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## Book

# Bridges to nowhere : state capture and corruption risks in fiscal transfers and public procurement at the local level in Southeast Europe

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# Bridges to Nowhere

**State Capture and Corruption Risks in Fiscal Transfers and Public Procurement at the Local Level in Southeast Europe**



# **Bridges to Nowhere**

**State Capture and Corruption Risks  
in Fiscal Transfers and Public Procurement  
at the Local Level in Southeast Europe**

The Regional Good Governance Public-Private Partnership Platform (R2G4P), coordinated by the Center for the Study of Democracy, Sofia aims to strengthen the rule of law in Southeast Europe (SEE) through delivering shared anticorruption solutions between state institutions and civil society. The current 2023 Regional Good Governance Report, looks into the legal, institutional and procedural improvements needed to prevent and tackle state capture and corruption risks in fiscal transfers and pork barrelling from the central towards the local level, and the ensuing public procurement in Southeast Europe (SEE). The report provides a first of its kind anti-corruption diagnostics of the integrity of the local level transfers and public procurement systems in nine SEE countries (Bulgaria, Croatia, Hungary, Romania, Albania, Bosnia and Herzegovina, North Macedonia, Montenegro, and Serbia). The report summarizes the key conclusions and policy recommendations from R2G4P's work in 2023.

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# LIST OF ABBREVIATIONS

<b>ACER</b>	Albanian Center for Economic Research
<b>AFCOS</b>	Protection of the European Union Financial Interests Directorate at the Ministry of Interior (Bulgarian anti-fraud coordination service)
<b>ANI</b>	National Integrity Agency (Romania)
<b>BiH</b>	Bosnia and Herzegovina
<b>CMS</b>	Corruption Monitoring System
<b>CPL</b>	Corruption Proofing of Legislation
<b>CRA</b>	Corruption Risk Assessment
<b>CRIs</b>	Corruption Risk Indicators
<b>CSD</b>	Center for the Study of Democracy
<b>CSOs</b>	Civil Society Organisations
<b>EEA</b>	European Economic Area
<b>EPPO</b>	European Public Prosecutor's Office
<b>EU</b>	European Union
<b>EUR</b>	Euro
<b>FBiH</b>	Federation of Bosnia and Herzegovina
<b>GDP</b>	Gross Domestic Product
<b>GERB</b>	Citizens for European Development of Bulgaria (political party)
<b>GIFT</b>	Global Initiative on Fiscal Transparency
<b>GR</b>	"Golden Rule" related to the authorisation of long-term debts only for investment purposes
<b>GRECO</b>	Group of States against Corruption
<b>GTI</b>	Government Transparency Institute
<b>HDZ</b>	Croatian Democratic Union (political party)
<b>IMF</b>	International Monetary Fund
<b>KPKONPI</b>	Commission for Combatting Corruption and Confiscation of Illegally Acquired Property (Bulgaria)
<b>MACPI</b>	Monitoring Anticorruption Policy Implementation
<b>MDLPA</b>	Ministry of Local Development, Works and Administration (Romania)
<b>MPs</b>	Members of Parliament
<b>NUTS</b>	Nomenclature of Territorial Units for Statistics
<b>OECD</b>	Organisation for Economic Co-operation and Development

<b>PEFA</b>	Public Expenditure and Financial Accountability
<b>PIT</b>	Personal income tax
<b>PNDL</b>	National Program for Local Development (Romania)
<b>R2G4P</b>	Regional Good Governance Public-Private Partnership Platform
<b>RS</b>	Republika Srpska
<b>SCAD</b>	State Capture Assessment Diagnostics
<b>SCAD-SLIT</b>	State Capture Assessment Diagnostics at Sectoral Level
<b>SDA</b>	Party of Democratic Action (political party in Bosnia and Herzegovina)
<b>SEE/SEE-9</b>	Southeast Europe (Bulgaria, Croatia, Hungary, Romania, Albania, Bosnia and Herzegovina, North Macedonia, Montenegro, and Serbia)
<b>SELDI</b>	Southeast European Leadership for Development and Integrity
<b>SNS</b>	Serbian Progressive Party
<b>SOE</b>	State-Owned Enterprise
<b>SPS</b>	Socialist Party of Serbia
<b>UCLG</b>	United Cities and Local Governments
<b>UNCAC</b>	United Nations Convention Against Corruption
<b>VAT</b>	Value added tax

# EXECUTIVE SUMMARY

## Public finances in SEE are vulnerable to capture

The rising global geopolitical tensions have put the European Union (EU) and its neighbourhoods under additional stress, as evidenced by the brutal wars in Ukraine, Nagorno-Karabakh, Israel and Africa. Corruption and **state capture vulnerabilities have turned into serious (economic) security concerns**, while simultaneously making them more difficult to tackle, in particular in non-established democracies, as entrenched elites turn to geopolitical leverage games. Addressing these vulnerabilities in Southeast Europe (SEE), is critical for the further integration of the region into the EU, and the survival of the democratic tradition in Europe.

The ongoing overlapping transitions in the technological, economic and geopolitical realms raise the significance of the proper **governance of public finances** in SEE. However, when government structures in charge of public finances have become geared into state capture networks, as has been evidenced in many cases in SEE, any general considerations about the optimal management design need to be modulated through knowledge about the **mechanisms of state capture**. The building blocks of state capture include a variety of tools, such as power over the design and enforcement of regulations, privileged access to public resources, control over the media and the financial sector, influence over domestic and foreign policy, etc. When the machinery of state has been captured by special interests, the real decision-making power over the allocation of public resources resides in the **leaders of patronage and clientelist networks** which shadow official government institutions, and which typically are party-political leaders with long-term access to public resources.

This report analyses the risks entailed by the **misuse of fiscal transfers from central to local governments** in nine SEE countries. Such transfers are typically a tool of equalisation policies seeking to offset disparities in the economic development of territorial units and ensure equitable delivery of public services across the whole country/society. When general rule of law is compromised, however, intergovernmental transfers can be susceptible to **corruption risks** which can undermine the effectiveness of these transfers and lead to misallocation or diversion of funds. The distortions created by clientelistic transfers are at risk of being further exacerbated by rigged local government procurement. When local purchasing and investment is compromised, the inequity of preferential intergovernmental transfers to local allies of the central government is compounded by the channelling of public money to local business cronies.

The impact of the cumulative distortions created by the misallocation of public finances at the intergovernmental and local levels goes beyond the national borders. Since the European Union is a major financial donor to these countries, their domestic policies and the way they procure services and assets



at local level have an impact on whether and to what extent **EU aid** is effective in promoting balanced economic development. In fact, typically it is the same **state capture cliques** which exploit both intranational and EU transfers for the benefit of special interests. **Uneven data availability** prevents definite conclusions about specific cases and patterns of state capture vulnerabilities in SEE, in particular as concerns EU candidates. Yet, the findings presented here should prompt further inquiries into the involvement of electoral or clientelistic considerations influencing the local allocation of European funds. It is at this level that all the governance risks converge and consequences are experienced by individuals and businesses. **Regular risk monitoring and assessment** through evidence-gathering mechanisms is therefore required to inform prevention policies.

## Fiscal decentralisation needs a strong revenue base

Given that intergovernmental transfers are used in SEE as an instrument which enables political influence on local governments, the level of fiscal decentralisation is a key underlying factor. Although most of the SEE countries have made substantial progress during the last 10 years, in one way or another the **fiscal decentralisation remains a challenge** for all of them. Most local governments remain highly dependent on the central government with a **significant share of transfers compared to tax revenue**. Their own revenues represent insignificant part of their countries' GDP, ranking below the EU and OECD averages. The same goes for local expenditure levels as a share of total government (public) expenditure and GDP.

### Subnational government expenditure as share of public expenditure and GDP in SEE

	% public expenditure	% GDP
EU27 average	34.3%	18.3%
OECD average	36.6%	17.1%
Albania	18.7%	6.2%
Bulgaria	17.7%	7.4%
BiH	10.5%	5.0%
Croatia	26.1%	14.2%
Hungary	12.5%	6.5%
Montenegro	11.5%	6.7%
North Macedonia	13.6%	5.2%
Romania	22.6%	9.5%
Serbia	19%	10.3%

**Source:** OECD/UCLG, 2022 *Country Profiles of the World Observatory on Subnational Government Finance and Investment*, 2022.

## Corruption risks in central-local government fiscal relations

Consequently, governments in the region might experience **resource allocation challenges** where municipalities have limited financial resources to address local needs, leading to disparities in service delivery and development across regions. The result are fiscal imbalances, limited local self-financing power and strong central government leverage. With the exception of Montenegro, in all other SEE countries the distribution of transfers from central government is the main instrument of keeping the local services functioning. This and the common lack of transparency and predictable intergovernmental system make the SEE local authorities **vulnerable to clientelist or electorally motivated interventions**.

Central funding through transfers, however, can undermine local fiscal autonomy. This is understood as the ability of subnational governments to raise tax locally to finance expenditures but also decrease local leaders' motivation to increase the tax burden in their jurisdictions due to the provided transfers from central government.

A high degree of administrative and fiscal centralisation could be a considerable risk factor for state capture; the latter, in turn, further institutionalises this centralisation. Risk evaluation should start with an examination of the design of the transfer system employed in SEE.

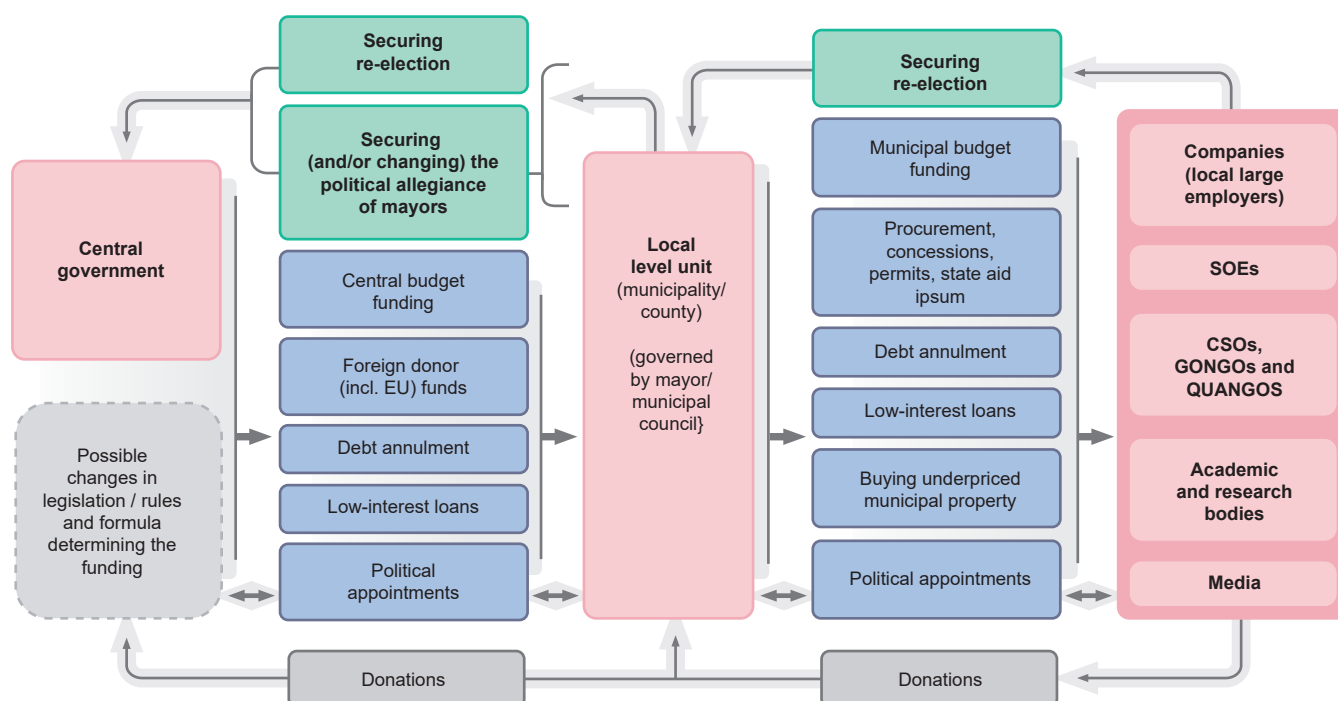
**Conditional transfers** allow central governments more latitude how and for what to spend the money than unconditional transfers. However, because they are allocated through intergovernmental negotiations, they provide local level leaders with a manoeuvring margin to extract additional resources from the central administration. Conditional intergovernmental transfers render local officials subordinate to the priorities of the centre, with the associated **rent-seeking** effects.

The room for manoeuvre of central governments with **unconditional transfers** is more limited since the amount which each municipality is receiving is determined by a formula. However, there are risks related to the political manipulation of the formula by the incumbent government or discrepancies between the determined by formula transfers' value and the actually distributed amounts. Reducing formula complexity and increasing its transparency during and after implementation is a logical step for the SEE countries to avoid or **moderate governance risks and political capture**. The simpler the transfer formula is to apply, the easier is the oversight of its implementation.

Risk mitigation policies require an **understanding of the incentives driving clientelism** in intergovernmental fiscal relations. Central and local governments, as well as the incumbent political parties, benefit by building central and local leaders' reputations, securing votes and re-election. Intergovernmental transfers in SEE have been used to **secure and/or change the political allegiance of mayors**. Similarly, the previous allocation of funds has served to re-confirm the political loyalty of mayors. However, the promise of future funding tends to sway some mayors to change their allegiance toward

the political party, which is most likely to win the upcoming elections. When the territory (municipality) is politically aligned with the incumbent party(s) of the central government it can benefit by **higher allocations from central budget funding or from foreign donor (including EU) funding** compared to similar in size and needs municipalities run by the opposition. Local companies, usually large employers, as well as in particular SOEs, benefit by **non-competitive award of municipal budget funding**.

