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CONTRACTING FOR STRUCTURAL FUNDS

How the EU's rules of the game shape the behaviour of Member State governments

HÉTFA Research Institute

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TABLE OF CONTENT

ABSTRACT	3
1. INTRODUCTION	4
2. RELATED LITERATURE	7
3. THE FUNDAMENTAL CONTRACTUAL LOGIC OF THE EUROPEAN UNION.....	10
3.1. Viewing the European Union through the Lens of Contract	10
3.2. The European Union as a Principal–Supervisor–Agent Relationship.....	10
4. THE CONTRACTUAL LOGIC OF EU COHESION POLICY	14
4.1. Applying the Principal–Supervisor–Agent Framework to Cohesion Policy	14
4.2. The Character of the Commission–Member State Contract for Spending Structural Funds	17
5. CHALLENGES FOR THE MEMBER STATE ARISING FROM ITS CONTRACT WITH THE COMMISSION	18
5.1. Does the contractual form fit the transactions between the Commission and the Member State?	18
5.2. The Member State’s dilemma: absorption versus policy effectiveness.....	22
6. CONTRACTING FOR THE IMPLEMENTATION OF COHESION POLICY WITHIN A MEMBER STATE .	25
6.1. Choosing agents within the Member State: Differentiated versus integrated implementing organisations.....	25
6.2. Designing contracts for agents within the Member State: Projectification versus insulation from project logic.....	27
7. HYPOTHESES DERIVED FROM THE CONTRACTUAL MODEL OF EU COHESION POLICY	30
8. CASE STUDY: HUNGARY AND THE STRUCTURAL FUNDS – A COUNTRY OVERWHELMED BY (VERY) LARGE FUNDS.....	31
8.1. Methodology	31
8.2. The goals of national government: the primacy of absorption over policy effectiveness.....	32
8.3. Choosing agents: the creation of an autonomous field of ‘development policy’	36
8.4. Choosing contract design: the tide of projectification.....	38
8.4.1. Employment policy	39
8.4.2. Higher education policy.....	40
8.4.3. Summary of findings about contract design	42
8.5. The distortive effects of projectification: indicators, high and low.....	42
9. CONCLUSIONS AND RECOMMENDATIONS FOR INSTITUTIONAL IMPROVEMENT	44
10. REFERENCES	46
ABOUT THE AUTHORS.....	52

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ABSTRACT

How do the rules of the game of EU cohesion policy shape the behaviour of Member State governments as they pursue their development goals? We explore this question from a contractual perspective. We argue that the analysis of the contract between the European Commission and a national government is crucial for understanding the latter's incentives. And the terms of this contract are largely determined by the underlying principal-supervisor-agent contract between Member States and the EC. We pursue the consequences of the Commission–Member State contract for the institutionalisation of cohesion policy within the Member State, which is interpreted as the creation of a chain of agency contracts. We show both theoretically and with an empirical case study that the resulting contractual system affects the policy process in fundamental ways. Drawing on the insights of new institutional economics, the analysis of contracts detects some deep-seated causes of widely-perceived inefficiencies of EU-funded policies and points to potential institutional remedies.

1. INTRODUCTION

In several Member States in Eastern Central Europe, EU Structural Funds amounted to over 40 per cent of government capital expenditure between 2007 and 2013 (EC 2013a). In the most supported countries, the overall share of programmes financed by Structural Funds peaked around 10 per cent of the national public budget.¹ This offered an unprecedented development opportunity. However, taking such an opportunity is a massive challenge for any government. Earlier analysis showed that even much smaller amounts of EU Funds required a ‘high-quality’ institutional environment to be effective (Ederveen et al. 2006). The experience of developing countries outside Europe suggests that larger inflows of external support further increase the strain on existing institutions and even raise the sceptre of ‘resource curse’ (Harford – Klein 2005). Therefore, the literature on foreign aid has turned its attention to the incentives of national governments and other agents in using monetary resources from external donors. Apart from internal political and administrative ‘rules of the game’, the contractual relations between donors and beneficiaries have been identified as the key source of these incentives (Brautigam – Knack 2004; Martens et al. 2004; Paul 2006; C. Williamson 2010). EU Member States also receive the Funds’ resources in the framework of contracts with the European Commission. In this study, we examine how these contracts influence the behaviour of national governments.

Our central thesis is that the contract between the European Commission and a Member State is one of the keys to understanding a national government’s main dilemmas concerning the use of Structural Funds and its internal institutional response to their receipt. We further argue that the terms of this contract are intimately linked to what might be termed the underlying constitutional contract of the European Union. According to Tallberg (2003), at the heart of European integration is a principal–supervisor–agent contract between national governments and the EU’s supranational organisations. Member States as initial principals employ the European Commission and the Court of Justice as supervisors of the implementation of multilateral agreements by themselves as agents. In this perspective, a national government’s challenges in cohesion policy arise as it must comply with its supervisor–agent contract with the Commission, whose terms are largely determined by the principal–supervisor contract between Member States as a group and the Commission. And these challenges can only be tackled by further contracting with implementing organisations and, through them, with final beneficiaries within the Member State.

We develop a theoretical model which tracks the contractual chain of EU cohesion policy. The model discusses the origins and the rationale of the contract by which Member States delegate the task of supervision over Structural Funds to the European Commission. It then proceeds to identify the consequences of this contract for the supervisor–agent relationship between the Commission and a Member State. We argue that the consequences follow from the principals’ effort to enable the supervisor to fulfil its tasks but prevent it from misusing its prerogatives. Member States protect their sovereignty by (i) retaining the rights to decide about budgetary appropriations

¹ See our calculations for Hungary, presented in Graph 2 below.

for strictly limited timeframes and (ii) delegating implementation to themselves while allowing the Commission to verify their compliance with administrative rules and negotiated performance indicators. The outcome is a project-form contract which expects the Member State to produce finite, specific and verifiable objectives within a limited timeframe. We argue that the character of this contract is the main reason for the general ‘projectification’ of cohesion policy (Sjöblom et al. 2006).

The project-form contract focussing on verifiable outputs is an important constraint on the government of a Member State. We draw on new institutional economics to explain that such a contract is ill-suited to policies whose true results cannot be captured by short-term quantification. This leads to a tension between formal compliance and policy effectiveness. Since resources are tied to formal compliance, the Member State faces a trade-off between ‘absorption’ and policy effectiveness. We further argue that a national government’s contractual choices within its jurisdiction depend on the relative importance attached to these two goals. Although governments respond in diverse ways, our model predicts certain contractual patterns. We examine (i) which organisations are contracted as implementing agents, and (ii) how their contracts are designed. Our key finding is that a preference for absorption over policy effectiveness leads to (i) contracts with differentiated (as opposed to integrated) agencies and (ii) the use of project-form contracts along the entire contracting chain (as opposed to at least partial insulation from project logic).

The projectification of the implementation process mediates the potentially distortive effects of the project-form contract between the national government and the Commission to the final agents of implementation within the Member State. Several recurring problems identified by programme evaluations, such as short-termism, excessive risk-aversion and undue focus on formal indicators are thereby linked to the inherent contractual logic of cohesion policy and, ultimately, the European Union. We also identify potential solutions to mitigate the distortive effects. One such solution is to downplay formal project requirements and allocate resources to beneficiaries who face appropriate incentives outside the projects, e.g. thanks to ownership or reputational concerns. Another is to rely on the existing non-projectified contracts within sectoral or regional administrations while developing their internal capacity to produce verifiable information required by the Commission.

Our model builds on the principal-supervisor-agent approach developed by Tallberg (2003) for explaining the institutions governing the EU’s Single Market. We apply the reasoning to cohesion policy and extend it to the contractual chain of lower-level agents employed by national governments within their jurisdictions. By doing so, we contribute to the literature on the ‘Europeanisation’ of public governance in Member States (Graziano – Mink 2007). So far Europeanisation has not been linked to the fundamental P-S-A logic of the EU, and the consequences of the formal project-form contract between the Commission and the Member State have received little attention. Although some authors have identified projectification as a key feature of cohesion policy at national and subnational level (Sjöblom et al. 2006; Kovách – Kucerová 2009), they did not rigorously link the phenomenon to the underlying constitutional contract of the European Union.

This study consists of two parts. In the first part, we develop the theoretical model of cohesion policy. In the second part, we present a case study in order to evaluate the theoretical model. The case study is about Hungary’s experience with Structural

Funds between 2007 and 2012. It is used to show that the proposed model offers a plausible interpretative framework for empirical observations as well as to check some of the hypotheses generated by the model. Hungary between 2007 and 2012 can be considered as an extreme case with one of the highest per capita Fund allocations and the almost exclusive funding of all developments in the public sector from EU Funds, partly due to severe economic recession and budgetary austerity. In such circumstances, the contractual dilemmas of Structural Funds should become especially pronounced. They may be present but less conspicuous and dwarfed by national political or administrative factors in countries with significantly smaller allocations. So the extreme case is chosen to highlight the general contractual logic of cohesion policy rather than country-specific mechanisms. Of course, further case studies in other Member States or comparative statistics are needed to test the empirical relevance and validity of our model.

Chapter 2 clarifies the links to the related literature. Chapter 3–6 develop the model. Chapter 7 summarises its main conclusions in the form of empirically testable hypotheses. Chapter 8 presents the case study. Chapter 9 concludes and makes recommendations for institutional improvement.

2. RELATED LITERATURE

Our study is related to several trends in the literature on the European Union. First, many aspects of Europe's political integration have been analysed from a principal-agent perspective (e.g. Pollack 1997; Kassim – Menon 2003; Tallberg 2003; Blom-Hansen 2005). The P-A approach is attractive as it provides a framework which captures both cooperation and conflict among political and administrative actors. It therefore promises to provide tools for exploring actors' relative autonomy and power relations. Not surprisingly, the most discussed issue has been the relative power of Member States and supranational bodies in various policy fields and phases of the politico-administrative process. We believe, however, that the approach has been successful not so much in uncovering elusive power relations² but rather explaining the EU's institutional features as the results of principals' efforts to control agents or the latter's efforts to show credible commitment to principals.

Tallberg (2003) has given the most comprehensive account of the interactions between Member States and 'Brussels' by describing it as a principal-supervisor-agent relationship, as noted above. However, he examined the construction of the single market, and did not discuss cohesion policy. Moreover, he did not analyse the institutions of implementation within Member States. Two studies that did apply the approach to cohesion policy are Blom-Hansen (2005) and Bauer (2006). Both of them focussed on the relationship between the European Commission and Member States in the process of spending EU funds, and asked whether the Commission's tools are effective in controlling Member States as implementing agents. Although these studies are highly relevant, they discuss only one link in the long chain of agency contracts which is our interest here. Another difference is that we view the Member State-Commission relationship primarily from the position of the national government rather than the Commission.

Our study is also closely related the extensive literature on Europeanisation, which seeks 'to assess 'the effectiveness of European-level policies at the domestic level, as well as to understand how new European opportunities and constraints affect national politics' (Vink – Graziano 2007: 3). Although cohesion policy is a much-studied policy field in terms of Europeanisation, most scholarly attention has been paid to its effects on the territorial aspects of governance within Member States. These include changes in the functions and relative power of different levels of government and the emergence of 'multi-level governance' characterised by more fluid, network-type policy making overarching several levels of government (Bache 2008). A prominent explanatory factor for the latter (much debated) phenomenon is the principle of 'partnership' in cohesion policy which offered new participatory opportunities to subnational actors (Marks 1996). We aim to complement this literature by drawing attention to hitherto neglected effects of cohesion policy for the governance system of Member States. We do *not* consider issues of decentralisation but focus on institutional aspects of governance that are relevant for both national and regional development programmes. Rather than focus on partnership, we stress the importance of 'programming', another fundamental principle of cohesion policy.

² See the methodological critique of using P-A theory to identify the relative power of a principal and an agent (e.g. Pollack 2002).

There are a few studies that discuss the institutional details of the implementation process of Structural Funds (see Ferry et al. 2007; Wostner 2008; and references therein). They identify important institutional patterns and dilemmas of programme design and implementation. However, they discuss them as a list of management problems rather than phenomena that can be fitted into an overarching institutional theory of cohesion policy.

Econometric studies about the effectiveness of EU funds highlight the importance of institutional factors. However, they take existing institutions as exogenous factors that influence the utilisation of funds and do not consider the endogeneity of institutions. Moreover, they use variables of very general institutional features, such as corruption, the World Bank's good governance index (Ederveen et al. 2006) or subnational tax autonomy (Bähr 2008).

The literature on foreign aid to poor (mostly African) countries has paid much more attention to the contractual details of contractual relationships between donors and beneficiaries and the consequences of such contracts on public governance in target countries. As a result, getting contractual incentives right is now high on the agenda of aid organisations (Picciotto 2002; Brautigam – Knack 2004; Harford – Klein 2005). By this study, we wish to suggest that both the theory and practice of cohesion policy and, more broadly, the European Union has much to learn from this literature.

