strong resistance against what they perceived as violation of their political autonomy.

Conclusion

The increasing emphasis on activation policies went hand-in-hand with a tendency to decentralize such policies, resulting in more pronounced multilevel governance. We conceptualize intergovernmental relations in the regulation of unemployment as federal-subnational insurance contracts; the tension that arises in these relations is about moral hazard. In Switzerland, ineffective activation of UI and the dumping of SA caseloads were the main issues. In Belgium, ineffective activation of UI has been fiercely politicized for years, but policy-makers were unconcerned by transfers from SA to UI. In the US, most concerns about IMH related to SA, and US federal policy-makers emphasized financial remedies over minimum requirements.

We identified three factors explaining the variation between our cases: the generosity of insurance, the constitutional context of subnational autonomy and structural differences in subnational employment performance. Furthermore, we distinguish two types of intergovernmental challenges: subnational governments can question the federal interpretation of the insurance contract; they can also fundamentally reject the federal authority to regulate their policy. Further research is needed to analyze whether our perspective holds for other multi-tiered welfare states, specifically decentralized unitary countries. In contrast to federations, subnational governments in decentralized unitary countries generally have less constitutional autonomy and less fiscal capacity. Central governments in such countries, when faced with IMH, will probably rely more on minimum requirements than on financial remedies.

Our findings are relevant in the context of European debates on 'risk-sharing' in the Monetary Union and the creation of a Eurozone scheme of

unemployment re-insurance (European Commission 2017, 25–26). These debates are dominated by the concern that domestic economic, employment and fiscal policies would become lax when unemployment-related risks would, to some extent, be pooled across EMU Member States [reference deleted for review]. While the EU has experience with benchmarking and performance measurement, the integration of traditional core state powers at the EU-level is controversial – even in times of crisis (Genschel and Jachtenfuchs 2018). Therefore, the EU will likely have to apply a different mix of remedies than federal governments examined in this paper. Further research is required to identify feasible remedies against IMH if the EU were to establish a Euro-zone unemployment re-insurance. Our analysis shows that IMH can be mitigated, to some degree: it does not render a multilevel governance of the regulation of unemployment impossible.

We expect that IMH also affects other policy areas where a social risk is insured by federal governments and where subnational political responsibilities can influence that risk, such as long-term care for the elderly (Vabo 2010). But more research is necessary to establish if (and how) that is the case when both the nature of the insured risk and the intergovernmental division of labour are different than in the domain of unemployment.⁹

Notes

1. For our purposes ‘subnational’ refers to the constituent elements of a federal state.
2. These forms are the result of policies *within* the domain of unemployment regulation, on which we focus. While weak subnational economic and education policies also affect the risk of unemployment, these policy areas involve different political and bureaucratic actors. The link between policies developed within the regulation of unemployment and the risk of unemployment is more direct and therefore politically more salient.
3. We focus on *intergovernmental* decentralization because political and fiscal responsibility can only be transferred to subnational governments (López-Santana 2015, 14–16). Once political authority is decentralized, the ability of central governments to regulate the behaviour of subnational governments, as part of the ‘insurance contract’, is no longer absolute. When administrative responsibilities are decentralized to local branches of central institutions (intra-governmental decentralization) or to non-governmental parties (delegation), traditional principal-agent theories are more appropriate.
4. See the online appendix B for a comparison of these factors.
5. We refer here to the Extended Benefit program and Emergency Unemployment Compensation.
6. However, during that time the federal government was more concerned about the macroeconomic stabilization capacity of state programs. This reflects that both conditionality and opportunistic use of federal grants are relatively uncontroversial during economic crises (Trein 2019, 6).

7. Although the US federal government utilized financial remedies more than the Swiss and Belgian federal governments, there is no clear-cut dichotomy between choosing financial remedies and choosing minimum requirements. The two types of remedies are not mutually exclusive.
8. See the online appendix for a comparison, including measures of heterogeneity, qualitative assessments of constitutional contexts, concerns about IMH and policy remedies.
9. For example, in healthcare, there is strong policy emphasis on preventing the insured 'risks' from materializing, while activation policies are mainly curative; second, in healthcare, the pay-outs for the insured risk need not take the form of cash benefits.

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Appendix

Table A1. Summary of benefit generosity, interregional differences, constitutional context, concerns about moral hazard and remedies implemented in our 3 cases during relevant policy episodes

		Generosity			Heterogeneity			
		UI gross replacement rate ¹ , maximum duration & expenditure ²	SA benefit as % of average wage ³ & social expenditure ⁴	Summary of generosity	Coefficient of variation of sub-central unemployment rates ⁵	Qualitative assessment of constitutional context	Concerns about institutional moral hazard	Policy remedies implemented
United States	AFDC-TANF (1995–1996)	Not applicable	Not available, 0.3%*	Low	Low (22–23)	Federal and state push towards more state autonomy.	Federal concerns about state incentives for ineffective activation and some concerns about dumping.	Switch from co-insurance to block grants, much more state autonomy, relaxation of minimum requirements, but introduction of participation requirements.
	TANF reauthorization (2005)	Not applicable	2.8%, 0.1%	Low	Low (19)	States contested federal ‘overreach’ in the form of proposed minimum requirements.	Federal concerns about state manipulation of minimum requirements and misuse of funding. Little concern about dumping.	Ineffective tightening of participation requirements, introduction of sanctions for states.
	Extended and emergency UI benefits (2008–2014)	23%*, 99 weeks ⁶ , 0.4%*	Not applicable	Medium	Low (22–23)	Relatively little constitutional contestation.	Limited federal concerns about the lack of incentives to effectively activate	Minimum requirements for beneficiaries that received top-ups, but limited to the duration of the crisis.

