How to reduce the chance of government failures?
Types of failures and its remedies

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Abstract

This paper addresses the questions to what extent can government failures be reduced, and what are the main factors that determine the existence of these failures. By dealing with these questions the paper puts forward arguments in favor of the view that markets have their flaws as much as do governments. Therefore, research here must be concerned with the evaluation of the circumstances and factors which can still be controlled for to improve the performance of government agencies. Consequently, after a thorough review of the related literature in public choice and information economics, the paper proposes a typology of government failures based on an analogy of market failures. Next, it analyzes the explanatory factors beyond each of these failures in order to reveal the potentials for improvements. What the paper offers is a conceptual framework that can help to identify (and separate) those government failures that are under certain conditions evitable (from those that are not).

Introduction

There has been a long debate among economists between defenders of the market and advocates of government intervention about the necessity and justification of correcting market's shortcomings by public agencies. Thinking about public affairs is often like posing questions on the confrontation between markets and governments. The first camp believes that market are far away from being perfect allocational and distributional mechanism, and that governments emerge to correct the failures of markets. In the other camp we find those who claim that markets perform well and the governments are at the core of the most economic problems.

A view of government's intervention as the remedy for market failures is best known from Musgrave's (1959) three-fold classification of the objectives and the administration of fiscal policy and budget: *allocation and provision* of some goods and services not provided by market actors; *distribution* dealing with taxes and transfers, and stabilization, or maintenance of a high but noninflationary level aggregate demand and employment in the economy – all of these interventions with the aim to achieve the socially desirable or a more just outcome (c.f. more just distribution of income, well-maintained transport infrastructure and healthy environment, etc.). The existence of transfers as an instrument for governments to correct (mitigate) imperfections of market mechanism is justified by similar, economics-based arguments.

Nevertheless, the operation of governments is not free of other than economic concerns. In what follows, any discussion about the way how government function should involve aspects of political economy.

In this paper, first I shortly present the classical arguments justifying the existence of public interventions. Next, I provide a literature review on government failures, thereby presenting some classifications of these imperfections. In the third section I call upon the literature in public finance and public choice to arrive at a typology of government failures. Finally, the conclusion summarizes the typology of government failures and puts forward some considerations with regard to further research.

I Classical Justification of Government Interventions

The fundamental theoretical question behind public policymaking is: Why do we deal with it at all? – Alias, what is its ultimate goal?

There is a line of economic arguments based on welfare economics that provides justification for public-interest minded government actions. Public interventions into market processes are welcome under particular circumstances – namely, when markets fail to reach the socially efficient outcomes (alternatively, when markets fail to emerge at all).

Market imperfections are observable due to structural, informational problems, external effects in production and consumption, or as a result of the strategic behavior of market actors.[1] Any rigidity in markets (e.g. low mobility of labor force) or any asymmetry among the actors (see actors with significant market power or with unequal factor endowments) is usually classified as structural problems. Informational problems may arise due to uncertainty, i.e. incompleteness and/ or complexity of information. Uncertainty results in unexpected events that can not be accounted for *a priori*. Examples are asymmetric shocks that bring about regional imbalances and result in depressed regions. Negative externalities in production and consumption lead to suboptimal outcomes. As examples, one may refer to underinvestment in environment-friendly or in state-of-the-art technologies. These frictions play an important role in economic development and may result in diverging development paths.

Welfare economists suggest that there is a need for intervention by a benevolent, omniscient, entity with the omnipotence to enforce and compel the actors to achieve socially beneficial outcomes. Traditionally, this entity is the central agent – the state that pursues policies in line with the public interest. These policies are usually analyzed on the basis of such normative concepts as efficiency, equity and fairness. It would lead us far to present all the theoretical dilemmas connected to these concepts, to their appropriateness and to the trade-offs among them. Nevertheless, it is necessary to note that the core question concerning (regional) development policy is inherently connected to these concepts.