Our analysis is also linked to a small but important literature which argues that projects represent a new form of governance, which has proliferated in the public sector ever since it appeared as an innovation in US defence policy in the second world war (Blomquist – Söderholm 2002). Drawing on Scandinavian (Sjöblom et al. 2006) as well as Central European (Kováč – Kucerová 2009) experience, local and regional development programmes financed by Structural Funds are identified as one of the most 'projectified' fields of public policy. The defining feature of projects is taken to be their short-term, temporary nature as opposed to more permanent organisations in the public sector (Sjöblom 2006b). They are viewed as opportunities to involve previously underrepresented actors in the local or regional policy process but also as a vehicle for the emergence of a new class of experts – termed the project class – in local politics (Kováč – Kucerová 2009). Andersson (2009) also summarises some observations about the usual defects of projects, such as the actors' excessive focus on short-term project indicators and the projects' ad hoc nature leading to unsustainable outcomes. He also points to some sources of projectification in EU cohesion policy: (i) the prohibition of state aid to enterprises (going back to the Rome Treaty) encouraged its replacement by 'development projects'; and (ii) the European Union used projects as ad hoc organisation forms (outside existing national structures) to develop its own 'political arena'.

Although we take inspiration from this literature, we discuss the projectification of cohesion policy from a different perspective. We do not discuss projects as a general and arguably diffuse and many-faceted form of governance but focus on them as elements in the institutional system of EU cohesion policy. This allows us to avoid the never-ending discussion about what projects really are. The concept of 'project' is interpreted here as contractual form whose distinguishing feature is the expectation to *produce a verifiable result in a strict timeframe*. We provide a novel and, we think, more rigorous explanation for why and how projects (in this sense) fit into the system of cohesion policy. Another difference is that rather than focussing on the effects of

projects on local or regional society, we are interested in their effects on policy efficiency and effectiveness from the government's perspective. For this reason, we do not view projects as organisations that unite various social actors but as contracts of a special type that provide (imperfect) answers to principal-agent problems in the implementation chain of policy.

Many strands in the cited literature make it clear that actors in the field of cohesion policy are linked through a multitude of formal and informal, horizontal and vertical relationships. Our focus on a single vertical chain of contracts abstracts from most of these and is therefore a very crude simplification. It is certainly not offered as a comprehensive model of cohesion policy but as a partial model which serves to shed light on some important but so far neglected institutional mechanisms.

3. THE FUNDAMENTAL CONTRACTUAL LOGIC OF THE EUROPEAN UNION

3.1. Viewing the European Union through the Lens of Contract

The institutional focus, which we here follow, is in the tradition of New Institutional Economics (or the New Economics of Organisation) (O. Williamson 1975; 1985; Moe 1984). According to Oliver Williamson, the ‘overarching big idea’ of New Institutional Economics ‘was to move from choice to contract: bring the lens of contract systematically to bear on economic phenomena of all kinds’ (2005: 42). An idea which can be extended to political and administrative phenomena (Buchanan 1975; Dixit 1996; O. Williamson 1999). Accordingly, P-A relationships and other forms of delegations should be understood as contracts.

Why focus on contracts? New institutional economics argues that social analysis should pay attention to institutions, i.e. ‘rules of the game or, more formally,... the humanly devised constraints that shape human interaction’ (North 1990: 3). ‘Rules of the game’ are crucial for society because they enable cooperation and the resolution of conflicts. Arguably, contracts should serve as the building blocks for institutional analysis.³ They are the institutions most immediately designed by the parties who wish to initiate and sustain cooperation. By accepting certain rules, contracting parties commit themselves to cooperative courses of action. Contracts are, in turn, embedded in broader institutions (many of which can be explained as multilateral contracts) that facilitate or constrain contracting possibilities.

Contracts should not be understood in a narrow legal sense but much more broadly as ‘set[s] of mutually agreed promises’ that organise cooperation among two or more actors (Brousseau 2008: 37). Contracts in this sense include purely informal agreements. Even unstated but mutually reinforcing expectations can be fruitfully analysed as implicit contracts (Furubotn – Richter 1998). Contracts extend in time and may include rules for searching and selecting partners, negotiating agreements, expressing them verbally or in a written form, enforcing these agreements as well as adapting them to changing circumstances. To use Williamson’s expression, a contract is a ‘governance structure’ (1985) consisting of several interdependent rules.

3.2. The European Union as a Principal-Supervisor-Agent Relationship

The European Union⁴ is a complex contracting effort to facilitate cooperation among nation states. In the anarchic arena of international relations, multilateral agreements among governments must be self-enforcing. Self-enforcement is difficult to achieve because governments face dilemmas of collective action. Often, a government’s

³ The other approach is to start with property rights as building blocks of institutional analysis (Allen 2000).

⁴ Although the use of the name ‘European Union’ is anachronistic before 1993 and should be replaced by ‘European Communities’, we stick to it throughout the text for convenience.

compliance with the joint agreement is rational only if it can be certain that other governments will also comply, which presents a coordination problem. In other cases, free-riding on the compliance of others is the dominant individual strategy, which leads to a quick unravelling of cooperation, as in a prisoners' dilemma with many players (Yarbrough – Yarbrough 1987). One way to overcome these difficulties is to create a specialised agency to coordinate and enforce the implementation of multilateral agreements. The Rome Treaty can be interpreted as a long-term contract by the founding states aiming at cooperation on a wide range of political and economic issues (Doleys 2000). It was a multilateral contract which established its own enforcement mechanisms. The incentive to maintain one's reputation is perhaps the strongest guarantee of interstate agreements. Repeated interaction creates opportunities for both reward and retaliation, which may make cooperation a profitable strategy. However, the founding states went beyond this and created specialised supranational agents, such as the European Court of Justice and the European Commission, to provide coordination and enforcement services. The creation of these new organisations implied a new set of contractual relationships between the Member States and these supranational bodies.

Governments as principals employ EU-level organisations as their agents responsible for both smoothing coordination on agreements on specific issues and helping the enforcement of such agreements. These supranational agents act as supervisors of multilateral cooperation in a broad sense. Principals always want to see their agents act in their best interest. This is difficult to achieve because the information asymmetry inherent in delegation makes room for opportunistic agent behaviour. In the context of politics, this is the fundamental dilemma of both voters delegating power to elected politicians and elected politicians delegating power to bureaucracies. In the European Union, national governments need to assure that EU-level organisations properly fulfil their duties but do not use their autonomy to increase their power at the expense of national sovereignty. As the history of the United States of America shows, it is certainly a historical possibility that a higher-level government created as an agent of states can gradually turn the relationship upside down and become the member states' principal (Josselin – Marciano 2000).

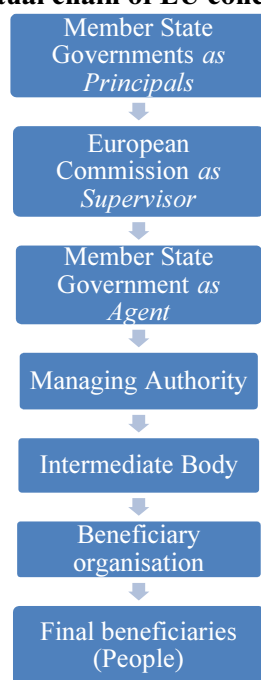
As in other instances of political delegation, Member State principals must place adequate contractual constraints on EU's supranational agents. Legal and administrative scholars call it the principle of limited powers (Siedentopf – Speer 2003). One such constraint is the preserved rights of representatives of national governments (in the European Council) on a broad range of policy making. The other crucial constraint is the strict limits on the Court's and Commission's rights to participate in policy implementation. Although both organisations' rights and de facto opportunities to interfere with national implementation have been enlarged very significantly since the Treaty of Rome, it is still true that in most policy fields Member States bear primary responsibility in their own territories for enforcing EU regulations and implementing policies jointly adopted at EU level.⁵ In the phase of policy implementation, the European Court's and Commission's roles are mostly limited to acting as supervisors of national governments.

⁵ Notable exceptions include monetary policy, the community initiatives of cohesion policy and aspects of foreign policy.

This division of labour in the course of implementation effectively creates a second level of agency relationships: between the Commission and the Court as supervisors and the governments of Member States who act as agents directly responsible for implementing policies adopted at the supranational level. Thus, we have a principal–supervisor–agent relationship (Tallberg 2003), as illustrated in the upper segment of Graph 1. In the supervisor–agent relationship, it is now the supranational bodies which must find ways to deal with information asymmetries and the opportunism of national governments, which have incentives to deviate from policies jointly accepted at EU level in order to reduce compliance costs or pursue particularistic national objectives.⁶

It must be stressed that the supervisor–agent relationships were created and fundamentally shaped by Member States’ considerations in the principal–supervisor relationships which had initially delegated powers to the Court and the Commission. The worries of national governments as original principals led them to attempt to design the contractual features of the supervisor–agent relationships in ways that enable the supranational organisations to fulfil their tasks as supervisors but prevent them from misusing their prerogatives.

Graph 1. The contractual chain of EU cohesion policy (a simplified scheme)



Policies that are adopted at EU level but implemented by national governments are of two basic types: regulations and expenditure programmes. The principal-supervisor-agent approach was developed and successfully applied by Tallberg to the regulatory

⁶ Tallberg (2003) argues that the preferences of EU Member States are threefold: (i) they want to see the proper implementation of Council decisions throughout the EU; (ii) they want to protect state sovereignty and prevent supranational enforcement beyond the minimum necessary; and (iii) they prefer to soften adjustment demands.

policies adopted for the creation of the Single Market. Our aim here is to apply the same approach to Structural Funds, which now make up the largest portion in the EU's budget and serve as the basis of its cohesion policy. Although the regulatory activities of the Court and the Commission, especially in competition policy (Thielemann 2002), are closely linked to cohesion policy, we believe the size and peculiar institutional solutions of Structural Funds justify a targeted analysis.⁷

⁷ Our analysis concerns the European Social Fund, the European Regional Development Fund and the Cohesion Fund. The European Agricultural Fund for Rural Development and other EU funds are not discussed as they differ from these Structural Funds in significant ways. Probably the most important difference from the perspective of national governments is that these funds are available for specific sectors rather 'across the board' for virtually all sectoral policies.

4. THE CONTRACTUAL LOGIC OF EU COHESION POLICY

4.1. Applying the Principal–Supervisor–Agent Framework to Cohesion Policy

The principal–supervisor–agent (PSA) approach to the European Union provides a theoretical framework which can be fruitfully applied to EU cohesion policy. We show that it offers a coherent narrative about why cohesion policy was established as a ‘Europeanised’ policy field, how its institutions developed over time and what are the characteristic details of the Commission–Member State relationship in this field. In terms of the PSA approach, the following questions need to be answered: (i) Why was the Commission delegated a supervisory task in cohesion policy? (ii) What are the contractual constraints on the Commission as a supervisor in this field? (iii) How does the P–S contract shape the S–A contract between the Commission and a Member State? To answer these questions, we begin by sketching the history of Structural Funds, which reflects the broader institutional dynamics of European integration.

The beginning of cohesion policy is associated with the creation of the European Regional Development Fund in 1975 (Bachtler – Mendez 2007). For some time, it was little more than a monetary transfer mechanism among Member States ostensibly to reduce regional disparities but more practically to smooth intergovernmental agreement on other issues (Marks 1996; Thielemann 2002). A turning point came with the establishment of the Single Market after 1988, whereby the size of funds increased significantly. This made the spending of funds a politically more salient issue, and governments which were net contributors increasingly demanded information on how and with what effect net receivers would spend monies (Bauer 2006; Molle 2008). As a consequence, the process of cohesion policy was ‘Europeanised’: the European Commission was assigned a central but carefully circumscribed role as a coordinator and supervisor of the spending of funds, with most of the planning and implementation left in national hands.

A key aspect of the limited powers of the Commission in this field is that representatives of national governments in the Council retain the right to decide on their allocation among Member States.⁸ This allocation becomes fixed for a given planning period (initially 5, later 7 years) and the Commission has no room to re-allocate funds from one country to another. The principle of ‘concentration’ provides the Commission with an important but restrained role in the process. According to this principle, resources should be concentrated on a limited number of objectives and the least developed regions. The Commission is responsible for proposing objectives and geographic eligibility criteria, which provide a framework for bargaining among national representatives. Although it can use these proposals to influence the distribution of resources, once the decision is made by the Council and the Parliament, it must act within the important constraints of fixed allocations for given timeframes.