**The intergovernmental spending channels exposed to corruption and state capture risks (clientelist transfer channels)**



Source: CSD.

**Oversight and transparency of central-local government relations in SEE are wanting**

Most municipalities in SEE comply with transparency requirements only partially. Information on local government finances is public in name only without actually being accessible, easy to understand, or even relevant to citizens' concerns. In the nine analysed countries **citizens and non-governmental organisations are rarely involved** in the decision-making related to local government finances. The associations of municipalities are sometimes involved, however not all their recommendations are taken into account.

In terms of oversight, the SEE governments mostly **rely on existing generic control mechanisms** to prevent all corruption-related and fiscal mismanagement risks – budget planning oversight, inspections by audit authorities, financial police and inspectorates, local level anticorruption and ethical committees, councils, codes, integrity and action plans, etc. However, the specific **issue of the abuse of discretion in transfers for partisan purposes** and the related corruption and state capture risks

remain unacknowledged. This leads to the **lack of targeted prevention and deterrence measures**, as well as sanctions.

National legislation and strategies in SEE do not specifically identify any corruption risks related to the misuse of national and foreign donors' funds from the central to the local level; when they are mentioned in the national integrity strategies it is in a very general way.

**Integrity provisions at the municipal level** in SEE are often very general, target low-level civil servants rather than decision-makers, lack clear deadlines for their implementation and are not tailored to local circumstances. Municipal integrity plans focus on managing risks related to budget planning, public procurement planning and implementation, contract drafting and conclusion, financial management and controls, etc., but are often very general.

### Compromised local procurement further exacerbates the distortions of biased fiscal transfers

Public procurement is the government activity with one of the **highest corruption risks** in SEE, due to the large amounts distributed through procurement procedures. The types of **public procurement irregularities** identified in the region include favouritism and clientelism, overpricing of contracts, tailored tender specifications, conflict of interest in the tendering process, high share of non-open procedures, short advertisement periods, contract modification and delivering sub-standard service in the implementation phase.

The **lack of public procurement integrity systems at the municipal level** and mechanisms not tailored to local needs render the existing national ones ineffective.

The transparency of procurement contracts is usually ensured through the launch of dedicated online procurement portals. Still, the quality and extent of information provided by the local authorities in these portals differs across SEE countries. Transparency requirements are rather optional, and there is no follow up sanction in the case the local administration does not comply.

The evaluation and assessment of the public procurement procedures and the effectiveness of prevention measures usually rely on self-assessment using descriptive and qualitative methods. There is a **lack of clear indicators and quantitative evidence-based instruments** which can evaluate results. Procurement oversight and anticorruption authorities mostly look into input indicators (regulations, procedures, resources), rather than outputs, i.e., actual impact.

### Evidence of political favouritism in local public procurement

In order to find out whether – and if so how – local procurement follows partisan interests, leading to contract allocation according to political loyalty and electoral considerations, this report has examined the **presence of politically motivated factors in the distribution of public procurement contracts**. The statistical analysis of the relationship between public

procurement contract values, political party affiliation of local leadership and election results in nine countries in the SEE region, allows for a number of conclusions.

**Political alignment with the central government means larger contracts.**

In most of the countries studied, data suggests that there is a politically motivated distribution of public procurement spending rather than one based on impartial allocation, reflecting public needs. When municipalities are politically aligned with the ruling party of the national level, they tend to receive larger public procurement contracts.

**Winning margins in elections pay off.** Higher winning margins in local elections, which are used as indication of less political competition, are generally associated with a greater chance of winning larger contracts. This suggests that municipalities with predictable electoral outcomes tend to allocate more public procurement spending. This is possibly due to a higher likelihood of corruption, capture, or abuse. Case studies from Hungary and Romania provide concrete examples of how **political networks** can lead to abuse of public procurement processes, including favouring certain firms with political connections and inflating contract prices. These cases highlight the potential for corruption and conflict of interest in local government in these countries.

**Combined effects of political alignment and electoral competition.**

The directions of the relationships between these two factors vary across countries. Positive coefficients in some countries (e.g., Bulgaria, Hungary, and Romania) may indicate that politically aligned municipalities receive larger contracts, which could be due to political motivations or administrative efficiency. In contrast, negative coefficients in other countries (e.g., North Macedonia, Croatia, and Serbia) suggest that politically aligned municipalities receive smaller contracts, possibly as a strategy to obtain loyalty or support.

**Importance of local networks and context.** Corruption in public procurement is often facilitated by well-established local networks. The predictability of election results may affect these networks, and a disruption of such networks may reduce opportunities for corrupt cooperation. It is also important to consider the specific context of each country, including the share of public procurement at the local versus national level and the degree of fiscal and administrative decentralisation.

## The way forward: reducing the risks from clientelistic intergovernmental transfers

There are a number of policy measures, that could reduce the risks from discriminatory and biased funding from the central towards the local level, as well as the misuse or mismanagement of national and foreign donors' funds.

### Improve strategic planning and evidence-based decision-making

The first step involves the recognition of the problem in government policies. Once the problem is recognised, the process could move towards the establishment of clear and transparent criteria for funding allocation. Further, the evaluation of risks of preferential and politically biased decisions should be mainstreamed into fiscal oversight. The latter should involve collaboration among multiple public bodies in order to ensure transparency, accountability, and equitable distribution of resources between central and local governments.

Officials responsible for making funding decisions need to be trained to recognise and react to cases of preferential treatment and bias, while municipal officials should be equipped to detect public procurement irregularities and use electronic tendering procedures. Civil society could help with the organisation of such capacity building, as well as the introduction of electronic procurement.

### Establish a regular public-private mechanism for monitoring funding decisions for a combination of corruption and fiscal risks

Anticorruption agencies, audit offices, financial inspectorates, the associations of municipalities and civil society and the media should review decisions related to budget transfers and assess any potential bias, discrimination, or conflict of interest. The audit offices and financial inspection institutions should establish procedures for random and regular inspections in **cooperation with anti-corruption authorities**, in addition to the ad hoc checks performed based on requests, referrals and complaints. The review of the budget transfer decisions should:

- Consider the choice between unconditional transfers and conditional transfers;
- Detect the corruption risks associated with formula-based transfers such as manipulation of the formula criteria, data falsification, formula complexity and political interference in formula design;
- Check the accuracy of data inputs for the formula and the fairness of the allocation process;
- Recommend steps towards the reduction of formula complexity and the increase of transparency during and after its implementation to avoid and reduce policy indiscretion and political capture;

- Assess the links between political affiliation and fiscal transfers in historical perspective, including at least the last two local election cycles, as part of the annual budget procedure.

### Apply regular corruption risk assessment methods

In addition to the financial audits and the self-evaluation reports of local government authorities, it is also recommended for the governments at central and local level to use a wider range of corruption risk assessment mechanisms, in order to develop a comprehensive approach towards tackling all corruption and conflict of interest threats. These could include the following state of the art tools developed by R2G4P partners:

- The Monitoring Anticorruption Policy Implementation (MACPI) tool, which assesses, monitors and facilitates the enforcement of anticorruption measures and policies at the level of individual public bodies, including municipalities;
- The State Capture Assessment Diagnostics (SCAD), which is based on anonymous online survey among a large pool of experts, as well as the State Capture Assessment Diagnostics at Sectoral Level Integrated Tool (SCAD-SLIT);
- The Corruption Risk Indicators (CRIs), which measure the corruption risks of public procurements;
- The Corruption Monitoring System (CMS), which provides victimisation and perception data in the corruptness of municipal councillors and municipal officials;
- The corruption proofing of legislation (CPL) and anti-corruption tools related to asset declarations on local level.

### Increase the integrity of public procurement at local level

National and **EU oversight** of local level public procurement should be prioritised and increased in both fiscal and anti-corruption control systems. In particular, the European Commission should seek to establish a more coherent framework of monitoring the effects of its interventions through its different funding instruments at the local level, in combination with national transfers. In addition, the following measures could help improve the integrity of local level public procurement:

- State **clear commitments and set deadlines for public procurement reforms** in strategic documents (e.g., National Recovery and Resilience Plans).

- Establish **regular and systematic monitoring** of political favouritism between the national and local governments in public procurement building on the tools developed in this study.
- **Improve e-procurement data collection and publication**, collecting more comprehensive data by, for example, lowering reporting thresholds and making public data more readily accessible for societal actors (e.g., data download options).
- Further **strengthen the policies for transparent and fair allocation** of public procurement contracts by increasing publication of calls for tender, making tendering terms more pro-competitive, diminishing the use of non-open procedure types, and breaking up dominant market position of incumbent firms often having strong political connections.
- Improve **oversight of public procurement at the local level**, including review of anti-competitive tendering terms, to constrain the strategic use of public procurement for rewarding political actors for their loyalty.





# INTRODUCTION

The war in Ukraine and the EU's rush to shore up its neighbourhood from authoritarian encroachment have focused the spotlight on **the unfinished business of enlargement and integration in Southeast Europe**.<sup>1</sup> And once again, the critical issues of contention, which have stalled EU's efforts in this respect are the **outstanding rule of law and state capture problems** in the region. Local incumbents have pushed hard to overlook those issues for the sake of geopolitical stability, yet EU leaders have been wary this is the right trade off to make, given the experience with previous enlargements.<sup>2</sup> In addition, Russia's **continuing global effort to discredit the European idea** has forced European institutions to upgrade their domestic democratic resilience defences, including the adoption of a broad, **new anti-corruption package**, which would further raise governance standards for accession.<sup>3</sup> Hence, SEE countries need to continue their efforts on fighting back high-level corruption and state capture elements, in parallel to **building up their institutions of democratic resilience** on a daily basis through painstaking work on legal, institutional and practical checks and balances. At the same time, their leaders would have to fend off mounting pressure from Russia and China on embracing their **authoritarian, state capture-based model of development**, supported by seemingly no-strings attached transfers for infrastructure (such as for example from the Belt and Road Initiative).<sup>4</sup> In this respect, the governance of EU and national fiscal policies and transfers<sup>5</sup> will play an increasingly critical role in sustaining democratic resilience and **showing democracy can deliver** through spurring the continuous inflow of **constructive capital**.<sup>6</sup>

Public spending always incites intense controversies among analysts and practitioners. However, its significance rises even further in times of transition.

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<sup>1</sup> Georgiev, G. et al., *Breaking the Code: Russian and Chinese Disinformation and Illicit Financial Flows in Southeast Europe*, Sofia: Center for the Study of Democracy, 2023.

<sup>2</sup> Mineva, D. et al., *Rolling Back State Capture in Southeast Europe: Implementing Effective Instruments for Asset Declaration and Politically Exposed Companies*, Sofia: Center for the Study of Democracy, 2023.

<sup>3</sup> European Commission, *Anti-Corruption: Stronger rules to fight corruption in the EU and worldwide*, 3 May 2023.

<sup>4</sup> Dobson, J. W. et al., *Defending Democracy in an Age of Sharp Power*, Baltimore: John Hopkins University Press, 2023.

<sup>5</sup> For simplicity, this report uses the term *transfer(s)* in both its (i) broader sense, meaning all allocations of funding from central to local level governments, which could include grants, revenue sharing (when collected by the central government), loans, subsidies, etc.; and (ii) narrower sense, meaning grants. *Grants* is the most common term used in the literature to denote the most common fiscal transfers from the central to local governments. *Grants* can be sub-divided in many categories, yet the most common ones are conditional vs unconditional and discretionary vs non-discretionary. Other common uses depending on their purpose could include capital grants, matching grants, equalization grants, performance-based grants, emergency grants, etc.

<sup>6</sup> Center for the Study of Democracy, *Promoting Constructive Capital in Bulgaria: Unlocking Bulgarian Regions' Potential for Private Sector Innovation and Development*, Sofia: Center for the Study of Democracy, 2021.

As technological, social and geopolitical shifts accelerate, the **purpose and effectiveness of public expenditure** warrant additional scrutiny. The management of public finances is intertwined with public administration reform, and even more importantly it needs to be considered within the more general framework of **public governance**. Public financial management cannot be optimised when its governance is compromised. When, as is the case in the countries of Southeast Europe (albeit to a varying degree), the government structures in charge of public finances have become geared into or incapacitated by **state capture networks**, any general considerations about the optimal management design need to be modulated through knowledge about the mechanisms of state capture.

State capture is a form of corruption which programmes public institutions for a systematic delivery of private benefits to their captors.<sup>7</sup> The **building blocks of state capture** include a variety of tools, such as power over the design and enforcement of regulations, privileged access to public resources, control over the media and the financial sector, influence over domestic and foreign policy, etc. In its mature form, it goes beyond a simple deviation in the functioning of a given public institution into a **stable pattern of institutional behaviour** resistant to the application of standard, generalised anticorruption policies; it becomes a virtual long-term privatisation of government functions.