[1] For a good overview bringing together the theories and a variety of the empirical appraisals concerned with market failures, see Cowen and Cramption (2002).

To what extent is a central agency capable to enhance growth and development in a given geographical territory by public interventions? The classical theories of growth and development suggest that market mechanisms – left to themselves – will lead to convergence of income in the long term.[2] The frictionless market approach predicts the equalization of economic performance in different regions. In this framework the role of a public agent is minimized – classically to the protection of property rights and individual rights. Note, however, that these theories are not able to explain many empirical observations – such as the uneven distribution of economic activities in originally plain, homogeneous territories.

As next candidates, theorists of new economic geography offered different answers. In these models the sc. agglomeration and centrifugal forces counteract in an equilibrium framework leading to spatial convergence – provided some strong assumptions on transportation costs and factor mobility. In what follows, justifications for still carrying out regional policies exist due to market failures.

The traditional form of government intervention was industrialization policy (see heavy sector-focused subsidization). Recently, there was a shift in public policy to more indirect methods. These include policies that facilitate market mechanisms by means of e.g. building infrastructure (reducing transportation costs and time), solving environmental issues (promoting investments in eco-friendly technologies), providing incentives for labor mobility, or by pulling in private investment (leverage effect of public investment projects).

Interestingly, advanced models in new economic geography demonstrate cases when public interventions (such as fiscal transfers, public investment in infrastructure) might not necessarily be helpful, or even may actually be harmful *via* strengthening polarization – *e.g.* by only concentrating on reductions in transport costs between core and periphery. Consequently, these models suggest that symptoms like congestion, regional inequalities and income divergence among regions should be taken for granted.[3]

[2] See endogenous growth theories, Romer (1986), Lucas (1988), Grossman and Helpman (1991).
[3] For interested readers, see Krugman (1992, 1994). For a good overview of related studies in development economics, see Rodwin and Schön (1994).

Still, one may argue that any public intervention – *e.g.* transferring money in form of special purpose grants - is suggested as far as the derived direct benefits of such transfers overweight the loss of efficiency due to market imperfection to be corrected.

Based on other normative principles, such as equity and fairness, redistributive public policies are recommended to encourage agglomeration effects in less developed regions. In this sense, these policies are designed to block depopulation and/ or at least to slow down the divergence among regions (as „third best"). The emphasis here lies on the provision of equal development opportunities – *i.e.* the promotion of horizontal equity.[4] Traditionally, horizontal equity is interpreted as equal right to access to any goods and services (for example, public infrastructure, education, health care, or good local government).[5] Transfers aimed at promoting investment in infrastructure, human capital or at enhancing labor productivity in depressed regions represent the indirect modes of intervention, primarily objected to facilitate market mechanisms and enforce development of backward regions.

Within the European Union the idea to launch regional development policies, most prominently to allocate transfers to backward regions is backed to a mix of these theoretical considerations. Expert views supported by the European Commission say the EU structural policy should speed up the convergence process between the more and the less developed countries and regions. The major arguments in favor of regional development transfers point to the benefits of increased economic and social cohesion among the member states *via* promoting a faster catch-up process of the less developed regions.[6] Along with the objective to bring about economic convergence among EU regions (measured in terms of per capita income), there is the desire to ensure equal chance to access to public infrastructure, to financing resources, and to innovation opportunities independently of the geographical location. In the next section let me briefly stylize some facts and give a short introduction into EU regional policy framework.

II Towards Theories of Government Failures

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[4] For the original concept of horizontal equity, see Musgrave and Musgrave (1989), Barr (1993).

[5] In public finance, education and health care are usually categorized as merit goods, provided by the paternatlistic state. For related arguments in development context, see Stiglitz (1998).

[6] See European Commission (2001, 2003, 2007).