(Continued)

Table A1. Continued.

Country	Episode	UI gross replacement rate ¹ , maximum duration & expenditure ²	Generosity SA benefit as % of average wage ³ & social expenditure ⁴	Summary of generosity	Heterogeneity		Concerns about institutional moral hazard	Policy remedies implemented
					Coefficient of variation of sub-central unemployment rates ⁵	Qualitative assessment of constitutional context		
Switzerland	Introduction cantonal activation (1995)	30%, 104 weeks, 0.9%	Not applicable	High	High (50)	Federal push towards centralization, cantonal push back against federal controls.	UI beneficiaries receiving top-ups. Federal concerns about cantonal autonomy in UI activation which resulted in ineffective activation.	Creation of cantonal system, minimum requirements including potential bonus/malus, focus on UI activation was reinforced through monitoring system.
	Reform of activation (1999–2008)	29–37%, 104 weeks, 0.4–1%	21–28.6%*, 0.2–0.4%	Medium	High (38–58)	Federal push towards centralization, cantonal push back against federal controls.	Federal concerns about dumping practices and about cantons prioritizing SA activation over UI activation.	Relaxation of minimum requirements, changes in eligibility criteria to prevent dumping, funding for activation offices capped and cantons have to co-finance ALMPs for SA clients.
	Debate on SA centralization (2004–2008)	Not applicable	21–22.2%*, 0.3–0.4%	Medium	High (38–49)	Renewed attempts at centralization, cantonal push back against federal overreach.	Federal concerns about SA fragmentation, differences between UI and SA activation and dumping.	Intergovernmental cooperation, introduction of non-binding common guidelines but no increased federal control.
Belgium		42%, Unlimited ⁷ , 2.8%		High	High (38–39)			

(Continued)

Table A1. Continued.

		Generosity		Heterogeneity				
		UI gross replacement rate ¹ , maximum duration & expenditure ²	SA benefit as % of average wage ³ & social expenditure ⁴	Summary of generosity	Coefficient of variation of sub-central unemployment rates ⁵	Qualitative assessment of constitutional context	Concerns about institutional moral hazard	Policy remedies implemented
Country	Episode							
	Cooperation agreement (2003–2004)		Not applicable			Political tensions w.r.t. the legitimacy and sustainability of ‘federal solidarity’ in the domain of social security.	Regional disparities in activation endangered federal solidarity, specifically because of concerns for ineffective activation.	Introduction of strict minimum requirements, better and stricter monitoring, better intergovernmental transmission of data.
	Constitutional reform (2009–2011)	37–38%, Unlimited ⁷ 3.1%	3– 26.8%*, 0.5%*	High	High (43–46)	A push towards decentralization. But also political persistent need to legitimize the federal solidarity embedded in social security, and further push for activation.	Focus on rationalizing policy responsibilities but also on continued mitigation of institutional moral hazard.	Legal framework consolidates existing minimum requirements, UI activation is now funded by regions; regions also competent for municipal SA activation.

¹OECD tax-benefit database: (summary measure of benefit entitlements) average of the gross unemployment benefit replacement rates for two earnings levels, three family situations and three durations of unemployment, 2001, 2003, 2005, 2007, 2009, 2011.

²SOCX database: unemployment benefits (10-7-1-1-1), 1990–2013.

³OECD tax-benefit database: maximum amounts of SA benefits for head of household + spouse in percentage of average wage, 2002, 2005, 2007, 2010. US: maximum amounts of family benefits (TANF) for a household with one child aged 3–12, in percentage of average wage, based on Michigan, 2002, 2005, 2007, 2010.

⁴SOCX database: income maintenance (10-9-1-1-1/2/3/4, includes other spending than SA cash benefits, for USA 1995: 10-5-1-1-1 + 10-7-1-1-2, USA 1997–2012: 10-5-1-1-2 + 10-7-1-1-3, 19, USA 1996=missing), 1990–2012.

⁵Figures in parentheses represent heterogeneity (the range of coefficient of variation during the relevant years) among the relevant sub-central governments.

⁶This represents the high point during regular, extended and emergency UI benefits, this did not apply to all states for all the relevant years; regular benefit duration was generally 26 weeks.

⁷Contingent on renewal by authorities. *Nearest available year.