One consequence is the Commission’s limited ability to use monetary contractual incentives to influence implementation by a Member State. It cannot reshuffle funds from underperforming to well-performing Member States to sanction or reward their

⁸ Subsequently, the European Parliament was given rights of co-decision.

respective implementation efforts. National allocation comes to be perceived as an entitlement, and the basic expectation is that this amount should be spent by the entitled Member State, unless some serious irregularities occur. Even keeping a small part of a national allocation as a ‘performance reserve’ proved to be a temporary and failed experiment.⁹ Another consequence of fixed allocations combined with a limited timeframe is that the national ‘absorption’ of funds becomes a salient issue. In fact, the Commission must show itself competent in creating a system which enables the timely spending of the Structural Funds (Molle 2008).

Another aspect of the Commission’s limited powers is the Member States’ role in the planning and implementation of the programmes on which national allocations are spent. The process is the following. Parallel to the decision-making process on fund allocation, the Commission proposes EU-level objectives as well as general spending rules for the Funds. Once the allocations are made and these rules are adopted by national representatives, the Commission translates them into formal contracts with Member States, nowadays called ‘National Strategic Reference Frameworks’ that consist of ‘Operational Programmes’ devoted to broad policy fields or regions. The Commission negotiates and accepts these contracts and subsequently monitors their implementation by national governments. This basic division of responsibilities has essentially remained unchanged since 1988 until today.¹⁰ In the meantime, contracting details have evolved and their evolution can be interpreted as a response to the following supervisor–agent dilemma: How can the Commission carry out its duties as a supervisor effectively if it must rely on national administrations as agents for actual implementation? Bachtler and Mendez (2007) tracked the major institutional changes in the practice of ‘programming’ up to the 2007-2013 period, which, we suggest, fit this interpretation.

After the reform of 1988, the Commission soon faced the problem that Member States were often unable or unwilling to provide adequate information about either their plans or their implementation. This seriously impaired its capabilities to act as an effective supervisor. In the second programming period (1994-1999), the Commission responded in a number of ways: (i) it required more detailed formal contracts (development plans) with Member States, (ii) it became involved more heavily in influencing national policy orientations and financial allocations, and (iii) strengthened monitoring and reporting requirements. However, Member States objected to the burdensome procedures and the limits on their freedom to choose policy instruments to achieve common objectives. As a response, the Member States and the Commission agreed for the third programming period (2000-2006) to separate their responsibilities more clearly. National governments were given more freedom to plan the details of their programmes and implement them, while they accepted more stringent formal obligations to control financially, report on, monitor and evaluate their implementation efforts. This drew a clear line between the Commission and national administrations and at the same time furnished the Commission with stronger instruments of supervision from outside. The fourth period (2007-2013) saw a further

⁹ To be precise, in the 2000-2006 programming period the performance reserve could be used to reward well-performing programmes within a country but not the country’s government as a whole.

¹⁰ One change is that the role of the European Parliament as a third actor has been strengthened: it must now accept the Council’s decision, too.

move in this direction: programme management responsibilities were further shifted to national competence, while the Commission focused increasingly on controlling and monitoring programme outputs. The coming fifth programming period (2014-2020) seems to reinforce this trend, with the Commission's intention to introduce more standardised and transparent output measures linked to EU level objectives (EC 2013b).

The Commission's strong focus on indicators and strict reporting requirements is motivated by both its restricted rights to intervene directly in the national implementation process and the expectations of national governments (as initial principals) that the Commission verify the results of cohesion policy. The implementation contracts between Commission and Member States must work in *the shadow of verifiability*. Reported information on procedures and outcomes has not only to be credible for the Commission but its credibility must be verified to representatives of other Member States in the Council. In fact, one needs to go further: representatives of net-contributor Member States must give credible information to their home electorates that their taxes are wisely spent by other countries. For obvious reasons, voters in all countries show a great deal of rational ignorance about the activities of governments of other countries and their effects. Political representatives must respond by providing them information shortcuts (Downs 1957). These include catchphrases (e.g. increasing competitiveness) and EU-level targets (e.g. increasing employment by a given percentage by a given year) which are used to guide programming; the absence of scandals of fraud; and visible or measurable outcomes, such as large-scale scientific or environmental projects, the number of supported start-up enterprises or the number of people finding employment after participating in EU-funded programmes. It should be added that, although the European Parliament is also involved in the supervision of Structural Funds, it faces similar information asymmetries and appears to reinforce rather than reduce the attention devoted to these information shortcuts, including easy-to-present outcomes instead of true policy effectiveness (Hoerner – Stephenson 2012). It seems appropriate to draw a comparison with the use of 'development projects' as key instruments of channelling foreign aid to third-world countries. A study reflecting on the long experience of the World Bank notes: 'the presumption of a direct and unambiguous relationship between public expenditure inputs and development results made it easy to "retail" development projects for external support' (Picciotto 1995: 2).

The stress on verifiable indicators has an additional explanation. The Commission's ability to tie payment to performance and, more generally, to sanction underperforming Member States is highly constrained. It has been argued that the Commission has in fact very limited means to influence the behaviour of national administrations precisely because it lacks sanctioning powers (Blom-Hansen 2005). However, there may be significant non-monetary sanctions. Governments of Member States participate in a repeated game of cooperation covering many policy areas and must build coalitions to further their goals. They must develop and maintain a reputation for keeping their promises or else they will find it difficult to convince others to cooperate. Naming and shaming a Member State government for not keeping its formal contractual promises during the implementation of Structural Funds can

therefore provide strong incentives.¹¹ Reputational mechanisms presuppose easily accessible and reliable information. The system of programming in cohesion policy is designed to provide such information. It serves as a reputation-supporting institution (Milgrom – Roberts 1992).

4.2. The Character of the Commission–Member State Contract for Spending Structural Funds

The evolution of cohesion policy has in practice led to a number of distinct contractual characteristics of the S-A relationship between Commission and Member State. In its current form, the contract defines broad policy objectives and explicit indicators of success for the ‘operational programmes’ to be implemented by the Member State. It also lays down rules for the Member State’s internal procedures of monitoring and reporting to ensure the supply of credible information about the indicators adopted as well as procedures of financial control and auditing to prevent the fraudulent diversion of funds. In other words, it takes the form of a performance contract which specifies quantified measures (or ‘indicators’) of performance and, at the same time, defines procedures for the agent to provide credible information about these measures. To use the language of the economics of contracts, it is an arm’s length contract rather than a hierarchical one. Whereas in a hierarchical contract one party has the authority to make unilateral decisions and give orders to the other party within a broad contractual framework, parties to an arm’s length contract remain independent and all debates must be resolved in the initial contract or by subsequent bargaining (Grossman – Hart 1986). Once the Commission and a Member State have signed the contract, both sides must stick to it or initiate its formal renegotiation.

As noted above, the Commission and each Member State sign a new contract for each programming period with a fixed allocation and timeframe. Hence, their contract is not open-ended but expects the agent to produce ‘finite, specific, monitorable objectives’ within a given timeframe (Picciotto 1995: 2). We call it a project-form contract and the subordination of public expenditure to this contractual form ‘projectification’. Although this usage of the term ‘project’ differs from the EU’s official terminology, we think it is an appropriate concept in scientific analysis. The EU defines a project as a ‘single, *non-divisible* intervention with a fixed time schedule and dedicated budget’ (1997: 14, our emphasis) and uses the terms ‘programmes’ and ‘frameworks’ for bundles of projects. By contrast, our definition of a project-form contract or, simply, a project applies to programmes and frameworks, too. In this sense, a National Strategic Reference Framework is a very large project-form contract signed between the Commission and a Member State, covering all smaller or larger projects to be implemented in a programming period. We use the same term for the different levels of programming to emphasise the fundamentally common character of these contracts.

¹¹ Zängle (2004) discusses the Commission’s general predilection for formal benchmarking.

5. CHALLENGES FOR THE MEMBER STATE ARISING FROM ITS CONTRACT WITH THE COMMISSION

As we have seen, the contract between the Commission and a Member State that governs the implementation of cohesion policy has a very specific character, shaped by the fundamental contractual logic of the European Union rather than the contents of the financed policies. The resulting contractual form constrains a national government's opportunities as it strives to design and implement public policies financed from EU Funds. In this chapter, we try to explore the precise nature of these constraints. We do this in two steps.

The *first* step follows a fundamental insight of new institutional economics: A contract design, if it is to maximise the value of cooperation, must correspond to the characteristics of the actual transactions between the contracting parties (Coase 1937; O. Williamson 1985). Therefore, we examine whether the terms of the S–A contract between the Commission and a Member State fit the transactions that are the contract's object. And to the extent that the fit is imperfect, we explore its consequences for the transactions. In this case, transactions are public policy actions ('developments') undertaken by the Member State in exchange for financial resources transferred by the Commission.

However, parties to a contract may not be actually interested in finding the best possible contractual terms for their transactions. This is especially likely in politics where, unlike in competitive markets, the incentives to maximise the value of cooperation tend to be weak (Moe 1984). Therefore, as a *second* step, we must explore whether a national government really perceives the contractual imperfections as challenging problems. And if it does, we must clarify its dilemmas in answering these challenges.

5.1. Does the contractual form fit the transactions between the Commission and the Member State?

There is a theoretical tradition in new institutional economics that claims that the measurability of the transacted good or service is the most important transaction feature to influence the contractual form (Barzel 1982; Allen 2011). Since the contract between the Commission and the Member State focuses on verifiable information, the handling of measurability problems is key to its success. Hence, the above-mentioned theoretical approach seems particularly well-suited to its analysis.¹²

The more challenging it is to measure relevant aspects of the good or service, the more difficult it is to specify the expected performance *ex ante* in a written contract. In the literature on business contracts, an aspect of performance is called 'contractible' if it

¹² Murrell (2004), who modelled the interactions of donors, contractors, and recipients in implementing institutional-reform aid projects, stressed that 'the output produced by such projects is a public good whose quality varies in not-easily-ascertainable ways. Therefore, adverse selection, moral hazard, and incomplete contracts are bound to be at the centre of any exercise that models the production of institutional reform' (70).

can be (1) defined *ex ante*, (2) observed upon performance, and (3) verified to a third party (Grossman – Hart 1986). These conditions are relevant here, as well. Although the contract between the Commission and a Member State is not subject to judicial enforcement in the same way as a business contract, its results need to be verified to third parties: the Council representing Member States as a Group and the European Parliament. We focus on measurability precisely because the project form contract between the Commission and the Member State places such great emphasis on verifiable information about the implementation of financed policies.

If not all aspects of an agent's service are contractible and contractual terms only capture the measurable aspects of his performance, he will have an incentive to divert his attention from unmeasured to measured aspects, provided the two are substitutes.¹³ For example, if a contract rewards (measurable) quantity but does not include terms on (non-measurable) quality, the agent will focus on quantity at the expense of quality. Should he choose to pay attention to quality, he would increase the risk of not meeting the contractual provisions on quantity. A project focussing on verifiable measured indicators may therefore be more or less suitable to government programmes depending on the measurability of their results.

Consider the following simplified example, which is based on the experience of actual evaluations (Hétfa – Revita 2013a) and shows the contractual dilemma for a hard-to-measure project. An important EU-level objective, enshrined for example in the Lisbon Treaty, and supported by the European Social Fund, is to increase the rate of employment across Europe. This is translated, among others, into an indicator of 'participants entering employment', which is to be measured as the number of participants who were not in employment at the start of a funded project and took up employment within 6 months of completing provision.¹⁴ Suppose that a national government agrees with the EU-level goal and would actually like to reduce unemployment. It is convinced that the best way to achieve this goal is to offer support services to long-term unemployed with disadvantages in the labour market. The indicator to be reported clearly covers only a single dimension of the performance of such a programme. One can think of several other relevant dimensions which the government may want to focus on but would thereby increase the risk of not performing well in the dimension to be reported to the Commission.

One aspect of *non-measured quality* is the average degree of disadvantage among programme participants. If the programme targets more disadvantaged people, its added-value per person may be greater but the expected value of the number of 'participants entering employment' is likely to be smaller. Another quality aspect is the *innovativeness* of the programme. Innovation tends to be accompanied by a greater variance of results. While a routine programme may produce the contracted value (but not more) of the measured indicator with near certainty, an innovative intervention may lead to a higher expected value but with a greater variance (i.e. both significantly

¹³ More precisely, the question is whether 'possible actions are substitutes or complements in the agent's cost function. In the substitutes' case, more effort in one dimension increases the marginal cost of effort in the other dimension, therefore increasing the marginal incentive payment for greater output of one task draws effort away from the other.' (Dixit 2002: 704)

¹⁴ See Hungary's Social Renewal Operating Programme, palyazat.gov.hu/download/2737/TAMOP_adopted_en.pdf (15.02.2014).

higher and lower values may obtain), thereby risking not meeting the contracted target. A third aspect is the *level of investment* in participants. With a given budget, making a smaller investment in the human capital of many people, e.g. by retraining them quickly, may increase short-term chances of employment (captured by the measured indicator), without much improvement in long-term employability. Making a larger investment in a smaller number of people, e.g. upgrading their general skills, may bring more substantial long-term improvement at the cost of reducing the value of the short-term indicator. To generalise, if an expenditure programme is characterised by significant unmeasured quality dimensions, a high degree of innovation or long-term returns on investment, the project-form contract of cohesion policy with its rigid focus on verifiable outputs will be a relatively ill-suited contract design.