It is a fact, that every single enlargement in the EU has eventually brought about an increase in the amount of public resources devoted to regional policy. The aim of the even stronger social and economic cohesion is explicitly incorporated into the Treaty of European Union (Article 2) and was further emphasized in Agenda 2000. The Structural Funds (SFs) are the principal instruments chosen to achieve this objective, and the EU fundings are meant to serve as a leverage effect on public investments in the related countries.[7]

The scale of the EU spending on sc. structural operations has been substantially increased over the years since the first reform in 1988. Over the period 2000-2006 the budget for regional policy was EUR 215 billion and it increased to EUR 490 billion in the recent programming period (2007-2013). The sums transferred to EU countries ranged between 0,9 and 2,5 % of the national GDPs. More than half of the fundings in the period 2000-2006 has gone to the sc. Cohesion countries (Greece, Portugal, Spain, Ireland), and EUR 21 billion to the new Member States.[8]

The operation of the SFs is governed in accordance with operating principles, such as complementarity to national actions, multiannual programming, partnership, proportionality of interventions, shared management between the Member States and the Commission. The SFs are mainly used for infrastructure development, productive investment, local and regional development as well as for improving human resources and promoting environment protection.

In principle it is prescribed that the sc. operational programs that are designed by the member states/ regions to allocate the fundings are complex economic and social development packages (*cf*. programs should be in line with and reinforce regional and national development plans). Simple subsidizing of individual firms or providing income subsidies to poor people are not allowed and considered.

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[7] Four separate funds constituted the Structural Funds up to 2006, each of them administered by different Directorate Generals in Brussels: European Regional Development Fund (ERDF), European Social Fund (ESF), European Agricultural Guidance and Guarantee Fund (EAGGF), Financial Instrument for Fisheries (FIFG). As a result of the revision of EU regional policy framework in 2006, in the new programming period the funds have been integrated and its number decreased. For further details, see the website of the Directorate General for Regional Policy: http://ec.europa.eu/regional_policy/index_en.htm.

[8] Before 2004 the sc. accession countries have received assistance from special programmes funded by the Structural Funds – such as the ISPA for assisting transport and environmental projects, the SAPARD for agriculture and rural development, and the PHARE for strengthening economic and social cohesion, and administrative and institutional capacities in the given countries.

The operative management is carried out by national and regional authorities, not by the EU Commission. The co-financing element required by any EU funding mechanism differs across the assisted areas - however, generally one quarter is at least expected per each program.

The stakes are not small. Financial resources dedicated to structural operations in sum varied slightly around on third of the EU budget in the last periods. While the Cohesion countries received on average 2,3 % of their GDP per year during the 1994-1999 period[9], and the new member states will receive between 1,7 – 2.9 % of their GDP per year in the period 2006-2013.

The capacity of member states and their regions to absorb such large-scale transfers in a productive way is in fact an issue occasionally investigated and questioned. One of the seminal studies investigating theoretically and empirically the absorption problems is provided by Herve and Holzmann (1997). Different evaluation studies and reports have been prepared and published by the European Commission or by consultants working in charge of the Commission that focus on the question whether the main goal of EU structural policy – economic and social cohesion, real convergence between Member States and their regions – is taking place at all.[10]

Nevertheless, the assessment and summary of the academic and practical debates on the huge topic of regional convergence is not the goal of this paper. Instead, the focus lies here on the efficiency problems related to Structural Funds.

Absorption problem is usually defined as the case when any recipient country/ region fails to achieve 100 percent of its target value programmed *a priori*. That means the administrative capability of a country or a region to deliver and implement the given operational program is not perfect. Certainly, this approach is strictly input-oriented, ignoring the original idea behind regional policy with the goal of economic convergence.

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[9] The SF share of these four countries between 1994 and 1999 was 57,4 per cent in average. Spain was the recipient of the largest nominal amount, though the others received more in terms of per capita assistance. For further details, see Boldrin and Canova (2000).

[10] See, for example, CSES (2003), Bradley et al. (2001), Beutel (2002), Ederveen et al. (2006), European Commission (2001, 2003).