This paper analyses the risks entailed by the **misuse of fiscal transfers from central to local governments** in countries with significant state capture risks. Within nations, such transfers are a commonly used tool of **equalisation policies** seeking to offset disparities in the economic development of territorial units. They are, however, no less commonly subject to partisan bias, and not only in Southeast Europe. Malpractice in central-local government fiscal relations can take various forms. At one end are **favouritism and political particularism** of the “pork barrelling” variety – not illegal but often highly unfair and ineffective appropriations for the benefit of single constituencies. In many countries, the distributive choices of sub-national governments are often related to their electoral incentives; politicians seek to reward constituents or sway opponents. At the other, however, **political cronyism** can degenerate into outright **embezzlement**. When the machinery of state has been captured by special interests, the real decision-making power over the allocation of public resources resides in the **leaders of patronage and clientelist networks** which shadow official government institutions.<sup>8</sup>

Since public investment often represents a significant part of discretionary spending, its overall integrity largely depends on the **fairness of procurement procedures**. However, when local government purchasing is affected by various corrupt practices, equalisation policies might achieve the opposite of their official intention. In this case, the **inequity of preferential intergovernmental transfers** to local allies of the central government is

<sup>7</sup> Center for the Study of Democracy, [Assessing State Capture Vulnerabilities at the Sectoral Level](#), 2021.

<sup>8</sup> “I am the one who doles out the portions in this country,” went the infamous phrase of a Bulgarian politician.

compounded by the channelling of public money to **local business cronies**. Such accruing of risks requires an integrative approach to the design of oversight policies, whereby the compliance with fiscal and procurement rules is supervised in a coordinated manner with the enforcement of anti-corruption regulations.

The impact of the cumulative distortions created by the misallocation of public finances at the intergovernmental and local levels goes beyond the national borders. Since the European Union is by far the largest financial donor to SEE countries, their domestic policies and the way they procure services and assets at local level have an impact on **whether and to what extent EU aid is effective** in promoting balanced economic development. In fact, it is the same **state capture clique** which exploits both intranational and EU transfers for the benefit of special interests.

The risks and damages inflicted by capture is all the more significant given that EU funds are the bulk of discretionary spending channelled towards local level development in the SEE countries. SEE public budgets are relatively small, and **regional development policies** tend to be delivered by way of EU funds. In the SEE countries sub-national territories are eligible for some form of EU funding under cohesion objectives, though SEE EU member states receive a much higher appropriation compared to candidate countries. As mandatory national spending (such as pensions) is bound by strict rules, it is difficult to appropriate corruptively for the benefit of political cronies. Hence, it is likely that EU funds would be a **special focus of pork barrelling and state capture networks**. Ultimately, political distortions in EU spending programmes erode the capacity of the Community to act as the promoter and guardian of good governance and economic development among its current and prospective members.

**Corrupt fiscal relations** between central and local government – in both the literal and broader senses – have even larger implications. Fiscal policy is centralised in most SEE countries and a **high degree of administrative and fiscal centralisation** is a considerable risk factor for state capture; the latter, in turn, further institutionalises this centralisation. Corruption is crucial in this process. In order to support increasing concentration of power in central government, junior government officials are often given some **licence to extract rents** from households and businesses. Thus, the retail market of corrupt administrative services becomes closely linked to the wholesale purchase of government policies. The resulting **authoritarian drift** makes government vulnerable not only to domestic but also to foreign capture, which, in times of **intensifying geopolitical rivalry**, poses structural dangers to countries. In a closely integrated Europe this ultimately affects the whole continent. Given that Southeast Europe has been among the areas most vulnerable to Russian and Chinese influence, how the **support structures of democratic resilience** are built from the ground up should be better understood.

It is small leaks that sink great ships, as the saying goes. It is imperative, therefore, that the integrity of the whole machinery of governance be maintained by **inspecting and strengthening the integrity of its every detail**.

The findings presented in the current report are far from conclusive and ultimate, given the lack and disparity in the quality of the available data. Yet, it makes **a first attempt at an integrated data-based look at the corruption and state capture risks** at this critical juncture of good governance of central to local government fiscal transfers. And it attempts to at least outline the clash between two interpretations of the existing data – one broadly democratic, including examples of positive developments, and one broadly clientelist, showcasing the existing governance gaps and risks. The data in of and of itself cannot determine which kind of political favouritism is at play in SEE countries. Hence, policy interpretations and recommendations should be interpreted more as **a warning call for action**, rather than a verdict and finger pointing. The report also provides a **unique empirical contribution** in terms of systematized data on local level institutional rules, decentralisation trends, fiscal transfers and public procurement. It should therefore prompt further inquiries into the involvement of electoral or clientelistic considerations influencing the local allocation of national and European funds. It is at this level that all the governance risks converge and consequences are experienced by individuals and business. The report also builds upon R2G4P's wider efforts on **finding public-private solutions** to governance problems in SEE, by consulting and showcasing examples of success stories in local governance. It further makes the call for continuing such public-private cooperation in prevention policies through regular risk monitoring and assessment by using the evidence-gathering mechanisms implemented in the development of this analysis.<sup>9</sup>

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<sup>9</sup> CSD is already applying advanced assessment methods to analyse both state capture at the national level and the individual public institutions which are then used to inform policy adjustments for improving the integrity of government. See: *State Capture Assessment Diagnostics*, Center for the Study of Democracy, 2019 and *Monitoring Anti-Corruption in Europe. Bridging Policy Evaluation and Corruption Measurement*, Center for the Study of Democracy, 2015.

# FISCAL RELATIONS BETWEEN CENTRAL AND LOCAL GOVERNMENTS: GOVERNANCE RISKS AND MITIGATION POLICIES

This chapter examines the fiscal decentralisation in SEE countries<sup>10</sup> focusing on the **intergovernmental transfers** as a political instrument which ensures the transmission of central to local policies, yet enables political influence on local governments. Decentralisation aims at ensuring the political, legal and fiscal appliance of the principle of subsidiarity through multilevel governance. This is intended to guarantee a certain degree of independence of local or regional governments in relation to central government. The concept of decentralisation is multi-dimensional, covering three distinct yet interrelated aspects – political, administrative, and fiscal. The dimensions are inter-dependent which means, ideally, there should be no fiscal decentralisation without political and administrative decentralisation and vice versa. As the SEE countries differ in population size, territory and history, their decentralisation models differ from each other as well. Countries in the region have varying **electoral systems and governance structures**, each facing unique challenges and political dynamics, affecting the established and emerging fiscal relations between central and local levels.

**Table 1. Features of the multi-level governance framework and key local level bodies in SEE**

MAIN FEATURES OF THE MULTI-LEVEL GOVERNANCE FRAMEWORK AND KEY LOCAL LEVEL BODIES					
Country					
Albania	Unitary Parliamentary Republic	12 regions <sup>11</sup>	61 municipalities	Municipal Council (elected by direct vote for a 4-year term)	Mayor (elected by direct vote for a 4-year term)
Bulgaria	Unitary Parliamentary Republic	28 districts <sup>12</sup>	265 municipalities	Municipal Council (elected by direct vote for a 4-year term)	Mayor (elected by direct vote for a 4-year term)

<sup>10</sup> When referring to SEE this report means the following nine countries: Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Hungary, Montenegro, North Macedonia, Romania and Serbia.

<sup>11</sup> Regions are not full self-governing entities in Bulgaria since they are not directly elected by vote but are formed by their constituent municipalities.

<sup>12</sup> Districts are deconcentrated structures. The role of districts involves the monitoring of municipal council decisions, participation in the co-ordination of municipal activities as well as co-ordination with the national level. Districts are headed by a governor, appointed by the Council of Ministers and supported by deconcentrated administrations. Deconcentration is often considered to be the weakest form of decentralisation.

Country					
MAIN FEATURES OF THE MULTI-LEVEL GOVERNANCE FRAMEWORK AND KEY LOCAL LEVEL BODIES					
BiH					
Federation of Bosnia and Herzegovina (FBiH)	Federal structure	10 self-governing cantons <sup>13</sup>	79 municipalities	Municipal Assembly (elected by direct vote for a 4-year term)	Mayor (elected by direct vote for a 4-year term)
Republika Srpska (RS)	Unitary Parliamentary Republic	–	64 municipalities	Municipal Assembly (elected by direct vote for a 4-year term)	Mayor (appointed by the municipal assembly)
District of Brčko (Former Brčko municipality)	Self-governing administrative structure	–	1 self-governing district	Municipal Assembly (elected by direct vote for a 4-year term)	Mayor Assembly (elected by direct vote for a 4-year term)
Croatia	Unitary Parliamentary Republic	20 counties <sup>14</sup>	428 municipalities & 128 cities	Local Council <sup>15</sup> (elected by direct vote for a 4-year term)	Mayor <sup>16</sup> (elected by direct vote for a 4-year term)
Hungary	Unitary Parliamentary Republic	20 counties <sup>17</sup>	3,178 municipalities	Municipal Council (elected by direct vote for a 4-year term)	Mayor (elected by direct vote for a 4-year term)
Montenegro		–	24 municipalities	Municipal Assembly (elected by direct vote for a 4-year term)	Mayor (elected by the assembly with the majority vote of a total number of councillors for a period of 4 years)
North Macedonia	Unitary Parliamentary Republic	–	80 municipalities	Municipal Council (elected by direct universal suffrage for a 4-year term)	Mayor (elected by direct universal suffrage for a 4-year term)
Romania	Unitary Parliamentary Republic	42 counties <sup>18</sup>	3 180 municipalities (103 cities, 216 towns & 2,862 communes)	Local Council (elected for a four-year term by universal, equal, direct and secret vote)	Mayor (elected for a four-year term by universal, equal, direct and secret vote)
Serbia	Unitary Parliamentary Republic	1 autonomous province <sup>19</sup> (Pokrajina Vojvodina)	117 municipalities and 28 cities	Municipal/City Assembly (elected by direct vote for a 4-year term)	Municipal president/Mayor in cities/Municipal Council (elected by the Municipal/City Assembly)

Source: CSD.

<sup>13</sup> The 10 cantons in FBiH are autonomous structures with their own governments and legislatures.

<sup>14</sup> Counties are regional self-government units with a large degree of autonomy. Counties are governed by assemblies and prefects (who constitute the counties' executive branch) which are elected by direct universal suffrage for a four-year term.

<sup>15</sup> Municipality and City Councils.

<sup>16</sup> Municipal and City Mayors.

<sup>17</sup> Counties are governed by councils composed of representatives (councillors) directly elected through secret ballot for four-year mandates. County councils are led by a council President, elected from amongst its members. However, counties are not considered as regional self-government units. Counties are more related to state deconcentrated structures.

<sup>18</sup> Counties in Romania are self-governing bodies. County councillors are directly elected in local elections for four-year terms and they are responsible for electing the president of the county council. However, the national government still exercises strong supervision over subnational governments, via the right to issue legal acts that are compulsory for the local authorities and the appointment of a prefect in each county, as a representative of the central government at the subnational level, with the mandate to control the legality of acts issued by the local authorities. Romania does not have a distinct and fully developed regional self-government level with elected regional governments. However, it's important to note that discussions and plans regarding the establishment of a regional level of self-government have been ongoing in Romania.

<sup>19</sup> According to the Constitution of Serbia and the Law on territorial organization of Serbia (Official Gazette No. 129/07, 18/16, 47/18, 9/20) there are two autonomous provinces. However, the status of Kosovo is under negotiations and Serbia does not exercise control over it. The designation "Kosovo" is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.

## Fiscal decentralisation

Although most of the SEE countries have made a substantial progress during the last 10 years, in one way or another the **fiscal decentralisation remains a challenge** for all of them. This report focuses on the subnational level, on the administrative units or entities, which exist beneath the national (central) government within a country. The subnational entities' names and divisions vary by country, which makes the comparative analysis more difficult and nuanced. However, common terms include provinces, regions, territories, counties, municipalities, and others.

## Subnational government revenue

According to the latest available data, local governments in Bulgaria, Croatia, Hungary, Romania, Albania, North Macedonia, and Serbia remain **highly dependent on the central government with a significant share of transfers compared to tax revenue**. Their own revenues represent insignificant part of their countries' GDP, ranking below the EU and OECD averages (17.9% and 17% respectively). The shares of transfers from central government remain high in most of the SEE countries.

**Table 2. Subnational government revenue by category**  
(% of total subnational government) for the nine SEE countries, 2020

Region/country	Tax revenue	Transfers	Tariffs and fees	Income from assets	Other revenues
EU27 (average)	40.1%	46.6%	10.3%		
OECD (average)	42.4%	53.3%	13.3%		
Albania	19%	73.8%	6.6%	0.2%	0%
Bulgaria	11.6%	82.6%	3.7%	2.1%	0%
BiH	55.3%	16.8%	25.1%	2.9% <sup>20</sup>	–
Croatia	34.2%	54.6%	9.7%	1.6%	0%
Hungary	29%	58.6%	11.5%	0.8%	0.2%
Montenegro	39.6%	13.4%	12.3%	6.9%	27.8%
North Macedonia	23%	71%	4.1%	1.8%	0%
Romania	8.7%	84.8%	5.2%	1.3%	0%
Serbia	12.4%	78.3%	7.4%	1.9%	0%

**Source:** OECD/UCLG, 2022 Country Profiles of the World Observatory on Subnational Government Finance and Investment, 2022.

<sup>20</sup> Property Income.



In contrast, **local tax revenue is relatively low**. However, in some countries (e.g. Romania) the low share of the tax revenues is partly due to the reclassification of shared taxes (e.g. PIT<sup>21</sup>, VAT<sup>22</sup>) to the “transfers” category. A similar situation has also been observed in Serbia. Montenegro and BiH are exceptions. Both countries have relatively strong fiscal decentralisation. Regardless of the limited information available on the subnational government revenues in each BiH entity, it is known that the most important source of revenue for local level comes from sharing VAT revenues, rather than from the transfers. The shared taxes are first collected by the central level and then divided between the central state, the entities and Brčko District. The share of transfers from central level to local level also is exceptionally low in Montenegro where local governments are able to finance their assigned responsibilities mainly through their own-source revenue, including taxes, user charges and fees. Therefore, **Montenegro is the most fiscally decentralised country in the region**.