How widespread and serious is the problem of measurability in cohesion policy? Although there is no direct answer to this question, there is a great deal of circumstantial evidence that shows that it is both widespread and serious.

Public management scholars have amply documented the unintended consequences of output measurement in the public sector. Thiel and Leeuw (2002) speak of a ‘performance paradox’: too much emphasis on performance measurement can lead to a deterioration of actual performance. ‘When organizations or individuals have learned which aspects of performance are measured (and which are not), they can use that information to manipulate their assessments. For example, by primarily putting all the efforts into what is measured, performance will go up.’ (271) In the public sector, non-measured aspects are especially important, not only because policy goals are often nonquantifiable and hard to measure but also because even the policy objectives are often elusive.

Authors who studied the projectification of EU-financed local and regional development policies in Scandinavia also drew attention in their case studies to the discrepancy between measured indicators and policy-relevant results (Andersson 2009). Even in the well-functioning governance systems of North European countries, project-form contracts encouraged the implementing organisations to focus on short-term formal indicators and make-believe activities. Although projects proliferated, they often did not add up to real and sustainable outcomes.

Official evaluations of the performance of cohesion policy repeatedly express dissatisfaction that ‘the indicators chosen for monitoring purposes are in many cases not the most relevant for judging programme outcomes since they do not relate directly to the main aims of the projects or measures supported’ (EC 2012: 29; see also EC 2013a). Although they stop short of acknowledging the very high (and often prohibitive) costs of proper measurement and verification, the problems are clearly not simply due to bureaucratic slack. To illustrate, the quoted evaluation report continues with the following example: ‘For investment in R&D or support to SMEs, where the major goal is to increase the rate of innovation or productivity [...] the indicators typically applied are the number of jobs created or firms supported or even simply the number of projects undertaken’ (EC 2012: 29). Even defining the rate of innovation is a huge challenge, let alone finding an indicator for it that could be measured and verified at an acceptable cost.

Another way to gauge the problem of measurability is by asking whether the parties in the supervisor–agent contract can structure their relationship – within the external

constraints originating from the principal–supervisor contract – in ways that mitigate the distortive effects of imperfect performance measurement. Economic theory (Miller 2005) as well as the literature on using indicators in the public sector (e.g. Mizell 2008) suggest two ways to reduce these effects. One way is to measure broader results and effects rather than more immediate outputs. The other is to tie financing less closely to measured indicators. To what extent are these recommendations feasible in this context?

The European Union has been moving partially towards the use of result indicators. While programmes financed by the European Regional Development Fund (ERDF) that create physical investments use output measures, programmes financed by the European Social Fund (ESF) and targeting investment in human capital now use both output and short-term¹⁵ result indicators. The reason officially given for this difference is that, for ERDF, results tend to materialise only in the long term, beyond the life of the programme, while for ESF they tend to occur already during the lifetime of the programme (EC 2013b: 11). Even for ESF, measurable aspects of broader policy goals – such as reduction in regional income disparities or improved access to certain public services in a given area – are precluded, however, because indicators’ ‘value should be influenced in as direct way as possible by the actions funded’ (ibid.: 10). This reasoning points to the classical trade-off between efficient incentives and efficient risk-sharing: a broader performance measure, e.g. percentage change in the level of employment, provides better incentives at the cost of putting too much risk on the agent (Milgrom – Roberts 1992). Programmes financed by Structural Funds can rarely achieve policy goals by themselves. A host of other policy measures (often uncertain at the time of the promise) and external circumstances exert influence on such indicators. Member States would take on significant contractual risks by accepting such indicators. From the perspective of risk-bearing, Member States as a group are likely to be better off, if the risks of economic cycles that strongly affect their ability to perform macroeconomic or macrosocial indicators are borne by the central budget of the EU rather than their respective national budgets. To the extent that economic cycles are not perfectly correlated across European countries, the central budget offers the possibility to diversify these risks.

The other way to handle the problems that emerge when important dimensions of agent performance cannot be captured by objectified indicators is for the principal to use incentives beyond formal contractual terms (Miller 2005). He should increase the relational character of the S-A contract, i.e. the parties should rely less on formal contracts but more on non-legal incentives and trust that emerge as they engage in recurring transactions (Furubotn – Richter 2007: 158-169). Short-term performance indicators may be kept but financing should not be based directly on them. Instead, indicators should be used more flexibly in recurrent negotiations that also consider broader circumstances and non-measured efforts after each financing period.¹⁶

¹⁵ The European Commission calls some result indicators, such as ‘participants who are in employment 6 months after leaving an ESF-financed project’ ‘long-term’ (EC 2013b: 11). Although it is reasonable to differentiate such indicators from more intermediate ones, an employment support programme can clearly have effects with a much longer time-span.

¹⁶ The public finance literature distinguishes between performance funding, which links financing directly to performance indicators, and public budgeting, which uses such indicators as the basis for budgetary negotiations. (Burke – Minassians 2001)

However, a relational contract leaves greater room for the parties to adapt to changing circumstances and make informal, non-verifiable judgements along the way. Giving such powers to the Commission would be at odds with its role as a supervisor bound by strong requirements of verification. The Commission's circumscribed autonomy therefore limits the possibilities to move the implementation contracts with Member States towards more relational forms. It limits but does not eliminate the possibilities.

The literature that discusses the European Commission's efforts to supervise national governments makes it clear that it has tools beyond procedural and outcome requirements. The principle of 'partnership' prescribes the participation of diverse national and subnational actors in the design and implementation of programmes. The Commission can use some of these actors as 'fire-alarms' who monitor implementation and signal problems to the Commission as they arise (Bauer 2006). Continuous, personal monitoring of a 'police patrol' type is also used: representatives of the Commission sit in the Monitoring Committees of Operating Programmes (Thielemann 2002). They also provide significant opportunities for learning, information exchange, expert input and networking (Cartwright – Batory 2012). Evaluation is an additional tool, which can provide more nuanced information on the efficiency and effectiveness of planned or implemented programmes (Stame 2008). It should be noted, however, that the Commission's inevitable focus on procedures and direct programme outputs also biases the evaluation process, which is often centred on 'issues of management processes, programme relevance, and the narrow assessment of programme objectives' (Hoerner – Stephenson 2012). Furthermore, informal tools may be used to shape the preferences of civil servants who participate in national implementation. These include socialisation and the tying of career incentives to Europeanised policy making or the institutional structure of cohesion policy (Mike 2004). In sum, partnership, evaluation, socialisation and career incentives are important methods which complement and 'soften' but do not fundamentally change the formal features of the S-A relationship as determined by the principle of programming. We believe that it is appropriate first to analyse the basic formal rules of the game and then proceed to ask how auxiliary and often informal rules augment their functioning. Here, we only take the first step. In fact, a great deal has been written about contractual aspects we consider auxiliary (and usually come under the heading 'multi-level governance'), while much less about the basic formal rules. We believe it is important to redress the balance.

5.2. The Member State's dilemma: absorption versus policy effectiveness

The above analysis identified the tension between the strong expectations of verifiability and the often insurmountable difficulties of performance measurement as a fundamental difficulty in the contract between the Commission and a Member State. However, this is perhaps merely a problem identified by us as benevolent social planners (or concerned citizens). Does a national government actually perceive it as an important problem to tackle? It clearly depends on whether it cares about those aspects of the policies financed from EU funds which are not subject to verified measurement. It will care about these aspects as long as it is concerned about the effectiveness of these policies in achieving substantive policy goals for relevant

political constituencies (or ‘*policy effectiveness*’ in short) rather than merely producing administratively verifiable information about them.

Several official pronouncements suggest that the primary goal of national governments is not policy effectiveness but the ‘*absorption*’ of funds, i.e. spending as much as possible of their budgetary entitlement. Absorption is the primary measure that is used in the interim evaluation of cohesion policy that compares Member States and policy areas in which the Funds are spent (EC 2012; 2013a). It is also a recurring theme in the public discourse on cohesion policy in several countries.¹⁷ Certainly, absorption may become a salient political issue in a Member State receiving relatively large funds, where voters may consider the government’s inability to spend available funds as waste of resources. Absorption can be ensured by complying with the procedural prescriptions and verifiable output requirements of the supervisor–agent contract. A government pursuing the sole goal of absorption would focus on this type of formal compliance and its only dilemma (and source of conflict with the Commission) would be how to keep the administrative costs of smooth compliance at a reasonable level.

Important though absorption is, it would clearly be inappropriate to model a national government’s behaviour as if this was its exclusive objective and the achievement of substantive policy goals did not matter. In the present institutional context of democratic nation states, the national government will be held accountable by voters and interest groups for success or failure in achieving macro-level policy goals such as reduction in regional disparities or increase in competitiveness as well as sector-level changes like increased quality of health care or better higher education. Of course, many goals are likely to be less benign, such as favouring producers’ well-organised interest-groups at the expense of consumers or welfare services to swing voters. This does not negate, however, that the national government will care about substantive policy effects felt by relevant social groups and will have at least some incentive to use EU Funds to bring about these effects. This is certainly to be expected in Member States where the share of EU funds reaches or even surpasses 10 percent of the public budget. Although the preferences of national governments need to be verified empirically (which we begin in our case study), it seems to us that a government’s goals are most reasonably modelled as including both absorption and policy effectiveness.

When both absorption and policy effectiveness are important goals, the government of a Member State faces a dilemma. Should it focus solely on compliance with the measured aspects of programmes to be reported to the Commission and thereby secure the absorption of funds? Or should it also pursue non-measured programme aspects conducive to its substantive policy goals and risk the loss of funds? In short, the dilemma of absorption versus policy effectiveness occurs. The trade-off between absorption and policy effectiveness is especially sharp for policies with hard-to-measure and diffuse results which defy the logic of projectification. Focussing on compliance with procedural prescriptions and verifiable short-term outputs rather than non-verifiable and/or long-term results in policy design secures absorption at the cost of achieving substantive policy goals, and vice versa.

¹⁷ For example, see the high political profile given to the absorption of EU Funds in political debates in Romania (e.g. Gardner 2012) and our Hungarian case study below. 17 September.

The government will try to strike a balance between absorption and policy effectiveness, depending on the relative political salience of the two goals. This may be influenced by several factors, most of them highly country-specific. Their analysis is beyond the scope of this study. In the following, we focus on how the government's (politically motivated) stance on absorption vs. policy effectiveness influences the way it contracts for the implementation of cohesion policy within its own jurisdiction.

6. CONTRACTING FOR THE IMPLEMENTATION OF COHESION POLICY WITHIN A MEMBER STATE

A national government does not implement EU-financed programmes itself. Rather, it negotiates the programme documents with the Commission, which are still relatively incomplete, i.e. contain many ‘gaps’ about the details of programmes, and delegates the ‘filling of these gaps’ and implementation to agent organisations within the Member State. In other words, the national government must engage in further principal–agent contracts as a response to its contract with the Commission.

Member States are obliged to create an official organisational structure responsible for the management of Operational Programmes. As prescribed by EU regulations, Managing Authorities and one or more levels of Intermediate Bodies are to be set up¹⁸ according to certain rules and made responsible for the implementation of programmes. Intermediate Bodies contract with beneficiary organisations, which may subcontract or distribute funds to other organisations or individuals. Thus, a sequence of P-A contracts is created, which can be interpreted as a subnational ‘continuation’ of the supranational line of agency relationships (as illustrated in Graph 1).

The prescriptions for a national institutional structure are one of the most idiosyncratic aspects of cohesion policy. This idiosyncrasy is directly related to the arm’s length nature of the Commission–Member State contract, which itself follows from the contractual constraints MSs as initial principals put on the Commission. Their main function is to provide the Commission with a continuous stream of verifiable information that implementation proceeds with an eye to the contracted measurable results and without fraud. These regulations are like playscripts that leave room for improvisation. They define the names and roles of implementing organisations but do not tell who will play their roles. They also define several aspects of how these organisations are supposed to act but leave many other aspects for national governments to decide (with the Commission retaining an effective veto right).

This metaphor makes clear the two fundamental contractual questions for the implementation of cohesion policy within Member States. (1) Which organisations shall the national government select as implementing agents? (2) How shall it design the contracts with these agents? We discuss the two questions in this order.