In addition, Herve and Holzmann (1997) provides also an output-oriented definition – namely, any deviation from the potentially highest growth path (*cf.* hypothetical optimal growth potential) can be conceived as an effect of absorption problem.[11] In both approaches the gap between the targeted optimal and the measured real values (in investment or in marginal outputs) is reflected in the sc. absorption rate. The formal evaluation practice in the EU measures absorption rates to assess the progress of fund management, and looks at the results of specific Structural Fund spending in relation to financial and policy targets.

It should be noted that the existence of absorption problems may not necessarily contradict the theoretical suggestions for transferring public money to countries and regions lagging behind, since all of these indicators fail to measure and assess the rather indirect macroeconomic effects of such transfers. Obviously, there is room for further analysis to assess the efficiency and effectiveness of EU transfers. This, however, lies beyond the scope of this paper.

In sum, we can claim that both EU reports and academic studies suggest that absorption problems regarding the EU Structural Funds may well be important. While staying with the assumption that transfers can foster economic development and thus at least some convergence, the main interest here is to investigate the kinds of absorption problems that can lower (hopefully no completely diminish) the efficiency of EU funds. In the following section a possible typology of absorption problems is provided – relying on the excellent overview of these problems by Herve and Holzmann (1997), however, elaborating a different typology based on the concept of government failures.

III Government Failures – Proposal for a Typology

Substantial literature in political economy and public choice has questioned the classical presumption of welfare economics on the benevolent, omnipotent and omniscient public actor (cf. government). What are the consequences of assuming that public actors charged with

[11] The method of calculation is as follows: the ratio of the present value of additinal output in the suboptimal growth path and the present value of additional output in the optimal growth path indicates the relative efficiency of Structural Funds intervention and thereby the scope of the absorption problem. The results range between 1 (no absorption problem) and an undetermined lower end which can be 0 (total inefficiency of transfers) – or, under certain circumstances, even negative in case transfers turn to be detrimental to growth.

allocation of fiscal transfers are not omniscient, or not benevolent and/or not omnipotent, respectively? Governments might be subject to failures as much as markets are.[12] By assuming the existence of government failures, here I claim that a significant part of absorption problems emerge due to government failures.
I suggest to cluster government failures in the following way:

i. *fundamental/ informational failures* - resulting from the lack of omniscience on the part of public actors,
ii. *institutional failures* – stemming from the arrangement and the organizational characteristics of public government, cf. its 'limited potence'[13], and
iii. *motivational failures* – relevant due to the lack of benevolence.

The first type of failures is basically due to severe informational problems in the form of uncertainty, complexity and asymmetry in information possessed by the relevant public actors. The source of the second type of failures is actually the non-existence of a perfectly organized government. Real-world government decision-making and implementation may suffer from inefficiencies unlike the first-best world (black-box) governments. Thirdly, opportunist and not public-interest-oriented agents may take over public decision-making positions and may dominate decisions on transfer allocations.

Consequently, the question arises: Whether the allocation of public transfers (~ government intervention) is the necessary - however, not certainly sufficient - method to stimulate national/ regional growth (~ to correct market imperfections)? The answer is conditional yes.

As suggested by positive theories both in economics and political science any government intervention can be justified as far as governments operate at less costs than any other

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[12] The term 'government failure' appeared first in the seminal paper of Wolf (1979). For a good overview on the related literature, see LeGrand (1991).

[13] The term 'limited potence' is interpreted here as the power of governments constrained and controlled by constitutional principles, by constitutionally guaranteed mechanisms (division of power, checks and balances, delegation and the consequential bureaucratic control mechansims, decentralisation, etc.), or even by civil control (cf. concept of partnership in case of EU structural fund programming and management).

corrective alternative (necessary condition); and the efficiency gains from public intervention overweight the related costs respectively (sufficiency condition).[14]

The consequences of informational failures – such as, the not intentional miscalculation, misreporting and misadministration by grant-giving and –receiving authorities – may be severe. In this paper I rather concentrate on failures of institutional and motivational type that may emerge at programming and managing Structural Fund allocations and during implementation of transfer policies. I do it for two reasons. First, informational failures are almost inevitably present and they strongly intermingle with institutional and motivational failures. Second, both institutional and motivational features of governments and public actors may be rather country specific – that provides a challenging task for comparative analysis and a sound base for country case studies.