Some countries have reverted to more centralised systems of fiscal management citing the effects of the economic crisis and the critical state of subnational finance. For instance, the Hungarian government has initiated an extensive constitutional reform which resulted in the **recentralisation of resources**, responsibilities and related expenditures, and debt. This has led to the relocation of tasks between local and central level and has restrained the fiscal framework for local government financing. Therefore, now Hungary’s fiscal decentralisation model includes a mix of local autonomy and stronger financial ties with the central government.

### Subnational government expenditure

The subnational government expenditure levels as a share of total government (public) expenditure and GDP in all nine SEE countries remain below the EU and OECD averages. The relatively low percentage indicates that **central governments are still the major provider of public goods and services**, and subnational governments are highly dependent on central government to finance their functions and competencies. It also suggests that governments in the region might experience **resource allocation challenges** where municipalities have limited financial resources to address local needs, leading to disparities in service delivery and development across regions. Croatia and Romania have higher percentage of subnational government expenditure as share of overall public expenditure, while BiH and Montenegro have the lowest. Yet, all four countries **have different governance vulnerabilities** related to central – local transfers when the revenue categories are also considered. Croatia looks the most balanced, with relatively high decentralisation of expenditures coupled with fairly higher level of local tax revenues. Romania, with its high share of local expenditure, which however, depends to an unusually high degree, on fiscal transfers from the central level is an example

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<sup>21</sup> Personal income tax.

<sup>22</sup> Value added tax.

of high risks of political discretion. BiH and Montenegro are the most fiscally decentralised countries within the SEE region on the revenue side. Yet, the very low levels of public spending on sub-national level, in particular in BiH, could be a sign that some municipalities are **practically deprived of public resources** to secure even basic public functions. As a result, they could be an even easier prey to central government political pressure, which could also mean higher corruption vulnerability.

**Table 3. Subnational government expenditure as share of public expenditure and GDP (2020)**

	% public expenditure	% GDP
<b>EU27 average</b>	<b>34.3%</b>	<b>18.3%</b>
<b>OECD average</b>	<b>36.6%</b>	<b>17.1%</b>
Albania	18.7%	6.2%
Bulgaria	17.7%	7.4%
BiH	10.5%	5%
Croatia	26.1%	14.2%
Hungary	12.5%	6.5%
Montenegro	11.5%	6.7%
North Macedonia	13.6%	5.2%
Romania	22.6%	9.5%
Serbia	19%	10.3%

*Source: OECD/UCLG, 2022 Country Profiles of the World Observatory on Subnational Government Finance and Investment, 2022.*

Overall, most SEE countries face similar challenges related to fiscal imbalances, limited local self-financing power and strong central control. In all SEE countries the distribution of transfers from central government is the main instrument of keeping the local services functioning. This and the common lack of transparency and predictable intergovernmental system make the SEE local authorities **vulnerable to clientelist or electorally motivated interventions** from the central level.

### **Intergovernmental transfers: vulnerabilities to misuse and corruption**

Fiscal relations between central and local governments, in particular the intergovernmental transfers, bear a number of governance risks related to local fiscal autonomy, social welfare and equitable development. Biased allocations to local level units and **clientelistic spending** are detrimental to the national economy, the rule of law, and the credibility of public institutions in general.

The intergovernmental transfers in almost all SEE countries can be considered as a key aspect of their political economy models of relations between central

and local level. As a result, there are risks that **central funding through transfers can undermine local fiscal autonomy**, understood as the ability of subnational governments to raise tax locally to finance expenditures. Such autonomy though could also decrease local leaders' motivation to increase the tax burden in their jurisdictions, through tapping transfers from the central government, financed by a "common pool" of resources collected elsewhere in the economy and minimising the costs of decentralised public service provision.<sup>23</sup>

**Figure 1. Level of fiscal decentralisation in SEE**  
(share of transfers to municipalities from all centrally allocated funds\*, %)



**Note:** \*The level of fiscal decentralization in SEE is calculated as the net transfers from the central budget to the municipalities minus any taxes and other transfers the central budget has received from the municipalities, as a share of the total expenditures and transfers of the central budget towards all budget recipients.

**Source:** CSD, based on ministries of finance reports and official statistics.

<sup>23</sup> According to Thorlakson, 'the centralization of public finances is an efficient indicator of the allocation of resources, or power'; Thorlakson (L.), 'Comparing Federal Institutions: Power and Representation in Six Federations', West European Politics, vol. 26, n° 2, 2003, p. 6.

The traditional approach to intergovernmental transfers assumes that the central government is a unitary actor trying to maximise the social welfare of the nation. However, this approach often does not reflect fully the political environment at the central level, where politicians have loyalties at the regional and/or local level and will attempt to direct transfers towards their regional or local constituencies and even influence decisions on distribution formulas.<sup>24</sup>

**Politically motivated transfers** when not properly disclosed publicly, clash with formal rules of budget distribution, which could result in the creative bending of these rules. When the pressure of political competition is added, and if controls are not robustly enforced, **intergovernmental transfers can be susceptible to corruption** which can undermine the effectiveness of these transfers and lead to misallocation or diversion of funds.

### Conditional and unconditional transfers

The intergovernmental transfers systems in all nine SEE countries are similar. Municipalities rely on conditional and unconditional transfers or their similar types – earmarked and non-earmarked transfers. Conditional transfers are linked to the implementation of specific policies, meeting certain standards, while non-conditional – are not. Both can be discretionary and non-discretionary, depending on whether they require or not annual approval by the government.

**Table 4. Intergovernmental transfers systems in SEE**

Albania	Conditional transfers	Unconditional transfers
	Conditional transfers (e.g., Regional Development Fund, funds from ministries) for delegated functions – formula-based, published in the annual budget proposal and the budget execution report of the respective line ministries, as a specific annex listing all conditional transfers to local self-government units (based on expenses forecast for each activity carried out in implementation of delegated functions).	Unconditional transfers for exclusive functions – Reconstruction Fund – formula-based transfers, published in the annual budget law (based on variables and equalisation threshold criteria).
Bulgaria	Conditional transfers	Unconditional transfers
	Earmarked subsidy for capital expenditures and general subsidy – allocated (based on the number of inhabitants, surface area and other criteria) and distributed via open calls, launched by the Ministry of Finance and/or given as transfers directly to municipalities from the state budget, or by the Ministry of Regional Development and Public Works.	Equalisation subsidy – formula-based (the equalization subsidy is set by law and cannot be less than 10% of the own revenue of all municipalities from the previous year. The mechanism for distributing the total equalisation subsidy per municipality is set out in the state budget act for the respective year).

<sup>24</sup> Bergvall, D., et al., "Intergovernmental Transfers and Decentralised Public Spending", OECD Working Papers on Fiscal Federalism, No. 3, OECD Publishing, Paris, 2006.

BiH <sup>25</sup>	Conditional transfers	Unconditional transfers
FBiH	Conditional transfers <sup>26</sup> for investment expenditures.	Formula-based that considers the population size (68%), and other coefficients related to the territory (5%), school-age children (20%), and the municipality's development index (7% of relative wealth).
RS	Conditional transfers for investment expenditures. <sup>27</sup>	Allocated according to the following formula: 75% on a per capita basis, 15% based on the territory and 10% based on the number of secondary school students. Also, equalisation transfer, calculated based on a series of criteria including: the total per capita revenues of registered businesses (35%), total budget revenue (25%), population density (20%) and the unemployment rate (20%).
Croatia	Conditional transfers	Unconditional transfers
	Fund for Decentralised Functions – 6% of the PIT is earmarked for specific decentralised functions, determined annually by line ministries.	Fiscal Equalisation Fund – redistributed according to local governments' individual shares set annually in the budget, calculated based on 5-year per capita PIT revenue and target revenue.
Hungary	Conditional transfers	Unconditional transfers
	Task-based, expenditure-oriented system of earmarked transfers – equalisation criteria based on the tax capacity of each municipality.	Mandatory deficit grant designed to cover the deficits that the municipalities incur through no fault on their own (based on expenditure needs rather than on actual output).
Montenegro	Conditional transfers	Unconditional transfers
	Other transfers related to EU-funded projects – small percentage of total municipal revenues, and are mostly intended for co-financing of European funds for projects aimed at municipal infrastructure development.	Equalisation Fund – allocation is formula-based and considers the fiscal capacity of the municipality (50%), total area and population (35%), and the remaining 15% are distributed in equal amounts for all municipalities eligible.
North Macedonia	Conditional transfers	Unconditional transfers
	Capital transfers (allocated from the central government according to annual plans for such projects). Specific transfers (determined by the contract signed between the mayor and the line ministry).	<p>Equalisation grant (funded by up to 4.5% of total VAT collection, and 65% is distributed on a per capita basis).</p> <p>Block transfers (based on a formula that takes into consideration enrolment, employment, number of children entitled to free school transportation, number of pupils and teachers, etc.).</p>

<sup>25</sup> The share tax revenue is divided according to a formula stated in the Law on Indirect Taxation in BiH, distributed to each entity. The final consumption tax is the most important indirect tax and thus the most important fiscal equalisation mechanism (horizontal/vertical). Currently, the municipal level in the RS participates, with 24% of the indirect tax revenues distributed in that entity, as does the municipal level in the FBiH, with 8.42%.

<sup>26</sup> Municipalities in FBiH receive conditional transfers allocated either from the FBiH entity or the cantons. There is no information how the conditional transfers are based and allocated to municipalities.

<sup>27</sup> There is no information how the conditional transfers are based and allocated to municipalities.

Romania	Conditional transfers	Unconditional transfers
	Sectoral block transfers (determined at county level and based on quantitative criteria (e.g., population)).	Equalisation transfers (according to a specific formula).
Serbia	Conditional transfers	Unconditional transfers
	Earmarked block transfers.	<p>Equalisation grant (allocated to local governments in which the population's average income per capita is below the national per capita income as calculated by the relevant authorities).</p> <p>Unconditional grant to individual local government is based on a formula including metrics related to the population size, territory, number of elementary and secondary school buildings, number of children attending preschool and number of preschool buildings). Solidarity transfer (the allocation is based on a coefficient for development that divides municipalities into four groups).</p>

Source: CSD.

**Conditional transfers** adjust the expenditure priorities of local authorities to national policies. The process contains in itself a natural governance conflict, as it implies that the central government has to convince subnational authorities to pursue certain policies or goals, which do not necessarily reflect local priorities, and which might also be under-financed, leaving the local governments to bear the wrath of disgruntled voters. When spending decentralisation is funded through intergovernmental transfers this renders local officials subordinate to the priorities of the centre, with the associated rent-seeking effects and related **risks of growing political bribery**.<sup>28</sup>

**Unconditional transfers**, on the other hand, are primarily meant to provide equalisation of public financing across the country, and the amount which each municipality is receiving is **determined by a formula**. However, there are risks related to the political manipulation of the formula by the incumbent government or discrepancies between the determined by the formula transfers' value and the actually distributed amounts.<sup>29</sup> Although the formula is a mechanism designed to limit the power of the central government in the distribution of funds<sup>30</sup>, when there is no transparency **the risks of manipulating or overruling the formula are high**.<sup>31</sup> In addition, the complexity of formulas might make it less comprehensible to the public and more prone to manipulation.

<sup>28</sup> Oates (W. E.), 'Fiscal Decentralization and Economic Development', National Tax Journal, vol. 46, n° 2, 1993, p. 237-243.

<sup>29</sup> Linda Gonçalves Veiga, Maria Manuel Pinho, *The Political Economy of Intergovernmental Grants: Evidence from a Maturing Democracy*, 2007.

<sup>30</sup> Kraemer, M., Intergovernmental Transfers and Political Representation: Empirical Evidence from Argentina, Brazil and Mexico. IDB Working Paper, 1997.

<sup>31</sup> Litschig, S., Are rules-based government programs shielded from special-interest politics? Evidence from revenue-sharing transfers in Brazil. Journal of Public Economics, 2012.

The SEE countries use different formulas to try to achieve equity and efficiency based on social (e.g., population and poverty), geographical (e.g., marginalisation and size) or economic (e.g., tax collection and economic dynamism) criteria for distribution of transfers.<sup>32</sup> However, their formula-based allocation of transfers in and of itself alone **does not always assure transparency**, which is a common issue for emerging and developing countries.<sup>33</sup> The formula could be public, but the data used to calculate the exact amount that should be allocated to municipalities might not be transparent and comprehensible for the general public. In other cases, the central government may decide to apply some elements of the formula, leaving at the same time space for discretion. Therefore, **formula-based transfers are not fully immune from manipulation**. Further, they sometimes may create loopholes which allow substantial and systematic circumvention. **Loopholes** which make formula-based transfers in SEE countries vulnerable to systematic circumvention, misuse and corruption include:

- possible **manipulation of the formula criteria**, e.g., adjusting population figures, economic indicators, or other criteria to artificially increase the allocation for political or personal gain, data falsification;
- formula **complexity** (designing a formula that is difficult for oversight bodies or the public to understand, making it easier to manipulate);
- **political interference** in formula design (pressuring officials to adjust the formula to benefit specific areas or politically influential groups), insufficient oversight mechanism (e.g., auditing processes or weak enforcement of rules);
- **inadequate monitoring and evaluation** (failing to conduct regular reviews and audits to assess the accuracy of data inputs and the fairness of the allocation process);
- **limited public participation** (not involving citizens or stakeholders in the development of the formula, reducing the likelihood of detecting manipulation).