6.1. Choosing agents within the Member State: Differentiated versus integrated implementing organisations

The literature stresses two dimensions in which the implementing organisations of cohesion policy can be distinguished: (1) their place in the territorial hierarchy of government¹⁹ (Hooghe – Marks 2003), and (2) their embeddedness in national public administration (Taylor et al. 2000; Ferry et al. 2007; Thielemann 2002). While the

¹⁸ As well as some additional bodies such as Certificate Authorities and Audit Authorities.

¹⁹ Often referred to as the effect of cohesion policy on ‘regionalisation’.

first aspect is more widely explored in the literature, we focus here on the second dimension, which has, at least from a contractual point of view, more straightforward consequences for both absorption and policy effectiveness.²⁰ Comparative studies of national implementation systems emphasise the crucial choice between pre-existing organisations integrated in national public administration and newly created agents specialising on cohesion policy. What Ferry et al. (2007) call ‘integrated’ and ‘differentiated’ systems of implementation.²¹ In an integrated system, all the roles of Managing Authorities, Intermediate Bodies etc. can be filled by existing organisations within various sectoral (e.g. health, economic development) or functional (e.g. finance) or subnational administrations. In a differentiated system, a wholly new and specialised network of organisations dedicated to cohesion policy may be created (Ferry et al. 2007). Real systems tend to fall between these two clear-cut solutions, which are perhaps best thought of as ideal types. In the chain of implementation from Managing Authorities to final beneficiaries, some organisations may be differentiated while others may be integrated into some pre-existing national administrative structure.²²

Why does the choice between integrated and differentiated organisations matter? Selecting a willing and capable agent is an important means by which a principal can control contractual hazards. This tool is not available for the Commission as a supervisor, which must accept all Member States as agents. By contrast, a national government can usually select its own agents for cohesion policy among a substantial number of public²³ organisations. It is notoriously difficult to pinpoint which organisational features make a public administrative body more or less motivated and capable. Heads of such organisations normally strive to increase or, at least, maintain their budget and competences by proving their worth to political sponsors or bureaucratic superiors (Dunleavy 1991). Unlike business firms for which profit is a single measure of performance, they are usually expected to pursue multiple goals, often initiated by multiple principals in the government hierarchy (Tirole 1994; Dixit 2003). This leads to a serious problem of accountability for any one goal prescribed by any one principal since the organisation can use its information advantage to argue that it was underperforming on that goal because it had to pay attention to other, equally important goals. The problem can be solved by creating single-purpose organisations. However, the obvious cost of such a solution is poorer coordination between interconnected goals pursued by different agents and the presence of disincentives to cooperate.

How does this abstract reasoning translate to cohesion policy? If the government’s key concern is the absorption of funds, it will want an agent to focus on this goal in a single-minded fashion. It should set this as the overarching organisational goal for the implementing agent, to be achieved by pursuing the subordinated goals of timely spending, no irregularities and the production of contracted indicators. A

²⁰ The question of embeddedness occurs at any territorial level of government.

²¹ Taylor et al. (2000) propose a similar typology by differentiating between ‘differentiated’ and ‘subsumed’ systems.

²² Hybrid systems are referred to as ‘composite’ (Taylor et al. 2000) or ‘aligned’ (Ferry et al. 2007).

²³ Rarely, private organisations are involved. This marginal possibility is ignored here and, we believe, does not affect the core argument.

straightforward option is to create a single-purpose organisation dedicated solely to programmes financed from EU funds. Organisations subordinated into a sectoral or regional hierarchy would, by default, be expected to further that hierarchy's substantive policy goals at least to some extent. By contrast, if the government wants the agent to consider programme aspects which are not to be reported to the Commission but are important for the government's policy goals, the agent's organisational goals should include these other aspects as well. A natural choice is to assign implementation to an integrated agency which is responsible for overall policy effects in a certain policy field or regional area.

We must note, however, that the difference between the organisational goals of integrated and differentiated agencies may not be so clear-cut in practice. A differentiated agency might be assigned broader organisational goals and an integrated agency might be strongly rewarded for its success in compliance with EU rules. As always, institutional details matter here. Therefore, we suggest that the analytical focus should be on the type and breadth of goals set for an agency, and the key distinction should be made between single-purpose organisations dedicated to absorption and compliance with formal EU rules and multiple-purpose organisations which must also contribute to substantive policy goals set by the national government.

6.2. Designing contracts for agents within the Member State: Projectification versus insulation from project logic

The design of contracts with implementing organisations raise an almost intractable list of questions (for an excellent overview, see Wostner 2008). Here we focus on the phenomenon of projectification, which we identified as a fundamental contractual feature of cohesion policy. The ultimate effects of the project-form contract between the Commission and a Member State depend on the terms of contracts the national government signs internally with its implementing organisations. The crucial question is whether the government will apply the project form to these contracts or use alternative contractual forms, better suited to financing hard-to-measure activities.

At first sight, the regulations of EU Funds do not leave much room for contractual choice. The official rules for planning, monitoring and financial reporting require the definition and enforcement of finite, specific, monitorable objectives even for parts of an Operational Programme. Operational Programmes are usually divided into several project levels, such as priorities, interventions, financing measures and individual 'projects', defined as 'single, non-divisible interventions' (EC 1997). Therefore, lower-level project-form contracts must be used within OPs, as well. However, a significant autonomy of contractual choice derives from the flexibility in defining what unit of intervention should be considered 'non-divisible'. Most Member States use two general allocation mechanisms: competitive grant schemes and strategic projects (Wostner 2008). While the former typically expect a multitude of final beneficiaries (lower-level public organisations, nonprofits, firms or even individuals) to carry out relatively small sets of tasks, strategic projects may be signed with high-level public organisations (such as sectoral ministries, their national or regional agencies). In the latter case, these public bodies may use their own mechanisms of governance to allocate resources within the single large project. That is, they need not sign project-form contracts with the organisations at the end of the implementation

chain but can rely on alternative contracting arrangements, designed for the policy field independently of EU funding.

To illustrate, consider again our example about employment policy. Assume that the government wants to finance active labour market services for the unemployed, such as training, counselling, job-matching.²⁴ One option is that the Managing Authority for the relevant OP signs a project with the Public Employment Service, which then uses its internal mechanisms to allocate resources within this large project. It can use a variety of contractual forms that are considered especially suitable in the specific policy field for encouraging and controlling those who contribute to the project's goals. For example, it may introduce career incentives or performance bonuses for PES officials that are tied to ongoing performance assessment (Mosely et al. 2003). It may also establish multiannual service-provision contracts with nonprofit service-providers (Bruttel 2005). The resources of the project may be channelled into the performance incentive system or the service-provision partnerships, both of which may be seen as contractual forms well-suited to the performed activities (Lundsgaard 2002). Another option for the Managing Authority is to initiate a grant scheme (probably through an Intermediate Body) directly for organisations which offer labour market services in the field, such as the above-mentioned local employment offices and nonprofits. In this case, project-form contracts are signed with the final implementers of the Operational Programmes, who will directly face the incentives associated with the project form.

In general, it seems useful to distinguish between two types of contractual schemes within Member States: (1) the full-blown projectification of the entire implementation process from the Managing Authority all the way down to the final agents, and (2) the partial insulation of the principal-agent chain from the project logic by relying on contractual solutions that are ordinarily used for the financed activity in the given policy field.

The choice between full-blown projectification and insulation from the project logic is influenced by the relative importance of absorption and policy effectiveness. As discussed above, the project form may create distortive incentives for hard-to-measure activities. So alternative forms of contract, designed with an eye to overcoming measurement problems, are likely to be preferred if the government gives precedence to substantive policy goals over absorption. At the same time, the insulation of agents from the project logic by relying on such contracts increases the risk of non-compliance with the procedural and indicator requirements of cohesion policy and threatens absorption goals. Thus, if absorption is the dominant goal, projectification is the more attractive option.

The willingness of the government (or its Managing Authority) to choose the 'insulation' option depends positively on the sectoral or regional administration's ability and willingness to use its internal monitoring and incentives to secure sufficient project results. Ability depends on the existence or relatively easy creation of internal systems of monitoring and control in a sectoral (or regional) administration. Willingness largely depends on how credibly the principal can threaten the agent with sanctions. For example, if there is a single large agent in a

²⁴ The stylised example was also inspired by our case study below.

policy field, e.g. a sectoral ministry, rather than a large number of project beneficiaries, a temporary bilateral monopoly is created, which makes principal and agent mutually dependent. The principal will think twice before applying strong sanctions in case of underperformance, so its threats to do so will be less credible.

More nuanced analysis should go beyond the crude distinction between the ideal types of projectification and insulation from project logic. Even if the project form is kept formally, its distortive effects may be ‘softened’ by de-emphasising its formal administrative requirements and replacing them with other contractual safeguards. For example, the project form may be used merely to ensure a non-risky minimum performance of the beneficiary and be supplemented by reliance on incentives provided by the beneficiary’s broader institutional environment. To continue the example on employment policy, projects may be allocated to providers of labour market services with an ownership structure or concerns about professional reputation that give them incentives to provide high-quality services. Church- and community-based nonprofits and members of well-organised professional associations may provide such examples. If the project’s formal requirements of verifiable indicators can be met relatively easily, the contracts may be more accommodating to interventions that are innovative, require risky investment or have immeasurable quality aspects.

7. HYPOTHESES DERIVED FROM THE CONTRACTUAL MODEL OF EU COHESION POLICY

Our model of EU cohesion relies on a specific perspective of the European Union. It views the complex relations between Member States and the European Commission as a principal-supervisor-agent relationship, in which national governments as principals delegate to the Commission the task of supervising the implementation of their multilateral agreements by themselves as agents. The model's core idea is that the Commission's position as supervisor implies a very strong focus on verifiability in the supervisor-agent contract which governs the implementation of cohesion policy. Several well-articulated conclusions follow from this model. They can be formulated as hypotheses to be tested in further empirical investigations.

The hypotheses are as follows:

1. *Member State's basic dilemma.* National governments face a trade-off between the goals of absorption and policy effectiveness, due to the project-form contract with the European Commission.
2. *Choosing agents within the Member State.* A key institutional choice for a national government is whether to contract differentiated (single-purpose) or integrated (multi-purpose) agencies for implementation.
 - 2.1. Focus on absorption implies the former, while focus on policy effectiveness the latter.
3. *Choosing contract design.* Another institutional choice is that between two types of contractual schemes: (1) the projectification of the entire implementation process and (2) the partial insulation of the principal-agent chain from the project logic by relying on contractual solutions that are ordinarily used for the financed activity in the given policy field.
 - 3.a. The choice between the two types of contractual schemes is influenced by the relative importance of absorption and policy effectiveness;
 - 3.b. as well as the government's trust in the sectoral or regional administration's ability and willingness to use its internal monitoring and incentives to secure sufficient project results.
4. *Distortions of the project form.* For hard-to-measure policies, the projectification of implementation leads to systematic distortions: neglect of unmeasured quality dimensions, short-termism and aversion to risky innovation.
 - 4.a. These distortions can be reduced by de-emphasising the project's formal administrative requirements and allocating resources to beneficiaries who face appropriate incentives outside the projects, e.g. thanks to ownership or reputational concerns.

To what extent do these hypotheses capture the real dilemmas of policy implementation in Member States? The following case study explores their validity for one country and a couple of policy fields. Besides showing the relevance of the contractual approach at least in one specific case, it is also an invitation to explore other countries and policy fields from the same perspective.

8. CASE STUDY: HUNGARY AND THE STRUCTURAL FUNDS – A COUNTRY OVERWHELMED BY (VERY) LARGE FUNDS

8.1. Methodology

The case study is about Hungary's experience in the programming period 2007-2013 of using Structural Funds for policies with typically hard-to-measure, long-term and often diffuse goals. We do not claim the case to be typical. It would perhaps be more appropriate to call it an extreme one. Hungary was allocated very large funds relative to its national budget, therefore we should expect that the contractual dilemmas would be sharper and more painful than in many other countries. Especially so in the policy fields analysed, due to important non-measurable programme aspects.

From a methodological point of view, our case study makes two claims. First, it purports to show that the dilemmas identified in the theoretical model actually occur and are important for the relevant actors in a country. Second, it aims to prove that the hypothesised causal relationships are truly at work. Confirming causality is particularly difficult in a case study since either temporal or spatial (i.e. cross-section) variation is needed to show that a causal relationship exists (Gerring 2007: 151-171). At the level of the general institutional features of cohesion policy in Hungary, we can only rely on a (very limited) longitudinal comparison. At lower levels, we can make use of variations across development programmes or individual projects within one country.

The case study is chiefly based on two evaluations of development programmes supporting active labour market policies and higher education that were co-financed by Structural Funds and implemented in Hungary between 2007 and 2012. This was complemented by additional data and document analysis and expert interviews. The programme evaluations were commissioned by the National Development Agency of Hungary, the highest governmental body responsible for the planning and implementation of cohesion policy and conducted between February 2012 and March 2013 by Hétfa Research Institute,²⁵ an independent private organisation, in collaboration with Revita Foundation.