Institutional failures

1. Administrative failures

To put it simply, the recipient country or region may lack administrative capacity (sufficient number of personal and staff) and experienced management capacity. As a result, they can not devote all the external funds for actual productive capital investment. Even though such problems are in the center of many evaluation studies, this aspect is often neglected in the academic literature. The most prominent examples of such failures are incomplete or overoptimistic planning (e.g. too ambitious policy goals and target values, lack of well-defined policies), red tape in administration, public management problems.[15]

These problems can be solved in the longer term by improvements in bureaucratic efficiency (increased technical efficiency program administration, training, exchange and networking of fund management experiences and good practices, etc.). Nevertheless, programmers may not forget that such improvements are cost- and time-consuming measures.

[14] Usually, this argument is accompanied by references to economies of scale and scope in the coordination and provision functions fulfilled by public governments (Hardin, 1987), or to the mutually beneficial gains due to having a „Protector” and „Enforcer” of proprty rights and contracts (Klein et al., 1997).

[15] Skouras *et al.* (1996) give good examples for such institutional failures from the Greek experience.

Notably, the EU followed a smooth practice with the Cohesion Countries and the new Member States – namely, the EU funds have been phased in gradually, starting from a low level and adjusted upwards.

2. Principal-agent problems

Government organizations are characterized by various agency relationships. These relationships are often more complex in the political arena that in the business world. It might not be so clear who is whose agent. Government offices and authorities (*cf* government agencies) are usually created as part of the legislative and executive branches of the state. Often they operate under the supervision of a minister, but they can also be accountable directly to the parliament or the prime minister himself. Unfortunately, the lines of authority and accountability might be rather blurred.

The governance of Structural Funds varies widely within the European Union. Member States are allowed to establish the prescribed authorities (see management, audit, and payment authority) with their own autonomy. Delegating decision rights on fund allocation, monitoring rights, financing and auditing competencies partly or completely to the national or regional levels is based on the principle of subsidiarity. In what follows, we can observe management authorities both at national and regional levels (see central offices and local offices).

The resulting institutional arrangements may represent excellent examples for multiprincipal agencies[16] - with eventually overlapping competencies, conflicting policy goals and interests.
For example, the priorities emphasized by line ministries/ ministers or by regional agencies may significantly differ from those stressed by a central government planning body. Such considerations, as of solidarity or populist fiscal expansion for re-election purposes, may often play a significant role, since all kinds of investments can have a short run positive effect (*via* increased local/ domestic demand). This type of conflict of interests may arise in both ways – election-biased central agencies or election-biased local officers.

The multiplicity of policy priorities (due to multiplicity of political goals) may lead to biased policy choices (*e.g.* economically inefficient investment-mix). Not surprisingly, there are

[16] For multiprincipal agency models, see Dixit (1989) and for insightful stories from the US government context, Wilson (1989).

views among experts that the ever-increasing structural transfers are in fact the signals of ongoing political bargaining games.[17]

In addition, inconsistencies in delegation may pose severe challenges – think about the case, giving full discretion to a regional body in deciding transfer allocation, but limited degree of freedom in financing decisions.

At the same time, there might be (and there are actually) overlapping competencies even at the EU level regional policy implementation (see the overlapping competencies of the different Directorate Generals whose approach and management style can differ causing a non-transparent system in the best case or institutional stalemates in the worst scenario. Notable, time and time-consuming investments may be lost in this way.