Therefore, it is crucial that countries within the SEE region not only focus their efforts on implementing correctly formulas but also increase their transparency in terms of political objectives. **Reducing formula complexity** and increasing its transparency during and after implementation is a logical step for the SEE countries to avoid or reduce political capture. The simpler the transfer formula is to apply, the easier is the oversight of its implementation.

<sup>32</sup> Kraemer (1997) classify these principles as follows: a) equity principle, according to which poorer regions should benefit through relatively higher funding to foster equalisation of living conditions across the nation; b) incentive principle, according to which per capita transfers in case of lower tax ratios should be constant or even decrees to control the differences in the level of development and hence, tax bases; c) political non-discrimination principle, according to which political or electoral interest should have no role in determining the distribution.

<sup>33</sup> Merkaj, Elvina/Fiorillo, Fabio et. al., [An Analyses of Formula-Based Intergovernmental Transfer Using A Comprehensive Model](#). [S.l.]: SSRN, 2021.



Both transparency and accountability rules are equally important to the formula structure, including the source of data and the methodology of calculation of the indexes used in the formula. For instance, the highest weight in the formula should not rely on **inaccurate or outdated data sets**. Criteria used by the SEE central governments should be clearly articulated to the public. Responsible institutions controlling the formula should be pressed to make public the data used for running the formula and the results obtained. Further, formulas should be kept protected from frequent changes, unless no clear rational is provided to the public.

At the same time, both conditional and unconditional transfers can be discretionary or non-discretionary. Though the division is not clear cut, discretionary transfers are typically such that are decided by the central government on an annual basis, whereas non-discretionary are decided on a longer-term basis. As such, **discretionary (unconditional) transfers** in the SEE countries are the most vulnerable to corruption and state capture risks, as they are the subject of negotiation between central and sub-national authorities in which central authorities may be more or less disposed to favour the particular municipalities to which the transfers apply. The discretionary transfers are especially prone to undue sub-national influence.<sup>34</sup> While they provide flexibility, they are more susceptible to corruption risks due to potential abuse of power and lack of transparency.

**Common risks** for the SEE countries, making the discretionary transfers vulnerable to corruption are political favouritism, clientelism and patronage (allocating funds to politically important areas during elections), inadequate oversight (lack of regular audits or independent reviews to monitor how discretionary funds are allocated and spent), arbitrary decision-making (decision-makers allocating funds without a clear rationale or justification), misallocation of resources (allocating funds to projects without contribution to the overall community well-being), limited competitive process (allocating funds without open competition or bidding process), lack of transparent decision-making (without disclosing the criteria or considerations used). Although they are necessary in the case of unique or temporary projects, such as the construction of infrastructure or the improvement of the regional or local economic structure, it is important that the central level choose the procedures of project selection and design and the role of negotiations and contracts with sub-national authorities. In this respect, the progress in the process of EU integration, with its capacity building for **planning and oversight of discretionary project spending** is particularly important for the region.

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<sup>34</sup> Bergvall, D., et al., "Intergovernmental Transfers and Decentralised Public Spending", OECD Working Papers on Fiscal Federalism, No. 3, OECD Publishing, Paris, 2006.



## Risks associated with municipal or regional development funds

Risks of political bias in intergovernmental transfers are particularly present when the funding for municipalities is distributed by various national funds, by the ministries of local/regional development and/or by government-controlled foundations. By design, these funds are tasked to allocate the financial support on a competitive basis (applications received by individual municipalities), or based on the needs of the municipalities according to fixed criteria. Yet, evidence suggests that the distribution of such funding in SEE might often be based on political alignment and misuse of the received funds for election campaigns.

**In Albania, the Regional Development Fund** distributes conditional transfers upon application by local government units. The distribution of transfers and management of the Fund is carried out by the Committee for the Development of Regions, consisting of the prime minister, the deputy prime minister and relevant ministries<sup>35</sup>. However, there are indications that the funding is allocated based on political ties, which do not reflect local development goals. For example, 26 municipalities controlled by right-wing parties<sup>36</sup> from the opposition have managed approximately 20% of the Fund in the period 2016 – 2018, while 34 majority-run municipalities were awarded the remaining 80% of the Fund.<sup>37</sup> Moreover, the size of the Regional Development Fund has increased significantly, leading to concern that it collects the funds that should have been allocated through unconditional transfers (budget transfers). Municipalities with low project application capacity and small populations often face difficulties benefiting from this Fund. The Fund's reports are not published online.

Hungarian organisations (mostly CSOs) with ties to the Fidesz party have been recipients of substantial financial support through the state's civic fund, particularly under the auspices of the **Municipal Civil Fund**.<sup>38</sup> Notably, Fidesz-affiliated groups have secured the largest disbursements of funds for election campaigns and the development of pre-election media resources within the framework of this Fund. Of the 83 grant recipients receiving HUF 11 million (EUR 29,657) each, almost half (38 organizations) are associated with Fidesz politicians.<sup>39</sup> An additional 12 entities maintain indirect connections to the ruling parties. These indirect links manifest through initiatives such as arranging campaign functions for local politicians or disseminating government messages via printed publications.

<sup>35</sup> Ministry of Finance and Economy, Ministry of Education, Sports and Youth, Ministry of Health and Social Protection, Ministry of Culture and Ministry of Interior.

<sup>36</sup> Albania has 27 right-wing municipalities from the opposition, however Kamez municipality has not benefited from the Fund.

<sup>37</sup> Albanian Association of Municipalities, [Report on Local Government Financing Instruments \(2016 – 2018\)](#), 2019.

<sup>38</sup> Zubor, Z., "Pártrendezvények közpénzből: választási mozgósításra használhatták az állami civil alap támogatásait" [Party events with public funds: grants from the state NGO fund could be used for electoral mobilization], [atlatszolhu.hu](#), 30 June 2022.

<sup>39</sup> Converted at exchange rates of 29.06.2023 14:00.

The objectives of state funding to independent civic organisations have evolved over time. While media infrastructure took precedence in the allocation of funds in 2022, the primary focus has shifted in 2023 towards orchestrating events designed to promptly engage and mobilise voters.<sup>40</sup> Some of these organisations claim to be politically independent. However, their active involvement in local elections and collaborative candidacy with Fidesz in electoral coalitions exposes their close association with the ruling party. There have been multiple instances of presence of local Fidesz candidates at these events. Moreover, the upper limit for funding across both application rounds was set at HUF 26 million (EUR 70,100), a threshold solely attained by organisations affiliated with the governing party.<sup>41</sup>

**In Romania, the National Programme for Local Development (PNDL)** is the main source of financing for local infrastructure in areas such as healthcare, education, water and sewage, heat and electricity, including public lighting, transport, roads, sanitation, culture, worship, housing and sports. Funding comes from the central government, which retains ample discretion regarding allocation and oversight of spending. In the period 2007-2022 funding from PNDL and its predecessors, the **Reserve Fund and other emergency funds**, have been allocated based on political criteria, with mayors in power receiving even up to three times more than those in opposition. The calculations also show that mayors from the funded counties have changed their political allegiance.<sup>42</sup> Experts monitoring the funds conclude that there is a lack of administrative capacity within the Ministry of Local Development, Works and Administration (MDLPA) to implement PNDL, Projects are managed on paper only, project implementation data are missing or are obtained long after completion, there are no effective controls and no performance audit to show whether or not PNDL is successful.<sup>43,44</sup>

### *Understanding governance risks in intergovernmental transfers: who wins what?*

In order to correctly identify the risks of transfers made for purposes other than equitable local development and in order to design efficient counter-measures, policy makers should first understand the “incentives”, the “benefits” and the “payment” expected for these benefits for each of the involved parties.

<sup>40</sup> Zubor, Z., “Pártrendezvények közpénzből: választási mozgósításra használhatták az állami civil alap támogatásait” [Party events with public funds: grants from the state NGO fund could be used for electoral mobilization], *atlatszol.hu*, 30 June 2022.

<sup>41</sup> Zubor, Z., “Megint Fidesz-közeliek szereztek nyerték a legnagyobb összegeket a kormány civil-támogató programján” [Once again, organizations close to Fidesz won the largest sums of money through the government's NGO support program], *atlatszol.hu*, 5 May 2022.

<sup>42</sup> The second chapter provides statistical evidence about the role of public procurement in influencing the loyalty of local governments.

<sup>43</sup> Expert Forum, *Special: Local investment programs and politics*, 2022.

<sup>44</sup> Expert Forum, *Report: How do we fix PNDL?*, 2022.

Central and local governments, as well as the incumbent political parties, benefit by:

- **Building central and local leaders' reputations, securing votes and re-election.** The process is often associated with promises and announcements made during election campaigns. It is not, however, necessarily limited to campaigning and can arise in any part of the electoral cycle. The idea behind the practice is that the money allocated to the representative's district, canton or municipality will benefit the lives of the local constituents, thereby securing their support and votes. Support in this context can also mean contributions to that politician's next election campaign.<sup>45</sup>
- **Securing and/or changing the political allegiance of mayors.** The previous allocation of funds could re-confirm the political loyalty of mayors. However, the promise of future funding tends to sway some mayors to change their allegiance toward the political party, which is most likely to win the upcoming elections.<sup>46</sup>
- **Decision-making power over local level contracts, investments and projects.** Non-transparent and discriminatory allocation of public procurement contracts, state aid, concessions, and investments projects based on political connections or pressure become an extension of privileged intergovernmental transfers thereby further exacerbating the misuse of public finances.
- **Decision-making power over political appointments.** In exchange for the national or foreign donor funds, the central level and/or local level leaders could ensure the political appointment of close to them persons in the municipalities, state-owned enterprises (SOEs) and/or companies (usually large employers).

When the territory (municipality) is politically aligned with the incumbent party(s) of the central government it can benefit by:

- **higher allocations from central budget funding** compared to similar in size and needs municipalities run by the opposition;
- higher share of foreign donor (including EU) funding;
- **debt annulment or low-interest loans provided by the central government**, which further discourages the strict financial management of the municipality/canton and compromises the oversight over investment decisions;

<sup>45</sup> Polyas, Election Glossary: [Pork Barrel Politics](#).

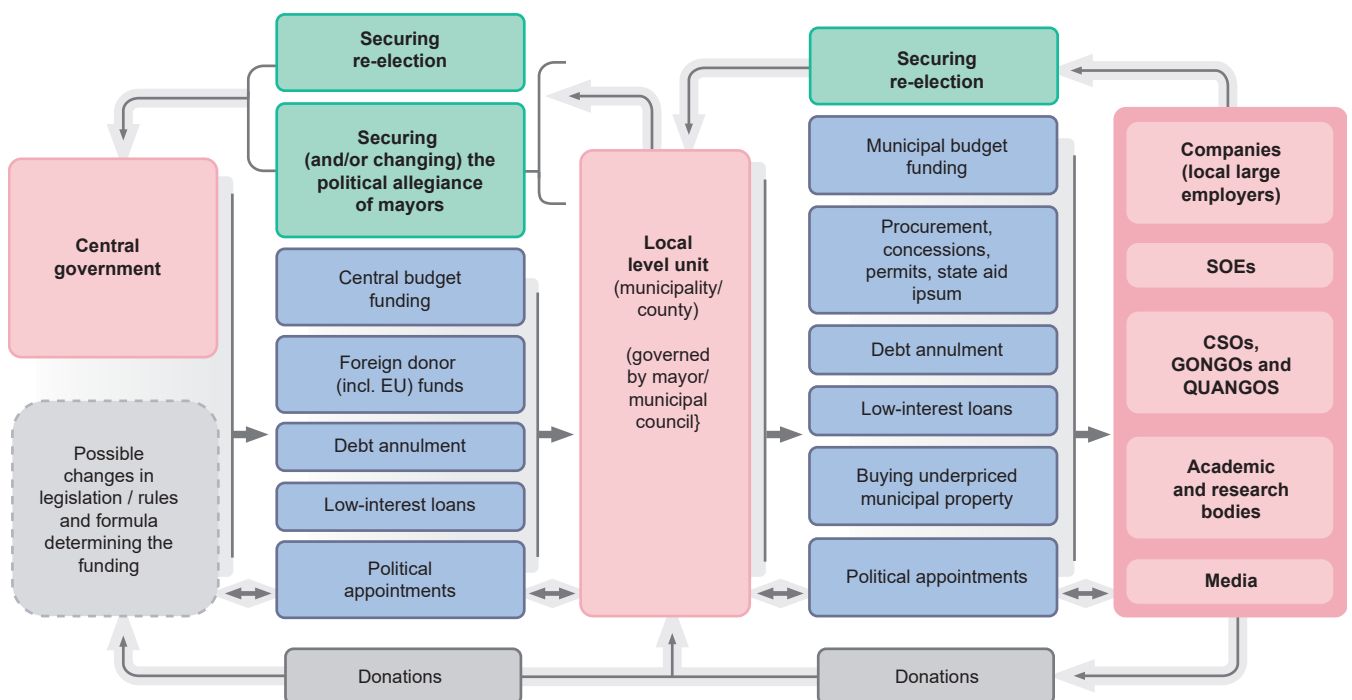
<sup>46</sup> The next chapter provides statistical evidence about the role of public procurement in influencing the loyalty of local governments.

- **decision-making power over political appointments** of close to the mayor / municipal council members in local companies, SOEs, and other recipients of the national or foreign donor funds.

Local companies, usually large employers, as well as sometimes SOEs, non-governmental, academic and media entities, benefit by:

- **non-competitive award of municipal budget funding**, foreign donor (including EU) funding, procurement contracts, concessions, permits and state aid;
- **debt annulment or low-interest loans** provided by the state or the municipality;
- the opportunity to purchase **underpriced municipal property**;
- securing **political appointments** in the municipal or central-level public bodies.