Broadly speaking, evaluations fall into two categories (EC 2013c). A contrafactual evaluation asks *whether* a policy makes a difference. It views policy as a black box and examines the quantifiable effects of this black box on well-specified parameters of the outside world. A 'theory-based' evaluation asks a different question: *why* a policy works or does not work. This approach looks inside the black box of a policy and systematically explores its internal mechanisms as well as the mechanisms connecting it to external actors. It develops and tests an 'intervention theory' (Leeuw 2013) or 'programme theory' (Pawson – Tilley 1997) that explains how a policy or programme

²⁵ The evaluations are accessible online in Hungarian at http://palyazat.gov.hu/human_fejlesztések_ertekelesej (15.02.2014). Executive summaries in English can be downloaded at http://palyazat.gov.hu/download/48706/Executive_Summary_Employability_Eval.pdf and http://palyazat.gov.hu/download/48114/Executive_%20Summary_Eval_Higher_Education_Programmes.docx (15.02.2014).

works.²⁶ The evaluations discussed here were theory-based and their ‘programme theories’ were institutional. They (i) identified how the programmes were institutionalised and fitted into the broader institutional structure of the relevant policy field; (ii) explored the incentive structure created by this institutionalisation; and (iii) their consequences for the effectiveness and efficiency of the programmes.

Each evaluation covered all forms of financial support assigned from Structural Funds to interventions in one broad policy field: active labour market services and higher education, respectively. The underlying idea was to examine how EU funds were able to contribute to the broad strategic goals of a policy field.

The evaluations used mixed empirical methodology, including (i) the analysis of programme documents, relevant legal texts, public databases and other written information sources; (ii) interviews with top policy makers and officials responsible for programme design as well as implementation and policy experts; (iii) case studies based on field work in higher education institutions and providers of active labour market services; and (iv) an online national survey among non-profit employment service providers²⁷.

8.2. The goals of national government: the primacy of absorption over policy effectiveness

The first question to be explored concerns the political goals the national government pursues with EU funds. Our model implies that absorption and policy effectiveness are the two general goals, which represent a trade-off for the government.

No Member State received a higher allocation of Structural Funds as a percentage of GDP for the 2007-2013 period than Hungary (KPMG 2011). Central and East European countries were the main beneficiaries of cohesion policy, with an entitlement of 2,7 per cent/GDP on average. With 3,6 per cent, Hungary was top of their lot (together with Latvia).²⁸ Although this number may seem small, its significance becomes clear if actual programme expenditure is compared to total budgetary expenditure by the national government. As shown in Graph 2, the share of programmes financed by Structural Funds (and obligatory national co-financing) amounted to as much as 10 per cent of the national budget. Even more striking are political pronouncements, such as the following by Hungary’s prime minister in 2012: ‘90 per cent of all funds spent on development in Hungary come from the European Union’.²⁹ Such a magnitude is supported by the calculations of the European Commission about the share of ERDF and Cohesion Fund allocations in government expenditure: 67,4 % for the 2007-2013 period – compared to an average 4 % in EU15 and 37 % in EU12. The share of funds remaining for the years 2013-2015, when

²⁶ Also called a ‘theory of change’ by Weiss (1995).

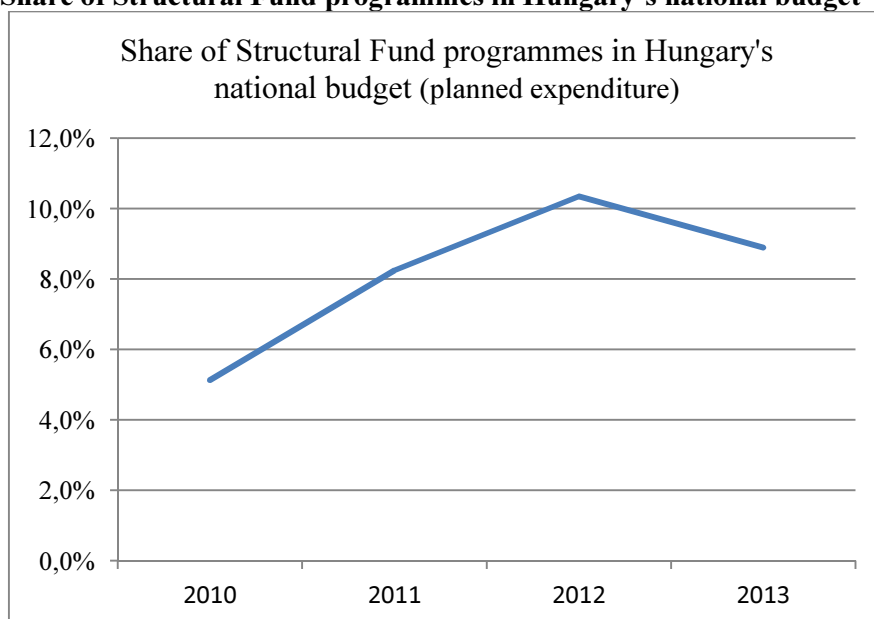
²⁷ No such survey was conducted among higher education institutions.

²⁸ The numbers show entitlements (not actual spending) and are based on GDP projections. In terms of EU funds per capita, Hungary came a very close third after Estonia and the Czech Republic, each receiving approximately 2500 euros per capita for 2007-2013.

²⁹ <http://eu.kormany.hu/nincs-magyar-fejlesztéspolitika-unios-forrasok-nelkul> (15.02.2014)

payment is still allowed, is even higher: 87,7 % (EC 2013a). But ‘development’ is a broader concept than capital outlays. In fact, EU funds played an immense role in virtually all budgetary measures beyond the automatic basic financing of government activities and even as replacements of such financing. They were used to fill gaps in ordinary (non-development) budgetary appropriations, which contracted significantly as a result of drastic austerity measures put in place by the national government after 2010.³⁰

Graph 2. Share of Structural Fund programmes in Hungary’s national budget

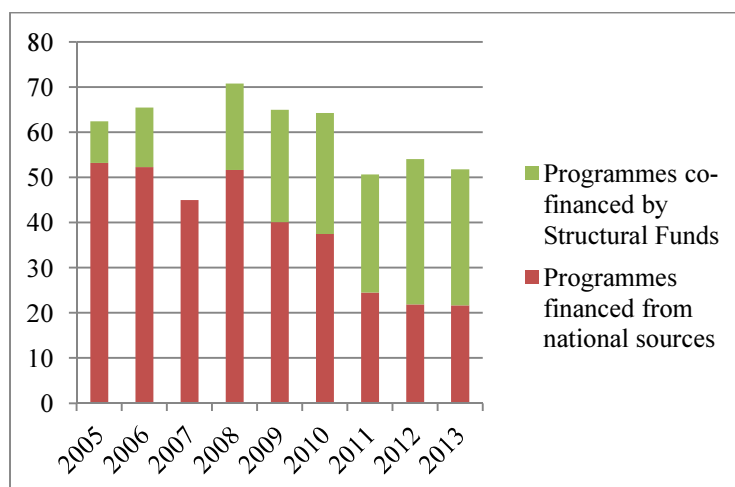


Own calculations based on appropriations in the annual Budgetary Acts.

In active labour market policy, programmes co-financed by Structural Funds gradually crowded out interventions financed from national sources. In recent years, they accounted for over 50% of programme expenditure by the National Employment Fund, the main financing channel of such measures (Graph 3). In a similar vein, national budgetary appropriations for higher education institutions decreased steadily in the period, while EU funds virtually poured into the sector, adding as much as 35 per cent in 2012 to yearly national budgetary support (Graph 4).

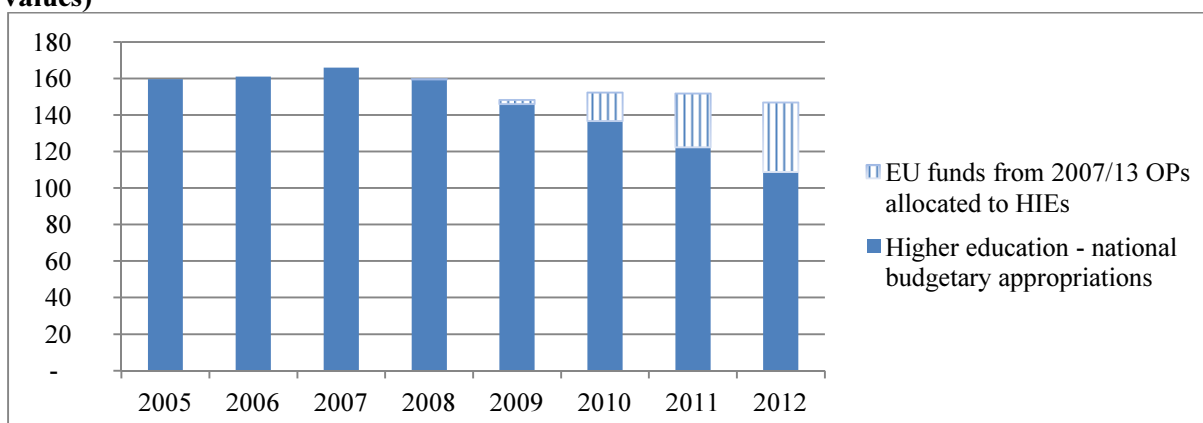
³⁰ As shown by OECD’s Economic Outlook (2013), Hungary reduced budget deficit by 8,25 percentage-points from 2006/7 to 2012/2013, surpassed only by Greece in this period.

Graph 3. Composition of the yearly (planned) budget of Hungary's National Employment Fund



No data are available for programmes financed by Structural Funds in the official budget.

Graph 4. Volume and composition of allocations to higher education institutions (planned values)



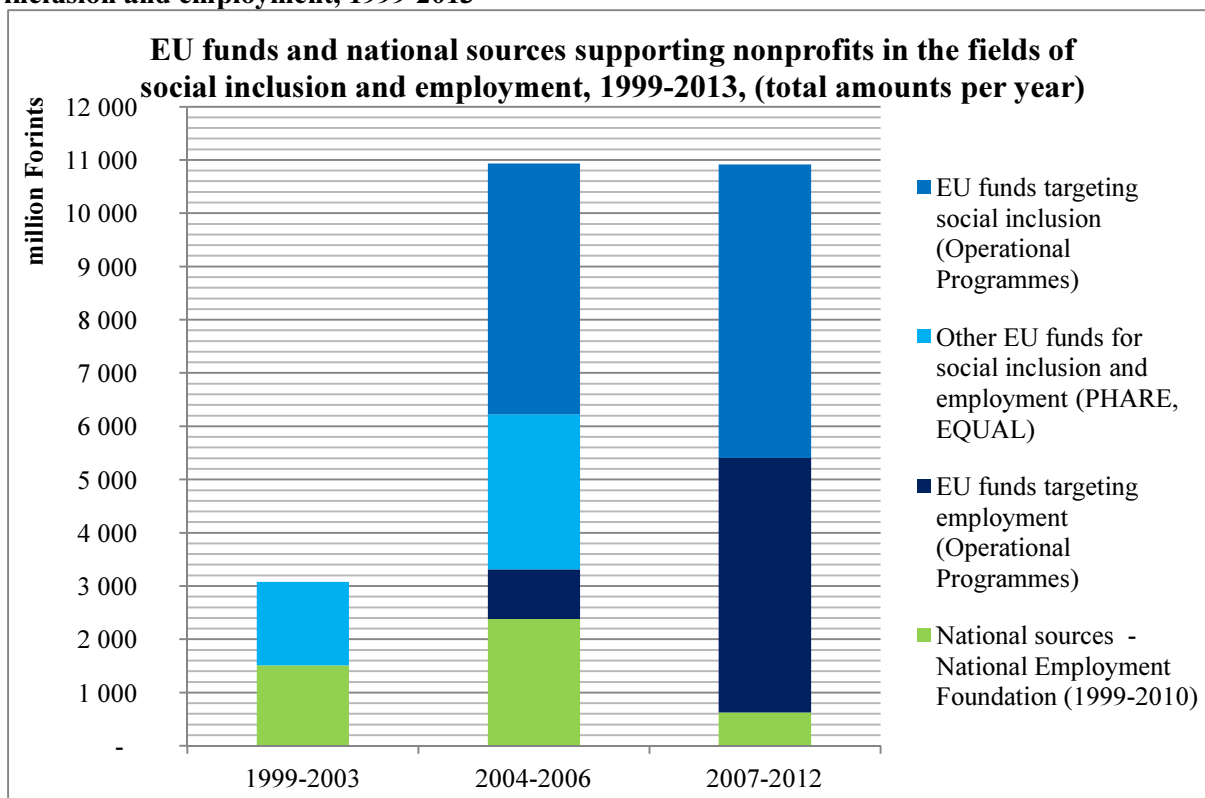
Own calculations based on appropriations in the annual Budgetary Acts and the official monitoring database for Structural Funds in Hungary (EMIR)

It was, of course, not crowding-out only. A notable consequence of EU funds was the creation or massive upscaling of certain policy areas hitherto virtually nonexistent or underdeveloped. One such area was the financing of non-profit service providers in active labour market policy and social inclusion. This sector was by and large created thanks to EU funds starting already before Hungary's accession (Hétfa – Revita 2013a). As Graph 5 shows below, yearly allocations to such nonprofits increased more than threefold after post-accession Structural Funds arrived. (Note also the shrinking of national resources after 2006.)