One has to note that fundamental informational problems are hardly to ignore here. Local actors (private or public, eligible for structural funding) have more precise information and knowledge on local development needs in many cases. There is a possibility both to hide and misreport relevant information, but also to calculate program parameters (*e.g.* expected private and social rates of return) with more precision. For program managers sitting in central offices the distinction between these two scenarios is far from being clear-cut.

As an example, we can take environmental investments: for the transfer-giving authority (principal) the estimation of the economic value of projects is very complicated due to the long time lag between the decision on and the realization of the project. The confidence in the calculated values is questionable – the burden of proof *ex ante* is not so strong (consider the potential spillover effects of the given investment). As a consequence, there is a possibility of moral hazard on the part of the beneficiaries.

Consequentially, there is no clear solution to the monitoring and controlling problems. Deficiencies in monitoring and controlling might be irreducible due to informational problems, but also due to free riding in monitoring, or shifting responsibilities respectively. (I will return to this latter issue later.) *Ex post* project evaluations are complicated. Both

[17] See Begg's (1999) discussion on the „fine political process" of allocating the EU funds among Member States and elaborating the related EU regulations. He claimes that the Funds have to reconcile several political economy aims, some of which contradictory in themselves. (p.15)

informational shortages and cost-restrictions make it difficult to design fully efficient monitoring and sanctioning mechanisms that would induce recipients to truthful revelation of their expectations (*e.g.* on the expected returns of assisted investment projects).

Motivational failures

3. Rent seeking

In case of public financial flows, some forms of rent seeking are almost inevitable. Rent seeking efforts are, however, unproductive only if they reduce capital formation by diverting resources to unproductive activities – alias, if private and/ or public actors pursue their own interest to gain individual benefits from discretionary decisions at the disadvantage of all the others. It is known from public choice literature that rent seeking may have the characteristics of increasing returns to scale. Several factors can possibly influence its magnitude; however, its costs can also increase more than proportionately with the amount of rent. [18]

In the EU SF context we can think of three levels where rent seeking might eventually emerge. First, there is a run of national governments for obtaining higher share from the Brussels funds. Second, there is a room for rent seeking in the national context, between central and local governments – in the case if central government plays a role of the central allocator of fund assistance and at the same time the mediator between the regional/ local governments. The regional/ local officers are interested in additional transfers and co-financed programs. Third, rent seeking might take place between any governmental body and the private actors. Private agents may collaborate not only as transfer-receiving actors (*e.g.* supported IT firms, tender-wining construction companies), but they may be partners in consultancy, auditing and training. Unfortunately, there are few empirical investigations on rent seeking because of measurement and assessment problems. Yet, there is no investigation pursued especially for the EU SF context.

The chance of unproductive rent seeking can be lowered by increased transparency in public decision making and operations. We may not forget, however, that along with institutional conditions political, cultural features of the given country and region may play important role in the predominance of rent seeking.

[18] For papers conceptualizing rent-seeking, see Tullock (1967), Krueger (1974).

In the case of the new Member States this basically Olsonian group phenomenon is certainly to be kept in mind. Especially, if we know that after big depressions at the start of the transition most of these countries are experiencing a longer period of rapid growth. Consequently, the constantly improving economic (and social) context favors the emergence and the continuous reorganization of interest representation. *Nota bene*, the changes in the distribution of lobbying powers also lead repetitive conflicts that unfortunately may feed back negatively onto the economic performance.

4. Timing related problems

In the EU context the first and foremost timing problem is the long time lag between project design and actual implementation, partly resulting from the institutional rigidities in the SF allocation process (see *e.g.* no advanced reimbursement of investment costs). The delay in implementation may lead to also to non-optimal growth path.