**Figure 2. The intergovernmental spending channels exposed to corruption and state capture risks (clientelist transfer channels)**



Source: CSD.

**Box 1. Unmasking party-political agendas at the local level: unveiling election-powered fiscal flows through data and statistical analysis (Croatia and North Macedonia)**

The increase in governmental transfers to municipalities before elections is a well-known phenomenon in various countries, particularly pronounced in developing ones.<sup>47</sup> This practice often occurs for political reasons, aiming to improve the public image of the ruling party or government as a form of vote-buying. In the context of decentralization efforts, there may be a natural increase in transfers to municipalities as they take on more responsibilities. These increases may coincide with election cycles. The threat posed by opposition parties during election campaigns can lead incumbent governments to boost transfers to municipalities to ward off opposition threats and secure their reign.

Engagement in tactical distribution of resources may be influenced by the stage of the electoral business cycle, especially if incumbent governments are more active in clientelistic practices in the run-up to elections.<sup>48</sup> This increases the vertical dependency of local on national governments and serves as a call for a fundamental re-evaluation of municipal financing policies.<sup>49</sup> Moreover, it adds to the existing debates on decentralization and dependence, arguing that, regardless of any potential efficiency gains, a departure from the reliance on intergovernmental grants could help minimize pork-barrelling diseconomies.<sup>50</sup> Thus, understanding how electoral factors shape resource allocation is crucial not only for policymakers but also for the broader public as it sheds light on the inner workings of governance and its implications for society at large. Addressing the challenges posed by distributive politics and ensuring that resource allocation aligns with the overarching goals of equity, efficiency, and countercyclical stability remains an ongoing imperative for governments around the world.

The analysis of **available statistical data around elections** could prove to be a powerful tool for detecting potential risks of discrimination and conflicts of interest in allocating **intergovernmental transfers and loans**. Yet, such data is not readily available in SEE, which limits transparency and oversight control considerably. Below are the findings from multiple regression analyses of data on election outcomes and fiscal transfers in Croatia and North Macedonia for the past decade.

<sup>47</sup> Shi M, Svensson J, Political budget cycles: Do they differ across countries and why? *J Public Econ* 90:1367–1389, 2006.

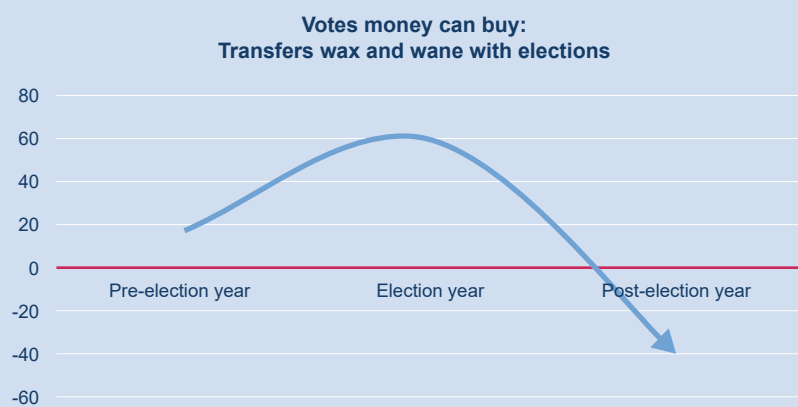
<sup>48</sup> Veiga LG, Pinho MM, The political economy of intergovernmental grants: evidence from a maturing democracy. *Public Choice* 133:457–477, 2007.

<sup>49</sup> Psycharis, Y., Zoi, M., & Iliopoulou, S., Decentralization and local government fiscal autonomy: evidence from the Greek municipalities. *Environment and Planning C: Government and Policy*, 34(2), 262–280, 2016.

<sup>50</sup> Balaguer-Coll MT, Prior D, Tortosa-Ausina E, Decentralization and efficiency of local government. *Ann Reg Sci* 45:571–601, 2010.

The analysis of the available data for Croatia, covering the 2014-2021 period, shows that:

- **Intergovernmental transfers** to municipalities increase by 20% in pre-election years and by 57% during the election year. However, during the election year, these transfers increase by 62% if the municipality is run by the candidate's party, and by 64% if the mayor is from the same party. The transfers usually drop by 30% after the election has passed. The right-wing party coalition tends to provide the largest (60%) increase of transfers to municipalities during election years, while the centre and left-wing parties provide lower shares (45% and 35%) respectively.
- **Government's loans to municipalities** also increase – by 85% in pre-election years and by 140% during election years.



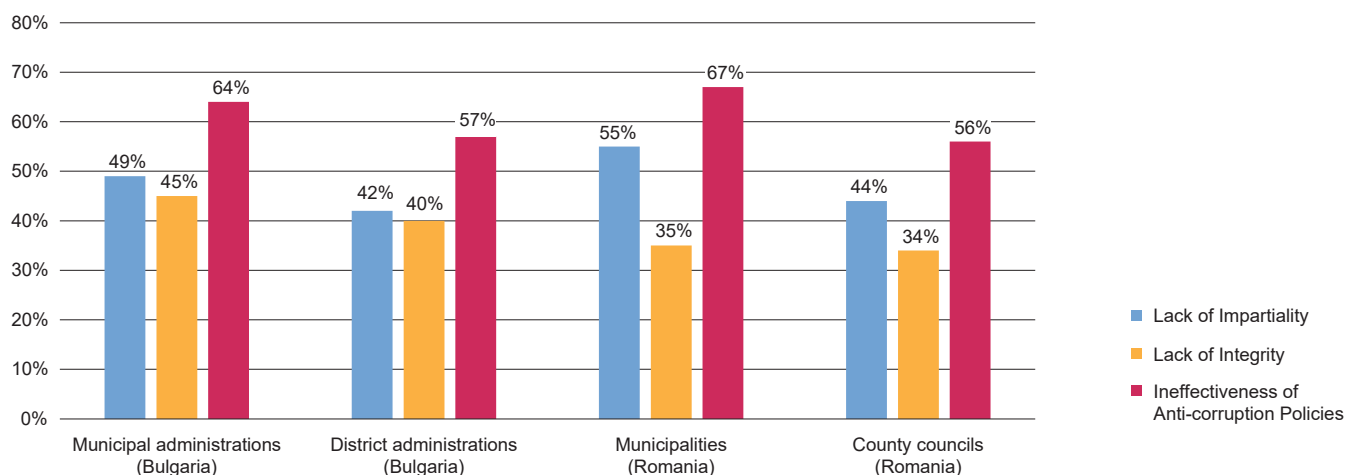
Similar trends are observed in **North Macedonia**. The statistical analysis of elections, mayor party affiliation, and budget transfer data from the past 10 years shows that the municipalities whose mayor is from the governing party get double the earmarked funds per capita compared to the other municipalities.

Source: CSD.

## Anti-corruption and oversight of local government finances

Data from the State Capture Assessment Diagnostics at Sectoral Level Integrated Tool (SCAD-SLIT), demonstrates that SEE municipalities are often affected by lack of integrity and impartiality. For example, in Bulgaria, the **lack of impartiality of municipal administrations** was pointed out by 49% of the respondents of the 2021 SCAD-SLIT survey. In comparison, the district administration was selected as a body which lacks impartiality by 42%, followed by the Customs Agency (38%), National Revenue Agency (35%) and the National Audit Office (23%). The municipal administrations are further assessed as lacking integrity by 45% of the experts, while 64% believe they have ineffective anticorruption policies. Similarly, in Romania 55% point out to the lack of impartiality of the municipalities – the highest share among all assessed public bodies. A total of 35% highlight the lack of integrity, while 67% note the **ineffectiveness** of their **anticorruption policies**.<sup>51</sup>

<sup>51</sup> Center for the Study of Democracy, [Assessing State Capture Vulnerabilities at the Sectoral Level](#), 2021.

**Figure 3. Lack of impartiality and integrity in municipalities**

Source: CSD, *Assessing State Capture Vulnerabilities at the Sectoral Level*, 2021.

### Fiscal oversight institutions

Effective fiscal oversight involves **collaboration and coordination among multiple public bodies** to ensure transparency, accountability, and the equitable distribution of resources between central and local governments. In addition, it is often reinforced by anti-corruption institutions, which work in tandem with fiscal authorities. The following bodies and institutions are typically engaged in overseeing and managing central-local government fiscal relations:

- **Parliaments and municipal councils** have the highest oversight authority related to fiscal matters. They are reviewing and approving fiscal policies, budgets, and transfers to local governments. Annual national budget discussions in parliaments are typically the most awaited policy debates in SEE countries. Yet, they tend to focus mostly on central level allocation. Municipal council discussions on the other hand, which debate local budgets, most often remain under the radar of national media and public attention, with the exception of the capital city budgets.
- **Ministries of finance or treasury.** In all 9 SEE countries ministries of finance play a key role in overseeing fiscal relations with local governments. The State Treasury in Hungary is supervising the transfers allocated to local governments considering the findings and recommendations from the State Audit reports. Financial ministries formulate fiscal policies, establish budgetary guidelines, and allocate financial resources to lower-level units.
- **Central fiscal authorities.** Both BiH and Romania have established central fiscal councils. They are responsible for monitoring and regulating fiscal relations between central and local governments. In BiH, the institutions overseeing the fiscal activities at entity level also enforce compliance with the budgetary calendar. In Romania, it acts as an independent body,



responsible for designing and implementing the national fiscal policy and promoting public finances' transparency.

- **Local government associations** represent the interests of local or regional governments. They advocate for the financial needs and autonomy of local governments and thus engage in negotiations with the central governments regarding fiscal matters. The National Association of Municipalities in Bulgaria, for example, has a crucial role in negotiating spending standards and fiscal allocation mechanisms with the Ministry of Finance.
- **Independent audit institutions**, such as the Auditor-General's Office or similar bodies, play a crucial role in ensuring transparency and accountability in fiscal relations between central-local government level. As independent oversight institutions, they conduct audits of local governments finances and report on compliance with fiscal regulations. Audit institutions are considered key organisations in fiscal relations between central and local level in Albania, Bulgaria, Croatia, Hungary, North Macedonia and Romania.
- In addition, local governments themselves, in particular of larger municipalities, have **fiscal authorities** responsible for budgeting, financial management, and revenue collection within their jurisdictions to guarantee compliance with both national and local fiscal relations.

Some countries have established special **inter-governmental coordination committees** or **councils** composed of representatives from both central and local governments to facilitate dialogue, negotiate fiscal agreements, and resolve disputes. For example, Serbia has established Local Government Financing Commission (known also as the "Commission for Intergovernmental Finances") to monitor the implementation of the intergovernmental finance system and make recommendations in this area. Similar structures also exist in North Macedonia (Committee for Monitoring and Development of Local Government Finance System with members from national and local governments) and Romania (Inter-ministerial technical committee for decentralisation and working groups for the decentralisation of competences).

**SEE EU member-states** have established separate systems for ensuring the sound spending of EU funds. These have been certified by the European Commission, and undergo regular monitoring. Central European institutions, like OLAF have local counterparts in the member-states responsible for investigating fraud with EU funds. The European Public Prosecutor's Office also has direct authority to investigate cases that infringe EU financial interests. In SEE non-EU countries, **international organisations and aid agencies** (e.g. the World Bank, bilateral donor programmes, the European Delegations, etc.) are overseeing fiscal relations in project-based funding through developing stricter rules of evaluation of projects to ensure transparency and promote good governance practices.



### Box 2. Fight against fraud to EU's financial interests

On 5 July 2017, Directive (EU) 2017/1371 on the fight against fraud to the Union's financial interest by means of criminal law (PIF Directive)<sup>52</sup> was adopted. The PIF Directive sets common standards for Member States' criminal laws, seeking to protect the EU's financial interests by harmonising the definitions, sanctions, jurisdiction rules, and limitation periods of certain criminal offences affecting those interests. These criminal offences (the "PIF offences") are: (i) fraud, including cross-border value added tax (VAT) fraud involving total damage of at least EUR 10 million; (ii) corruption; (iii) money laundering; and (iv) misappropriation. The harmonisation of standards also affects the scope of investigations and prosecutions by the European Public Prosecutor's Office (EPPO) because the EPPO's powers are defined by reference to the PIF Directive as implemented by national law.<sup>53</sup>

The deadline for transposing the Directive expired on 6 July 2019. As of 10 June 2023, the Commission opened infringement proceedings against 20 Member States for incorrect transposition of the Directive.<sup>54</sup> The difficulties for the full transposition are due either to some deficiencies in the definitions of the offences (e.g. "money laundering", "passive corruption"<sup>55</sup>), or to the lack of a criminal offence covered by the PIF Directive among the predicate offences.

## National anti-corruption strategies and legislation

National anti-corruption strategies and legislation in SEE **rarely identify specific corruption risks** related to the misuse of national and foreign donors' funds from the central to the local level; if they are mentioned in the national integrity strategies at all, it is in a very general terms. The Bulgarian Public Finance Act (Article 20)<sup>56</sup>, for example, stipulates that the use of funds should be based on the principles of comprehensiveness, accountability and responsibility, adequacy, economy, efficiency, effectiveness, transparency, sustainability, and legality. The National Anti-Corruption Strategy of Bosnia and Herzegovina 2022-2024<sup>57</sup> recognizes the following risks as obstacles to a successful fight against corruption: lack of political will, failure to meet internationally assumed obligations, insufficient independence,

<sup>52</sup> Directive (EU) 2017/1371 of the European Parliament and of the Council of 5 July 2017 on the fight against fraud to the Union's financial interests by means of criminal law (OJ L 198, 28.7.2017, p. 29–41).