It is hardly an exaggeration to say that Hungary's policy makers and public administrators were overwhelmed by the large inflow of Structural Funds. The intricate regulatory framework that accompanied the spending of funds made absorption itself a massive implementation challenge. Not surprisingly, absorption became a salient political issue from early on and grew only more important as

austerity set in. As an internal memorandum of the (left-wing) government made it clear in 2008, ‘the (political) measure of success both externally [by the European Commission] and internally [in Hungary] will be the degree of absorption (since effectiveness can be judged only after some time)’. In 2012, the prime minister (now from the political right) agreed: “Every single cent of the EU funds has to find its way to its destination and we will not accept any compromise in this”.³¹

Graph 5. EU funds and national sources supporting nonprofits in the fields of social inclusion and employment, 1999-2013



Own calculations based on data from official reports for Phare, Equal, and the National Employment Foundation, and the monitoring database of Structural Funds in Hungary (EMIR)

Although absorption was a political ‘trump-card’, governments also wanted the funds to contribute effectively to its policy goals. The framework contract for the period 2007/2013 signed with the Commission was widely marketed by the government as the ‘New Hungary Development Plan’ which ought to support several policy goals.³² After a change in government in 2010, this expectation grew markedly stronger as the government introduced its own new development plan for reinvigorating the economy

³¹ See note 24.

³² See e.g. the Prime Minister’s remarks in 2007 in the press about the Development Plan’s importance to long-term strategic goals: <http://stop.hu/belfold/gyurcsany-az-umft-nem-lett-politikai-csatarozasok-aldozata/185882/> (15.02.2014).

after the financial crisis³³ (called New Széchenyi Plan, named after the great Hungarian 19th century statesman), which was financed entirely by EU Funds. By ‘repackaging’ the programmes co-financed by the EU and placing it high on its political agenda, the government increased its political commitment to spend the funds in ways that further its own substantive policy goals. In fact, it could hardly have done otherwise. As the numbers above make clear, it had little non-EU resources to finance anything beyond the basic routine active activities of the public sector. EU funds were seen in 2006 – not unreasonably – as ‘free money that was additional to sectoral budgets.’ Consequently, existing sectoral policies could be pursued largely independent of EU funds. As a result of the fiscal crisis leading to austerity, the situation changed: the government had to realise that ‘EU funds are virtually the only sources available for any policy initiatives’.³⁴

All in all, absorption had high political salience and remained the overriding concern of Hungarian governments throughout the entire period. Policy effectiveness remained secondary but gradually increased in importance, especially after national budgetary resources ebbed due to recession and austerity. According to *Hypothesis 1*, national governments face a trade-off between the goals of absorption and policy effectiveness. Both goals were clearly present in Hungary. The analysis of public statements and documents does not allow us to conclude that there was a trade-off between the two goals. As we shall see, however, the government’s struggles to institutionalise the implementation of cohesion policy revolved around this trade-off.

8.3. Choosing agents: the creation of an autonomous field of ‘development policy’

Our model implied that the relative importance of absorption and policy effectiveness drive the choice of implementing agents within the Member State; and the most important choice is between differentiated (single-purpose) and integrated (multi-purpose) implementing organisations.

In 2006, Hungary opted for a differentiated and highly centralised system of implementation. This was a response to the perceived difficulties of the partially integrated system put in place after Hungary’s accession to the EU (Heil 2013). In that system, Managing Authorities were integrated into ministries as ordinary departments. The main problems were the slowness of implementation and the proliferation of tendering and contracting procedures. What was demanded by potential beneficiaries and their political representatives was ‘simplification, standardisation and acceleration’ (Heil 2013: 38). One source of the problems was that the logic of programming and project management was alien to the organisational culture of most ministries. This was made worse by the fact that the implementation system was largely developed and run by officials who had belonged to the tightly-knit cadre previously responsible for PHARE and other pre-accession programmes (Mike 2004;

³³ Between 2009 and 2010, Hungary had a caretaker government with little political autonomy. So political response to the financial crisis (which was mainly a crisis of the public budget in Hungary) was somewhat delayed until after the next parliamentary elections.

³⁴ Quotations from an interview with a high-level government official.

2010). They had gained experience in working with the European Commission and the project logic characteristic of cohesion policy, which proved to be a great asset after the accession. But they remained outsiders to sectoral policies and traditional parts of national public administration. As a consequence, Managing Authorities did not integrate effectively into ministerial structures. Hence, the main benefit of assigning implementation to multi-purpose integrated agencies – the coordination of the use of funds with related policy actions – could not be realised.

The new system united all Managing Authorities (MAs) in a separate ministry called the National Development Agency. MAs became responsible for the design, monitoring and evaluation of Operating Programmes. The roles of Intermediate Bodies were assigned to organisations created specifically for these tasks (both at national and regional level). Their responsibilities were strictly administrative in nature, including tendering, contracting, payments, monitoring and audit.

Thus, the system created in 2006 was separated as much as possible from pre-existing parts of public administration. This is perhaps most clearly reflected in the Hungarian habit of referring to all EU funded projects as measures of ‘development policy’, viewed as an independent policy field. The institutional system was designed so that its central goal and success criterion would be the smooth implementation of Operational Programmes rather than contributing to any specific substantive policy goals. It was acknowledged from the start that it will be challenging to channel sufficient sectoral expertise into implementation and coordinate EU funded projects with nationally financed activities (Heil 2013). Nonetheless, the institutional setup was designed to give priority to absorption and regular implementation. Basically all reports and evaluations agree that absorption and the regularity of spending were the primary goals of ‘development policy’ both between 2004 and 2006 and between 2007 and 2013.³⁵

The system set up in 2006 was kept in place after a change in government in 2010 despite far-reaching institutional reforms in many segments of the public sector. As the programming period progressed, absorption remained the most important political measure of success for the National Development Agency.³⁶ At the same time, the role of sectoral ministries in the design (but not the implementation) of individual financing constructions was somewhat strengthened. They became responsible for ‘preparing the professional content of financing constructions’ and ‘following the professional aspects of tendering calls and strategic projects’.³⁷ Hence, they were given a stronger say in the professional content of project designs while the entire institutional system of implementation was kept in place. This can be interpreted as a small step towards an integrated model. That this interpretation is correct is proven by the fact that the government has most recently³⁸ decided to abolish the National Development Agency and move the Managing Authorities to sectoral ministries. This was done in preparation for the next programming period starting in 2014

³⁵ For example. Hungarian State Audit Office (2006; 2011), KPMG (2011), Perger (2009).

³⁶ See e.g. the media coverage about an outgoing president of NDA, whose performance was evaluated solely in terms of absorption rates: <http://www.origo.hu/gazdasag/20130429-tavozik-az-nfu-vezetoje.html> (19.07.2013).

³⁷ 4/2011. (I. 28.) Governmental decree.

³⁸ At the time of writing this study.

The institutional development of cohesion policy in Hungary is clearly linked to the dilemma of absorption vs policy effectiveness. It reflects the primacy of absorption but also the growing (secondary) emphasis on policy effectiveness. The large size of funds made absorption a very serious administrative challenge and also a politically salient issue. The national government responded by creating a ‘single-purpose’ National Development Agency uniting all Managing Authorities and a system of ‘single-purpose’ Intermediate Bodies. As the importance of EU funds for several policy sectors became clear (largely due to a contraction of the national budget), sectoral administrations became responsible for the ‘professional content’ but not the institutional (i.e. contracting) features of EU funded programmes. Thus, our findings support *Hypothesis 2* which stated that a key institutional choice for a national government is whether to contract differentiated (single-purpose) or integrated (multi-purpose) agencies for implementation. The shift towards an integrated system as the relative political importance of policy effectiveness increased is also in line with *Hypothesis 2a*, which stated that focus on absorption implies a differentiated solution, while focus on policy effectiveness implies an integrated one.

8.4. Choosing contract design: the tide of projectification

In addition to selecting agents, a national government has some autonomy in choosing between different contractual forms these agents should use. In our model, the crucial choice was between project-form contracts and other contract types ordinarily used for the financed activity.

Like many other Member States (Wostner 2008), Hungary adopted the practice that the Managing Authorities of cohesion policy (through their Intermediate Bodies) used two fundamental forms of contracting: competitive calls for tenders and strategic projects. Tendering procedures aimed to select public or private organisations which became the final beneficiaries of funds. In Hungary’s system, these organisations signed project-form contracts. So this form of contracting corresponded to the projectification of the entire implementation process, as explained in the theoretical model above. Strategic projects were not tendered but typically signed with sectoral ministries or their high level agencies, which were then responsible for using their existing internal governance structures for implementation. At least in principle, strategic projects provided the contractual framework that could insulate the end of the implementation chain from project logic. So the contractual choice identified in our model was clearly present in Hungary.

In the following, we summarise the findings of evaluations of the use of EU Funds in employment policy and higher education policy. They allow us to see if the dilemma of relying on the full projectification of the implementation chain or insulating lower-level implementation from the project logic was actually perceived by decision-makers in Hungary (*Hypothesis 3*). The comparison of different interventions also enables us to check if contractual design really depends on the trust of Managing Authorities in the sectoral administration (*3a*). Unfortunately, we cannot examine the influence of political goals on contract design (*3b*). Policy effectiveness gained somewhat in importance relative to absorption over time, therefore a shift away from full projectification towards insulation from project logic should have occurred.

However, we do not have sufficient information about how contractual design *for the same type of policies* changed over time.

8.4.1. Employment policy

An important goal of the ‘Social Renewal Operational Programme’ was to increase the volume and quality of active labour market policies. One package of programmes financed services provided by the public employment service (PES), while another package targeted non-profit service providers. We explore and compare the contract design of these two packages.

The PES in Hungary is a multi-level network, consisting of ministerial oversight, a national office (National Labour Office), regional centres³⁹ and local branch-offices. As for the programmes financing PES services, the Managing Authority had to decide with which level(s) to contract and in what form. In principle, it could contract with the national office (or the overseeing ministry) for one large strategic project and leave its implementation to the internal governance system of PES (corresponding to the ideal type of ‘insulation from project logic’). Alternatively, it could issue a call for tenders to regional centres or local branch-offices and sign project-form contracts directly with them (corresponding to the ideal type of full-blown projectification). Or it could choose some other contractual solution in-between. In fact, it chose the last option.

The MA signed several strategic contracts with a consortium led by the ministry responsible for labour market policy and consisting of the regional labour market centres. Separate contracts were signed for three broad target groups: disabled people, people who have received social assistance, and unemployed people belonging to socially disadvantaged groups.⁴⁰ The strategic contracts defined subprojects for each region, making each regional PES centre directly responsible for keeping procedural obligations and fulfilling contracted indicators. In this way, it partially circumvented the existing internal governance structure of PES. It chose not to rely on its internal system of management by objectives. Nor did it accept its existing monitoring system but requested regional centres to set up a parallel system for EU-funded projects. It did not have sufficient trust in the capability of the existing internal systems, which were themselves under development. Nonetheless, experts of the PES and its ministerial oversight were closely involved in the planning and professional control of regional projects as well as their coordination with non-EU-funded activities (which target groups should receive what kind of services in what volume). In sum, implementation was partly projectified, partly reliant on the internal governance mechanisms of PES.

For the programmes financing non-profit service providers, a very different contractual design was chosen. The ministry proposed that non-profit service providers should be financed through PES. Regional centres could decide about the mix of services and outsource to external providers what they cannot efficiently

³⁹ Subsequently reorganised into county-level centres. (Hungarian has 7 NUTS-2 level regions, made up of 19 counties plus the capital.)

⁴⁰ The contracts belong to the following measure of the Social Renewal Operating Programme: SROP 1.1. Development of the Employment Service and the Establishment of an Integrated System of Employment and Social Policy.

produce in house. This corresponds to the usual international practice and the recommendations of the relevant literature (Butler 2005): coordination and professional control requires that external non-profit providers are contracted by the public organisation that is responsible for labour market services. After long discussions, the Managing Authority vetoed this solution. Instead, it announced open tendering calls for nonprofits directly through its Intermediate Body. The main reason for the MA's reluctance to rely on PES was the underdeveloped state of the organisation's capacities to contract for and manage external service provision. The MA had no trust in the ability of PES to handle complex and risky contracts with third parties in compliance with all relevant regulations. In effect, a new tendering system was created for non-profit service providers within the field of 'development policy', which began to function parallel to and largely uncoordinated with the PES system. In contractual terms, the government and its agencies used project-form contracts in the full length of the implementation process, down to the final beneficiary organisations and explicitly rejected other contractual solutions.