In addition, the fact is often neglected in the EU evaluations that completed projects often continue to require further funding – as generally being long-term investments in (quasi) public goods. Actually, countries/ regions which are not able to spend all the transfers for the programmed investments in the given fiscal years are considered to have absorption problems (as defined in the II section above). As a consequence, the recipient countries/ regions understand well that such a „failure" can lead to the suspension of Brussels financial streams. Logically, they might be biased in their motivation to spend all the calibrated grants within the planned auditing period, regardless of the insight whether this push-out of assistance is reasonable in strictly economic sense. The deadweight loss of such supported investments might be significant. Unfortunately, no empirical investigation tried to asses yet this loss.

5. Shifting responsibilities

As was mentioned above, blurred lines of delegation and unclear assignment of responsibilities might give rise to tensions among different government actors involved in the management of EU funds.

Further, there could be an inherent conflict of interest between central and regional or local authorities. Whereas regional and local governments in most of the countries are not responsible (directly) for macroeconomic variables such as growth, unemployment or inflation, their investment preferences might differ and usually do differ from the socially (nationally) optimal ones. Their decisions - even not intentionally - might have significant positive and negative spillovers at the macro level. In case regional growth or unemployment deteriorates, however, authorities at the lower level might have an incentive to shift responsibilities for the unpleasant outcomes and turn the central level agencies the scapegoats.

Beside the short-listed, potential institutional and motivational failures some further points concerning the macroeconomic effects of fiscal transfers should also be briefly considered. First, public investments and infrastructure development projects are by definition long-term projects, as returns appear only on longer time horizon. In practice, however, these investment decisions have not insignificant opportunity costs realized in the short run, such as delays in private investment decisions due to increased uncertainty ('waiting for decisions on grant') or to modified expectations, or crowding out of private investments by the public sector. Second, another related side effect of fiscal transfers already in evidence for developing countries is that while recipient governments aim to satisfy co-financing requirements, they neglect the maintenance of their own capital stock.[19] Third, transferring money to needy regions, localities might be beneficial only if these sums do not generate dramatic shifts in domestic/ local consumption patterns – *i.e.* if the transfers do not trigger sc. 'income shocks' in the given territory.[20] Last, but not least, when transfers through excess demand effects in the non-tradable sectors generate upward pressure on the overall wage and price level, and eventually deteriorate competitiveness of the tradable sectors is unquestionably harmful for growth. Some empirical evidence suggests the existence of this sc. Dutch disease-type macro effects in Spain, Portugal, and Greece in the late 1980s and early 1990s, though with the exception of Ireland.[21]

In the EU context the fact that money amounts allocated to one or the other member state are fixed well in advance and national governments can calculate on them for 7(+2) years in advance trivially affect their political strategies. Presumably, prospective future transfers give some leeway and provide the possibility for delaying necessary structural adjustment. This phenomenon highlights again the point from above (motivational failures): politicians, decision makers, politically captured bureaucrats can be biased in their incentives to achieve short term gains from regional policies at the costs of planning and programming long-term

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[19] For more on this issue within the literature on international aid schemes and development transfers, see Stiglitz (1998), Hall and Jones (1999).
[20] For details on the impact of transfers on the intertemporal consumption-investment pattern, see Barr (1993).
[21] See, Herve and Holzmann (1998, p.78).

structural reform steps (for example, government institutional reform both at national, regional or local level, education, health care or pension reform). Even more, Objective 1 criteria of eligibility of EU funds (regional GDP being lower than 75 percent of EU average) might induce public actors to opt for a slower development (for example *via* less investment, more consumption) in order to receive allocations from EU Structural Funds even longer. Notably, these are mere intuitive speculations, no empirical investigation confirm or reject them, yet.

IV Conclusions

Two caveats ahead: first, the typology of absorption problems based on the conceptual framework of government failures might no be complete at this point. Still, it may help to structure discussion and to design case studies in an appropriate way. Second, without further analysis and detailed case studies it is more than challenging to draw conclusions and make proper policy recommendations now.

Nevertheless, I think that some lessons and experiences drawn from the Cohesion Countries may provide useful „benchmarks" in the endeavor of assessing the extent and types of absorption problems in the new Member States.