<sup>53</sup> Euclid, [Protecting the EU's Financial Interests through Criminal Law: the Implementation of the "PIF Directive"](#), 2021.

<sup>54</sup> OLAF, [34th Annual Report on the Protection of the European Union's financial interests and the Fight against fraud](#), 2022.

<sup>55</sup> "Passive corruption" is usually defined as refraining from acting in accordance with the official's duty.

<sup>56</sup> Ministry of Finance, [Bulgarian Public Finance Act](#), 2017.

<sup>57</sup> Agency for the Prevention of Corruption and Coordination of the Fight against Corruption, [Strategy for the fight against corruption in Bosnia and Herzegovina 2022-2024](#), September 2022.

lack of financial and other resources, the complexity of the political system, lack of systematic approach and coordination. The national anticorruption strategy does not distinguish risks according to levels of government and does not identify the public bodies that should address such risks. The Hungarian National Anti-Corruption Strategy 2020-2022<sup>58</sup> identifies corruption in public procurement, nepotism and clientelism, money laundering and financial fraud, corruption in budget planning, bribes and payoffs and corruption in the tax system as risks.

SEE **anticorruption agencies** are usually not the main institution responsible for overseeing and investigating complaints related to fiscal matters, although they may cooperate with the fiscal control bodies listed above in cases of allegations of corruption in central-local fiscal relations. Only in Bulgaria and Croatia **inspectors** perform oversight functions both over fiscal spending and anticorruption.

**Anticorruption strategies** in SEE identify some risks which could indirectly be linked to the abuse of fiscal transfers. However, the majority of these risks and related measures concern the planning and spending of national and foreign donor funds at the local level rather than any discriminatory or partisan bias in the decision-making related to the transfers from the central budget. The main focus is placed on:

- The **insufficient transparency of local level budgets**. Measures in that respect are usually foreseen in local anticorruption and integrity plans, or the national anticorruption strategies.<sup>59</sup> For example, the frequent changes to the regulations on the publication of information by local-level authorities is recognised as a risk by the Operational Plan for the Prevention of Corruption in Areas of Special Interest of Serbia (2022).<sup>60</sup>
- **Weak financial controls and inadequate monitoring** mechanisms at local level are highlighted in Albania<sup>61</sup> and Romania<sup>62</sup>, corruption in budget planning in Hungary<sup>63</sup>, and sudden changes in budget allocation patterns – in Romania.<sup>64</sup>

<sup>58</sup> Ministry of the Interior, [Hungarian National Anti-Corruption Strategy 2020-2022](#).

<sup>59</sup> E.g. in Serbia, the integrity plans (2021 – 2024) specifically outline the risks related to fund spending at the local level.

<sup>60</sup> Agency for Prevention of Corruption, [Operativni plan za sprečavanje korupcije u oblastima od posebnog rizika](#) [The Operational Plan for the Prevention of Corruption in Areas of Special Interest], 2022.

<sup>61</sup> E.g. Albanian Ministry of Justice, [Inter-sectorial strategy against corruption 2015-2020](#), March 2015; Official Gazette of Romania, [National Anticorruption Strategy \(2021-2025\)](#), 22 December 2021.

<sup>62</sup> Republica România, [Strategia anticorupție](#), [Republic of Romania, Anti-Corruption Strategy], 22 December 2021.

<sup>63</sup> Magyar Köztársaság, [Korrupcióellenes Stratégia](#), [Republic of Hungary, Anti-Corruption Strategy], 2015.

<sup>64</sup> Republica România, [Strategia anticorupție](#), [Republic of Romania, Anti-Corruption Strategy], 22 December 2021.

- Risks of **favouritism in awarding contracts and tenders**, non-transparent procurement procedures, lack of competitive bidding and market assessment are identified as corruption risks in Romania<sup>65</sup> and Hungary<sup>66</sup>.

The anticorruption agencies in SEE often provide **methodologies, guidelines and red flags** for assessing the corruption risk at local level, intended to help the preparation of the integrity plans. The anticorruption agencies are also tasked with checking reports on municipal integrity plans' implementation. Very often though agencies, rely only on **self-assessment** reports prepared by the local level units as the sole source of information. There is also a distinct **lack of sanctions** in case plans have not been developed or published.

The Croatian strategy for prevention of corruption for the period from 2021 to 2030<sup>67</sup> identifies several **risks related to local level budget management**: low integrity of local government officials and civil servants; companies owned by the local government could appoint politically connected persons to management positions; companies owned by local governments can assume debt guaranteed by the local government, which could result in potential debts for local governments, especially if these companies are poorly managed and if the leaders are politically connected.

The Bulgarian Strategy for Preventing and Combatting Corruption (2021 – 2027)<sup>68</sup> underlines as risks the **ineffective public and internal institutional supervision** over the management of municipal property, the spending of public funds through public procurement and the planning/implementation of municipal budgets. It also warns that public consultations with the interested local communities could be done just as box ticking and that there is insufficient transparency in the relationship between local authorities and local business.

In **Montenegro**, the Agency for Prevention of Corruption has prepared Rules for the Drafting and Implementation of the Integrity Plans (2016)<sup>69</sup>. The rules place strong focus on the need of cooperation during the elaboration of the plans with the oversight bodies, especially the internal financial control or internal audit regarding risk of corruption, other illicit or unethical behaviour. Key risks include the area of financial planning and management (risks related to the budget planning process, public procurement planning, implementation of public procurement, drafting and signing of contracts, monitoring of enforcement of contracts, financial reporting, financial management and control, budget execution, etc.). Risk intensity is measured by an assessment of “probability”

<sup>65</sup> Republica România, [Strategia anticorupție](#), [Republic of Romania, Anti-Corruption Strategy], 22 December 2021.

<sup>66</sup> Magyar Köztársaság, [Korrupcióellenes Stratégia](#), [Republic of Hungary, Anti-Corruption Strategy], 2015.

<sup>67</sup> State Gazette, Croatian Parliament, [Strategy for prevention of corruption for the period from 2021 to 2030](#), 29 October 2021.

<sup>68</sup> Republic of Bulgaria, [Национална стратегия за превенция и противодействие на корупцията \(2021 – 2027 г.\)](#) [National Strategy for Preventing and Combatting Corruption (2021 – 2027)], 2020.

<sup>69</sup> Agency for Prevention of Corruption, [Rules for the Drafting and Implementation of the Integrity Plan](#), January 2016.

of occurrence of risk in a specific time period and the “consequence” that the risk causes – e.g. financial damage, loss of expected revenues, as well as other forms of non-material damage, such as loss of trust of the public in the work of the authority, harming the reputation of the authority, etc.

In **Serbia**, the at-risk areas identified in the Manual for the Integrity Plan Development and Implementation<sup>70</sup> published by the Anti-Corruption Agency include payments to third parties (subsidies, donations, premiums, loans, sponsorships), the generation of revenues (fiscal and parafiscal levies, fees) and contracting which is not regulated under the public procurement. The risk is measured via an electronic questionnaire, filled in by the employees of the public body. A software application that classifies risk intensity at low, moderate and high levels. The probability factor of the risk can also be measured as small, moderate or high. The survey results are then reviewed by a working group, and the head of the institution appoints a person responsible for implementation of planned improvement measures.

Anticorruption provisions related to fiscal transfers to the local level are mostly contained in **local government integrity plans**. These are internal documents with legal and practical measures, which aim to prevent and eliminate possibilities for the occurrence of various forms of corrupt and unethical behaviour within local government bodies. Integrity plans focus on managing risks related to budget planning, public procurement planning, public procurement implementation, contract drafting and conclusion, financial management and controls, etc. Yet, local government bodies entrusted with implementing and overseeing these integrity plans have low capacity and powers, mostly limited to inspections and referrals of complaints and suspected corruption cases to other relevant authorities.

Integrity provisions at the municipal level in SEE are often very general, target low-level civil servants rather than decision-makers, lack clear deadlines for their implementation and are not tailored to local circumstances. For example, in Albania, local government units are obliged to allocate an item in their budgets for the improvement of integrity instruments. However, none of the municipalities have allocated more than 1% of the budget for the approval and implementation of plans according to the forecasts in the Anticorruption Action Plan 2022.<sup>71</sup>

## Financial inspections and audits

When applied effectively, financial inspections and audits are among the strongest government tools which could be employed to detect and tackle irregularities, political interference and conflict of interest in the budget distribution and spending at all levels.

<sup>70</sup> Serbian Anti-corruption Agency, [Manual for the Integrity Plan Development and Implementation](#), 2015.

<sup>71</sup> Ministry of Justice, [Intersectoral strategy against corruption 2015-2023](#).

In North Macedonia, the State Audit Office has highlighted deficiencies in the criteria for evaluating projects seeking capital development transfers from the ministries. This deficiency raises questions about the efficacy of the evaluation process. In Bulgaria, the Agency for State Financial Inspection monitors the spending procedures of state funds and performs checks for fraud.<sup>72</sup> The Agency cooperates with the National Audit Office and the European oversight authorities.

In Croatia, the financial audit of local governments is conducted annually by the State Audit Office for a selected number of municipalities.<sup>73</sup> The state auditors assess the **risks of significant misrepresentation of data in financial statements and the risks that procedures are not conducted in accordance with the law**. They also inspect internal controls over the preparation, compilation and publication of financial statements, as well as internal controls that ensure business compliance. The State Audit Office cannot impose sanctions; however, it provides a conditional opinion and recommendations for improvements. The audit office is also supposed to inspect whether the local government has followed up on previous recommendations, but audits of the same local government are rarely conducted.

### Box 3. Financial management guidelines

The Strategy of the Council of Europe for Innovation and Good Governance on Local Level from 2007 is based on 12 principles, including “Efficiency and Effectiveness” (i.e. best possible use is made of the resources available, audits are carried out at regular intervals in the municipality to assess and improve performance), “Stable Financial Management” (an internal audit function reviews financial transactions to ensure compliance with approved internal procedures, multi-annual budget plans are prepared, with consultation of the public), “Openness and Transparency” (the public in such a way as to enable it to effectively follow and contribute to the work of the local authority), “Ethical Conduct” (the local public interest guides the allocation of budgetary resources of the municipality) and “Rule of Law” (common interests of all residents do prevail, not the special interests).<sup>74</sup>

In Romania, the Court of Auditors assesses **financial management and compliance with anticorruption policies at the local level**. Their reports provide insights into corruption risks in the distribution of public funds. However, given that the distribution of funding is very much discretionary, there are few provisions regarding how funds are allocated, particularly for investment. Still, what few provisions exist are generally complied with.

<sup>72</sup> Република България, [Закон за Държавната финансова инспекция](#), [Republic of Bulgaria, Law on State Financial Inspection], 24 October 2017.

<sup>73</sup> Državni ured za reviziju, [Financijske Revizije](#), [State Audit Office, Financial Audits], 2007–2023.

<sup>74</sup> Council of Europe, [Strategy for Innovation and Good Governance on Local Level](#), 2007.

# THE IMPACT OF CENTRAL-LOCAL POLITICAL ALIGNMENT ON PROCUREMENT INTEGRITY

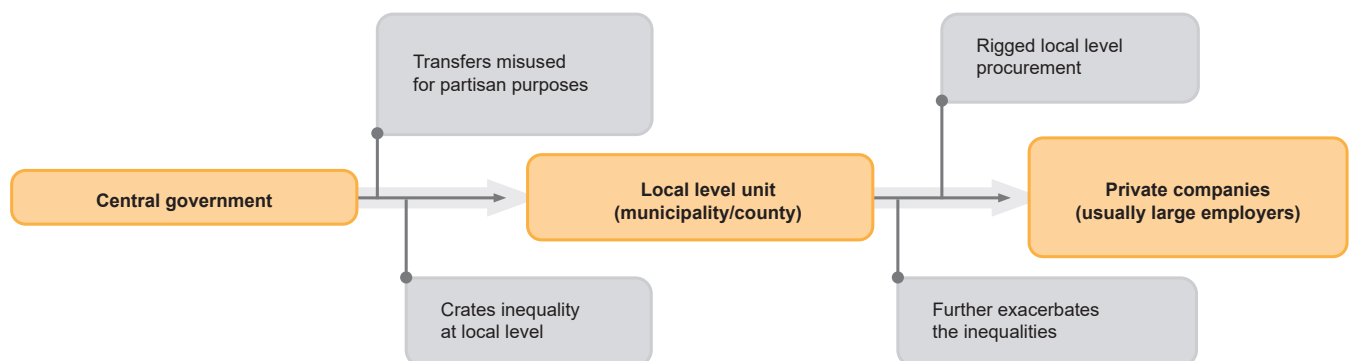
Equalisation policies pursued through intergovernmental transfers can only achieve their ostensible objectives if the recipient local governments spend in a way that ensures value for money. When local purchasing and investment is compromised, the **inequity of preferential intergovernmental transfers** to local allies of the central government is compounded by the channelling of public money to local business cronies.

## Public procurement integrity at local level

In SEE, public procurement is the government activity with one of the highest corruption risks, due to the large amounts distributed through procurement procedures. The types of public irregularities identified in the region include favouritism and clientelism, overpricing of contracts, tailored tender specifications, conflict of interest in the tendering process, high share of non-open procedures, short advertisement periods, contract modification and delivering sub-standard service in the implementation phase.<sup>75</sup>

A substantial concern is that malpractices in national procurement affects purchasing at the local level. Local level units (municipalities, cantons) receive politically biased transfers from the central level in exchange of party loyalty and favours, and in turn they use part of the received funds for awarding tenders to specific companies. Even though the financial loss perpetrated by each municipal actor is on a smaller scale, its multiplication effect across the countries might cause significant damage to the state budget. The corrupt relationship between national and local actors could be abused to such an extent that **state capture takes place also at the subnational level**. Public procurement can then be transformed into a tool for political interference within the central-local fiscal relations, which exacerbates the inequalities

Figure 4. Negative cumulative effect of compromised procurement integrity at all levels



Source: CSD.