Both packages of labour market programmes corroborate *Hypothesis 3* that the choice between projectification and insulation from project logic by relying on existing sectoral contract design present an important dilemma for the government. We detected a general preference for projectification, which was deemed desirable in order to secure absorption. However, the two packages differed in their extent of projectification. As for the package for non-profits, the Managing Authority chose full-blown projectification because it had no trust in the ability of PES to manage outsourcing in compliance with administrative requirements and indicator prescriptions. As for the package for internal service provision by PES, the Authority accepted a combination of project-form contracts and reliance the organisation's internal contractual mechanisms since it had more – though also limited – trust in the ability of PES to manage at least its internal affairs. This is in line with *Hypothesis 3b* that stated that reliance on projectification is more likely if the government lacks trust in the sectoral or regional administration.

8.4.2. Higher education policy

As Graph 5 illustrated, higher education institutions saw a substantial part of their budgetary support replaced by financial sources from Structural Funds. Most (though not all, as we shall see) of these sources were contracted in project form through a competitive call process, similar to the case of non-profit providers of active labour market services. Although the ministry responsible for higher education took an active part in designing the calls, they were not integrated into the national system of financing higher education institutions but were managed separately in the differentiated sphere of 'development policy'. The efforts and failure of integration are best illuminated by the example of the so-called 'research university projects'⁴¹. In 2010, the ministry responsible for higher education announced a certification procedure for 'research universities'.⁴² The idea was taken from the German Excellence Initiative (launched in 2006) which awards extra funds in a competitive selection process to higher education institutions which excel in high-quality research.

⁴¹ Financing measure SROP 4.2.1/B within the Social Renewal Operating Programme.

⁴² See <http://www.nefmi.gov.hu/felsooktatas/archivum/kutatoegyetem-minosites> (15.02.2014)

Unlike the German system, the Hungarian ministry did not attach funding directly to the title but declared that certified research universities ‘may receive additional financial support in a separate procedure’⁴³. However, this was not to be. Instead a call for tenders was issued by the responsible Managing Authority (through its Intermediate Body). The call was issued *before* the certification process ended, used different criteria and was eventually won by almost all Hungarian universities, several of which were not to receive certification as ‘research universities’ (Hétfa – Revita 2013b). The call was considered by all institutions as a one-time affair for three reasons. First, the availability of future resources from either the national budget or the Structural Funds of the next programming period were seen as highly uncertain. Second, the call was not integrated into the national governance system of higher education, which could have given it permanence. Third, the projects had to be completed in 2 years, which is far too short to engage in any serious new research programmes. The comparison with the German system is striking. There, the two most important and stable national organisations in research policy⁴⁴ were given joint responsibility for running the Excellence Initiative. Three rounds were financed between 2006 and 2012, offering five-year contracts for the selected organisations. Ironically, the German federal government now believes that the main weakness of the Initiative is that it provides support in the form of ‘projects limited in time and topics’ and is now planning to shift to more ‘permanent arrangements’ to finance research excellence in higher education.⁴⁵ How would they judge the Hungarian case? It would, of course, be wrong to put down the choice of a less-than-suitable contracting form simply to the myopia or incompetence of Hungarian government. It was rather a compromise between absorption and policy effectiveness, the goal of absorption winning the day (Hétfa – Revita 2013b).

It is also worth examining a counter-example, which sheds further light on the factors that facilitate the integration of fund allocation into a national system. The programme ‘Campus Hungary’ was launched by Balassi Institute, the government’s central organisation responsible for international cultural relations (i.e. the Hungarian counterpart of the British Council or Goethe Institut). The Managing Authority contracted with Balassi Institute for the implementation of a strategic project. The Institute uses the funds to award short and medium-term scholarships to Hungarian students studying abroad and foreign students studying in Hungary. It signs ordinary scholarship contracts directly with individual students (rather than universities), selects scholars through an academic committee, and expects academic reports rather than financial accounts and promised indicators. Instead of using project-form contracts with the final beneficiaries, it relies on the traditional contracting method of the field and insulates the allocation process from project logic.

⁴³ I/D. §, 276/2009. (XII. 4.) Governmental decree.

⁴⁴ The German Research Foundation (Deutsche Forschungsgemeinschaft) and the German Council of Science and Humanities (Wissenschaftsrat). See www.dfg.de/en/research_funding/programmes/excellence_initiative/ (15.02.2014).

⁴⁵ E.g. see the press release by the German Federal Ministry of Education and Research: Mehr Kooperation von Bund und Ländern an den Hochschulen [More cooperation between the Federal Government and the States in Higher Education] <http://www.bmbf.de/press/3291.php> (15.02.2014).

Why was the integrated contracting solution accepted for Campus Hungary but not for research universities? In the former case, the Managing Authority had trust that a national organisation could allocate resources in a way that ensured absorption and regularity. Trust existed because a management and monitoring system for students' travelling scholarships was relatively easy to set up and run. By contrast, contracts with universities were much larger and covered a plethora of activities. Thus, they were much more complex and risky. Setting up a national management and monitoring system would have been much more costly and far more difficult for the managing authority to control from outside. Moreover, the establishment of such a dedicated system would have required significant institutional investment, whose return would have been questionable due to the uncertainty of future financing from EU funds in the next programming period.

8.4.3. Summary of findings about contract design

The findings of evaluations are in line with the hypotheses about the choice of contract design within Member States. A key issue of financing both active labour market policies and higher education is whether to use project-form contracts or other contractual solutions with final beneficiaries (*Hypothesis 3*). This translates into a choice between setting up a separate calls system or relying on existing or newly created sectoral governance structures. The more costly and difficult it is to set up a sectoral system of allocation and monitoring which can ensure absorption and regularity, the less willing a managing authority will be to transfer the responsibility of lower-level contracting to national sectoral agencies, and the more it will prefer direct project-form control over the entire implementation process (*Hypothesis 3b*).

8.5. The distortive effects of projectification: indicators, high and low

Our theoretical model highlighted the potentially distortive effects of project-form contracts for hard-to-measure policies (*Hypothesis 4*). We also argued that these distortions can be mitigated by reducing formal project expectations and relying more on other contractual safeguards tailored to hard-to-measure activities (*Hypothesis 4a*). The evaluations of EU-cofinanced programmes in employment services and higher education in Hungary also provide evidence pertaining to these conjectures. Document analysis of contracts, interviews with policy makers, experts and implementing officials as well as a large number of case studies about the organisations which actually implemented the projects (universities, nonprofits, and employment offices) were used to evaluate the efficiency and effectiveness of the programmes.

The financing contracts evaluated in Hungary all focussed very heavily on financial regularity and the production of indicators. The key indicators were simply taken from the Operating Programmes and transposed into financing contracts. (A few other indicators were added when the OP-level indicators seemed particularly irrelevant or incomplete for the projects.) Initially, financing was tied in a rather crude form to indicators: if a beneficiary did not produce a certain threshold value of the indicators on average, it had to pay the money back. This placed the entire risk of project performance captured by indicators on the beneficiary. The government played a 'hot potato' game of risk-shifting: the national government shifted the risks associated with

the production of indicators to Managing Authorities, the latter to Intermediate Bodies, which shifted them further to beneficiaries. As the programming period wore on, indicator risks materialised and threatened absorption. The government responded by taking over part of the risk from project beneficiaries: indicator values could now fall below threshold levels to a certain extent and funds would be lost only in proportion to the gap between actual and threshold values. However, the change was not motivated by more efficient risk-sharing. The risks of beneficiaries were considered only so far as they threatened timely absorption. So far there was a real danger that beneficiaries would throw back the hot potatoes of risky indicators. In fact, Managing Authorities emphatically did not look upon indicators as either performance incentives or risk-sharing tools. They viewed them simply as obligations, imposed by the contract between Commission and Member State, to which all benefitting actors should contribute roughly in proportion to the funds received (Hétfa – Revita 2013b).

Potential beneficiaries responded by promising as low indicator values ex ante as possible without endangering access to funds, and structuring their activities ex post to minimise the risk of not fulfilling producing contracted indicator values. When their ex ante strategy worked out well, indicators became mere administrative burdens (that could be very high, actually), without distorting effect on the organisation's activities. This was the case for most indicators in several projects in higher education. Universities promised numbers of refereed publications or numbers of PhD students involved in research projects, which could be easily fulfilled. As suggested by our model, this was not necessarily the system's worst outcome. Evaluation showed that incentives outside the project-form contracts often played a very effective role in inducing the beneficiaries to undertake meaningful and productive activities. Higher education institutions embedded in international science networks or strong partnerships with regional employers often had strong incentives to make good use of their funds.

When indicators were high enough to influence the behaviour of beneficiaries, highly risk-averse behaviour prevailed. Most non-profit beneficiaries in the field of active labour market policy had to tailor their activities to fulfil indicator requirements (Hétfa – Revita 2013a). They refrained from truly innovative activities and 'cherry-picked' their project locations, target-groups and individual participants very cautiously. Although they were assumed to reach the most vulnerable social groups, they faced strong perverse incentives not to do so.

All these findings are in line with *Hypothesis 4* that project-form contracting with a strong emphasis on verifiable information cannot ensure the policy effectiveness of government support to hard-to-measure activities. It is rather good at preventing the blatantly fraudulent spending of funds and making all actors bent on contributing to official indicators. It is much weaker at providing proper incentives to beneficiaries. In many instances, the best it can achieve is to allocate money to actors who face an institutional environment with good incentives anyway (*Hypothesis 4a*).

9. CONCLUSIONS AND RECOMMENDATIONS FOR INSTITUTIONAL IMPROVEMENT

The workings of EU cohesion policy are to a large degree determined by the original contract between the Member States and the Commission which delegates supervisory powers over common policies to the latter. The Commission is expected to control how national governments spend Structural Funds, using their own agents for implementation within Member States. A project-form contract between the Commission and the Member State is signed ‘in the shadow of verifiability’: representatives of Member States in the Council (and the Parliament) expect the Commission to produce verifiable information on the lack of fraud as well as the results of financed programmes. An important consequence is the Commission’s strong emphasis on quantified, short-term indicators of performance and compliance with administrative procedures. This leads to risk-averse Member State behaviour and biases implementation so that non-measurable and long-term programme outcomes and effects are neglected.

One implication is that many problems of cohesion policy can be mitigated only if the expectations of verifiability are lessened. One way to achieve this would be to transform the European Commission into a federal government. It would then become the principal rather than a supervisor. Short of such a fundamental change (which, of course, may be undesirable, if for no other reason, than a European electorate’s difficulty of controlling such a supranational principal), shifting the focus of Structural Fund spending towards a smaller number of interventions may mitigate contracting problems. For more visible and focused expenditure, more qualitative evidence could at least partly replace the current regiment of quantified short-term indicators as verified information. Unfortunately, the Commission’s proposal for the next programming period (2014-20) points in the opposite direction: it plans to put even more emphasis on even more standardised indicators and, as a new element, even attach explicit sanctions to underperformance in terms of indicators (EC 2013b).

Even if the contract between Commission and Member State does not change favourably, a national government has some room to mitigate the problems caused by rigid project-form contracting. An important impediment, at least in countries with large fund allocations, is the political salience of absorption for its own sake. Initiatives to change political discourse may draw attention to the costs of absorption in terms of policy effectiveness. But even without a supporting discourse, the government may be able to shift spending towards easy-to-measure interventions for which the project form is more appropriate. In addition, it may try to devise the implementation process for hard-to-measure policy areas in such a way that implementing agents be insulated from project logic. Typically, this requires strengthening sectoral governance structures (such as a Public Employment Service or a financing system of higher education, as shown in our case study) so that they could be trusted to comply with the Commission’s administrative prescriptions and the requirements to supply verifiable values of indicators. If this condition is satisfied, they can use their own, non-projectified contracting practices with the final beneficiaries of funds. A step in the right direction is the Commission’s novel concept of ‘ex ante conditionality’ (EC 2103b). This is basically the requirement that national strategies for affected policy fields should be prepared before the national contract

about the programming of Structural Funds is signed. Of course, a strategy on paper is not yet the actual institutional development of public administrative structures.

Even where the project form is kept, there may be room for increasing effectiveness by more thoughtful contract design. A more reflected and professional approach to handling risks and providing incentives rather than simply demanding that beneficiaries produce indicator values may often be a significant improvement. An alternative is more conscious reliance on incentives outside the project contracts, such as reputation, and selecting beneficiaries who face such incentives.

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