Policymakers and –planners often neglect or underestimate institutional and motivational failures on the part of (central or local) governments, however, these factors might be among the most significant distorting ones. Some of the problems are inherent to the public sector and the political arena, the negative consequences of some others, however, can be minimized.

Particular attention could be given to minimizing the possible motivational problems in the administration of EU funds. The effective use of financial allocations requires partnership and enhanced civil control, *i.e.* the involvement of social partners, NGOs and the private sector on the one hand, while a stronger willingness to collaborate and cooperate within the public sector, on the other hand. In countries with centralist traditions and weak civil sector it is more than challenging to give birth to such control mechanisms.

The need for co-financing might also enhance ownership and commitment at national and regional/local actors – although it is questionable whether this requirement can easily be met by most of the (potentially eligible) government authorities (see in case of depressed budget of local authorities).

Remarkably, the EU has also recognized the need for longer adjustment of the less developed regions/ countries with regard to administrative capacities. Additional community instruments have been designed and implemented to assist institutional development (fund managing authorities), to train civil servants, and in the case of new Member States financial allocations are slowly phased in (see slow increase of the sum of yearly allocations through the seven years programming period).

Finally, some preliminary results on the relevance of absorption problems in the case of Hungary. Regarding administrative failures: it is strongly recommended to develop administrative capacities at every level of public government in Hungary. This deficit is partly still the legacy of transition, but also the consequence of the permanently ongoing, still unfinished public administration reform in Hungary. Training officials to enhance their ability to program, manage, monitor and evaluate transfer operations is an unavoidable task. Based on the experiences in the pre-accession period and in the period 2004-2006, there is evidence of absorption problems due to inappropriate public investment projects design, red tape in administration, weak controlling mechanism on the part of the fund managing authorities (see no allocation of committed funds to public transport investment projects). Correction for these shortcomings, such as learning and implementing modern management skills (monitoring, multi-year programming and prioritizing), as requested by the EU, generally takes time.

As concerning the principal-agent problems of institutional type: first and foremost the internal organization of government should be reconsidered in order to constrain the negative consequences of overlapping and often inconsistent competencies. To shortlist just the major inconsistencies in the Hungarian institutional setup: unclear separation of county's/ region's roles and responsibilities, low willingness for horizontal and vertical cooperation both at the national level and at the national-regional context. We may conclude that there are overlapping competencies both at the central government level (see line ministries contra the National Development Agency) and at the national-regional level (see the National Development Agency in partnership with the Ministry in charge of local governments and regional development versus the regional/ local authorities and bodies). Overlapping competencies and the lack of clear-cut decision-making process result in unwillingness to share information and cooperate, or even in shifting responsibilities respectively.

With respect to EU funding there is inevitably a lot of motivational type of failures involved. It needs further detailed analysis to assess the risk of rent seeking in the Hungarian case. Interviews and document analysis should focus for example on the investment financing regulation at the local government level, on the procurement regulations, on the degree of transparency of public reporting on the management of EU funds. One may easily predict that rent seeking opportunities open wider with the start of the new programming period due to the increased amount of EU funds allocated to Hungary.

As far as timing related absorption problems are concerned: experience from the previous periods suggest that dealing with the EU bureaucracy needs many time and may causes severe time lags and delays in project management. Many of the beneficiaries (primarily local governments) have very poor sense of financial rationality the signal of which is the negligence of the future financial needs (maintenance costs) of given public investment projects.

This paper attempted to give a new typology of possible transfer absorption problem and a first-flush assessment of the Hungarian situation. Certainly, there could be further ideas taken from public choice literature to be relevant for the EU fund management (*e.g.* adaptation of cycling majority thesis in elaborating national development priorities, time inconsistency problems in managing structural fund operation throughout the political cycles, strategic behavior of line ministries, regional and local authorities, etc.) that are left out at this stage of the research, however, kept in mind for later discussions.

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