<sup>75</sup> Center for the Study of Democracy / R2G4P, Analyzing Public Procurement Risks: Training manual, 2022.

among regions/municipalities, as well as at intra-municipal level (among districts or neighbourhoods).<sup>76,77</sup>

Each of the SEE countries' strategic anticorruption and integrity promoting documents points to particular mechanisms for avoiding conflict of interest and abuse in public procurement.<sup>78</sup> Still, the strategies often lack efficient implementation. In Serbia, for example, the Law on Public Procurement does not apply when public procurement contracts are signed with other countries, international organisations and financial institutions.

**The lack of public procurement integrity systems at the municipal level and mechanisms not tailored to local needs render the existing national ones ineffective.** For instance, in Bulgaria, conflict of interest requirements at the municipal level do not prevent explicitly conflict of interest when municipal councils approve their budgets allowing the municipal actors substantial discretion, as long as they fit the legal framework.<sup>79</sup> Despite that municipal councils have set up standing anticorruption committees,<sup>80</sup> which receive alerts and complaints about conflict of interest and corruption, these bodies have only the power of referral.

## Achieving transparency in public procurement

Risks to public procurement integrity can be identified by utilising big data to focus checks and audits on the riskiest buyers, suppliers, and sectors, and ensuring transparency and civil society oversight.

The transparency of procurement contracts is usually ensured through the launch of dedicated procurement online portals. Still, the quality and extent of information differs across SEE countries. For example, in Bulgaria, all

<sup>76</sup> Center for the Study of Democracy / R2G4P, [Rolling Back State Capture in Southeast Europe](#) 24 January 2023.

<sup>77</sup> Center for the Study of Democracy / R2G4P, [Public Procurement Integrity in Southeast Europe: Mechanisms, Red Flags, and State-Owned Enterprises in the Energy Sector](#), 2022.

<sup>78</sup> Republika e Shqipërisë, [Strategjia e Kombëtare Për Prokurimin Publik](#), [Republic of Albania, National Public Procurement Strategy], 4 November 2020; Vijeća Ministara Bosne i Hercegovine, [Akcioni Plan Vijeće Za Implementaciju Inicijative "Partnerstvo za Otvorenu Vladu" za Period 2022 – 2024](#), [Action Plan for Implementation of the Open Government Partnership Initiative 2022 – 2024], November 2021; Republic of Bulgaria, [Национална стратегия за превенция и противодействие на корупцията в Република България 2015–2020 г.](#), [National Strategy for Prevention and Counteraction of Corruption in the Republic of Bulgaria 2015-2020], April 2015; Republika Hrvatska, [Akcijski plan Strategije suzbijanja korupcije 2021.-2030](#), [Republic of Croatia, Action Plan for the Anti-Corruption Strategy 2021-2030], 28 July 2022; Guvernul României, [Despre Strategia Națională Anticorupție](#), [Government of Romania, Anti-Corruption Strategy, 2021]; Magyar Köztársaság, [Nemzeti korrupcióellenes program](#), [Republic of Hungary, Anti-Corruption Program], 2015; Magyar Köztársaság, [A 2020-2022. közötti időszakra szóló középtávú Nemzeti Korrupcióellenes Stratégia](#), str. 11-12, [Republic of Hungary, The medium-term plan for the period 2020-2022 National Anti-Corruption Strategy, pp. 11-12], 2022.

<sup>79</sup> E.g. see: Trud, [КПКОНПИ установи конфликт на интереси при общинари в Стара Загора и Хисаря](#) [KPKONPI found conflict of interest with municipal officials in Stara Zagora and Hisarya], 28 March 2022.

<sup>80</sup> Republic of Bulgaria, [Национална стратегия за превенция и противодействие на корупцията в Република България 2015–2020 г.](#), [National Strategy for Prevention and Counteraction of Corruption in the Republic of Bulgaria 2015-2020], April 2015.



information on the awarding process of public contracts is made public, but there is little follow-up information on their execution and on whether contractors are adhering to the quality standards set in the contract.<sup>81</sup> In Bosnia and Herzegovina, Montenegro, and Serbia municipalities publish scarce information on only few steps from the procedure. Transparency requirements are rather optional, and there is no follow up sanction in the case the local administration does not comply. Hungary also lacks effective sanctioning for the non-compliance with disclosure regulations related to contracts signed by the central and local level units, as well as received national and EU budgetary support.<sup>82</sup>

### Evaluation of the public procurement processes

The evaluation and assessment of the public procurement procedures and the effectiveness of prevention measures usually rely on self-assessment using descriptive and qualitative methods. There is a **lack of clear indicators and quantitative evidence-based instruments** which can evaluate results. Procurement and anti-corruption authorities mostly look into input indicators (regulations, procedures, resources), rather than outputs, i.e., actual impact.<sup>83</sup> In Romania, for example, evaluation is typically conducted through a combination of **self-evaluation and external evaluation** mechanisms, performed by specialised institutions and bodies, including the Ministry of Public Finance, the National Agency for Public Procurement, the Court of Auditors, and the National Anticorruption Directorate. Indicators include the number of corruption cases detected, penalties imposed, increased competition in bidding processes, enhanced transparency, and improved efficiency in public procurement.

### Political favouritism in local public procurement – statistical analysis and case studies

The degree and modes of political favouritism in public procurement at the local level are best understood on the basis of empirical evidence. In order to find out whether – and if so how – local procurement follows partisan interests, leading to contract allocation according to political loyalty and electoral considerations, this section examines the presence of politically motivated factors in the distribution of public procurement contracts. It analyses the statistical relationship between public procurement contract values, political party of local leadership and election results in nine countries in the SEE region (for two countries, only descriptive analysis was possible due to data gaps).

The first type of data used for the analysis is **public procurement data** aggregated by municipality – year level with additional aggregation to NUTS-2 or NUTS-3 regions for descriptive analysis. The aggregated variable

<sup>81</sup> Ibid.

<sup>82</sup> Amnesty International Hungary et. al., [Assessment of compliance by Hungary with conditions to access European Union funds](#), April 2023.

<sup>83</sup> Center for the Study of Democracy / R2G4P, [Rolling Back State Capture in Southeast Europe](#), 24 January 2023.



needed for the analysis is the bid price summed for municipality–year, which is the dependent variable in the regression analysis. In addition, supply and procedure type share and market share were calculated at the municipality–year level or at the NUTS-2/3 region–year level, depending on the number of municipalities in the country. The second type of data used is the **elections data** which describes mayors and municipal assemblies and their electoral performance. The data includes the name of the municipality, the year of the election, information about the winning candidate or party, and information about the non-winning candidates and parties, where available. In addition, the data also covers the coalition of national parties that form the government and municipal coalitions where such data is available. For a more detailed overview of the available electoral data per country see the table below.

**Table 5. Description of available electoral data**

Country name	Type of elections	Years of elections	Number of municipalities / provinces / cities included in the dataset
Albania	Mayor	2015, 2019, 2023	61
Bosnia and Herzegovina	Municipal Assembly	2016, 2020	144
Bulgaria	Mayor & Municipal Assembly	2015, 2019	27
Croatia	Mayor	2017, 2018, 2019, 2020	552
Hungary	Mayor	2008, 2009, 2010, 2011, 2012, 2013, 2014, 2015, 2016, 2017, 2018, 2019, 2020, 2021, 2022	2773
North Macedonia	Mayor & Municipal Assembly	2013, 2017, 2021	73
Montenegro	Municipal Assembly	2010, 2012, 2013, 2014, 2016, 2017, 2018, 2019, 2020	26
Romania	Mayor	2008, 2012, 2016	2473
Serbia	City/Municipal Assembly	2012, 2016, 2020	140

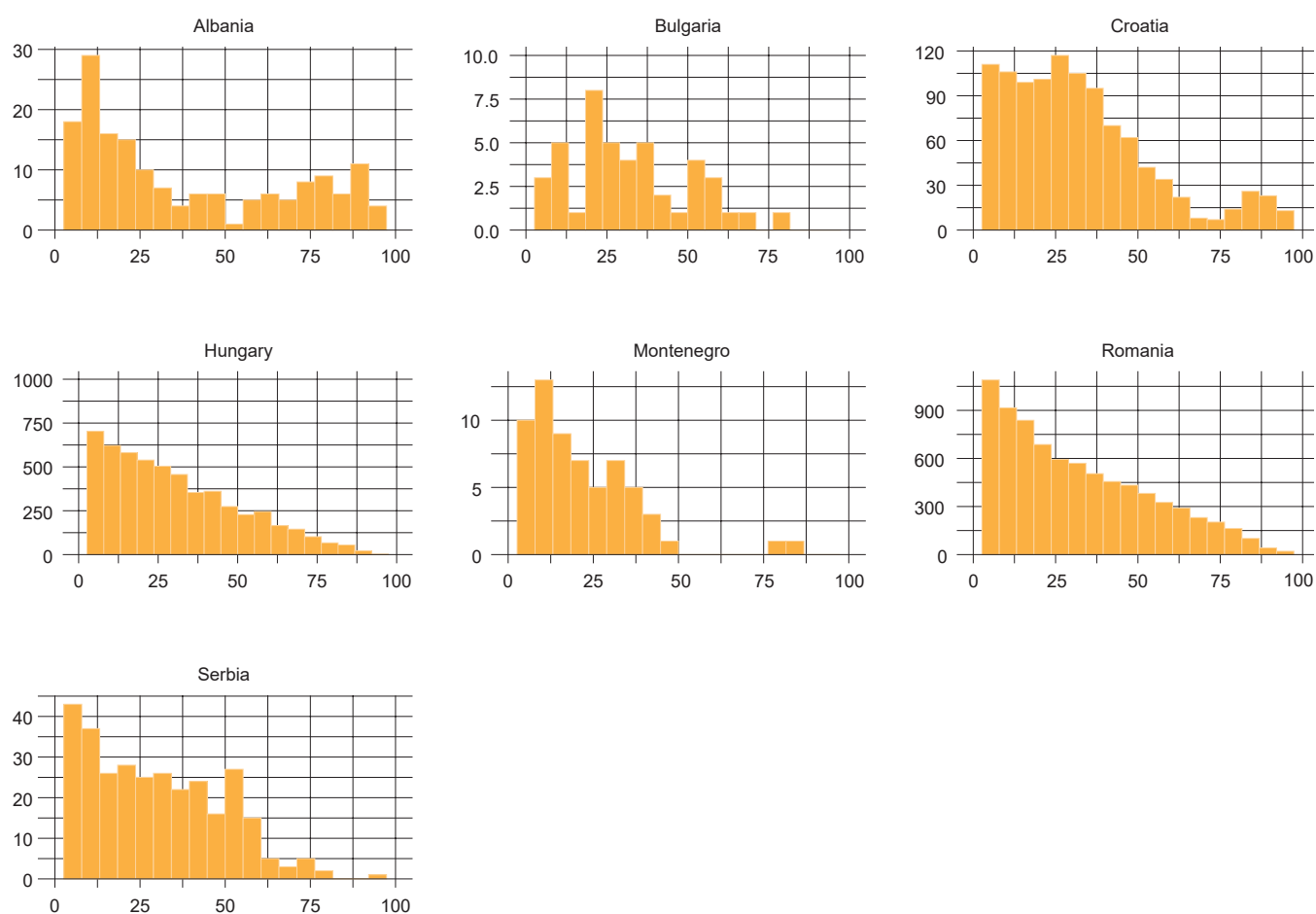
Source: GTI.

The methodology of this section includes both descriptive analysis (e.g. frequency distributions) and fixed effects panel regression models<sup>84</sup>. The regressions were run with several predictors, with two variables of particular interest from the perspective of political favouritism: political alignment

<sup>84</sup> The fixed effects panel regression model accounts for the unique characteristics or attributes of each municipality that do not change over time or are not included in the model's independent variables. These fixed effects can capture unobserved factors that are specific to each community, such as local geography, population, culture and others. Each model includes several other control variables to ensure that the effects found are robust, including the share of sectoral public procurement spending, the average number of bidders per area, etc. The alignment model is restricted to the sample of observations with only municipalities that had a change in alignment (thus excluding those that were also politically aligned with the national level and those that had never been aligned with the national level) to ensure clarity of the results and interpretation of the coefficients. For the winning share model, the value of the dependent variable is lagged by one year to test whether the amount of public spending prior to elections is determined by the level of expected political competition in the locality.

between the municipal and the national governments and winning margin per electoral cycle. First, the political alignment variable was generated using the party affiliation of the mayor or the party forming the municipal government and that of the national government. If the mayor's party is part of the coalition that forms the municipal government (where such data are available), or if the municipal assembly parties, including the winning party, are also represented in the national assembly coalition, we consider that municipality to be politically aligned. Second, the winning margin was calculated as the difference in vote share between the winning candidate or party and the second-best candidate or party.<sup>85</sup> The distribution of winning margins for seven countries is shown in Figure 5.<sup>86</sup> As can be seen in the figure, the distribution is predictably mainly skewed to the right, with the majority of observations between 0 and 50, which tends to signal a higher average level of competition observed in the region. However, Albania and Croatia show a further peak in the distribution in the 75-90% range. This either signals a very low level of competition in some exceptional municipalities, or could be a sign of a high level of polarization.

**Figure 5. Frequency distribution of winning margin (municipality-year)**



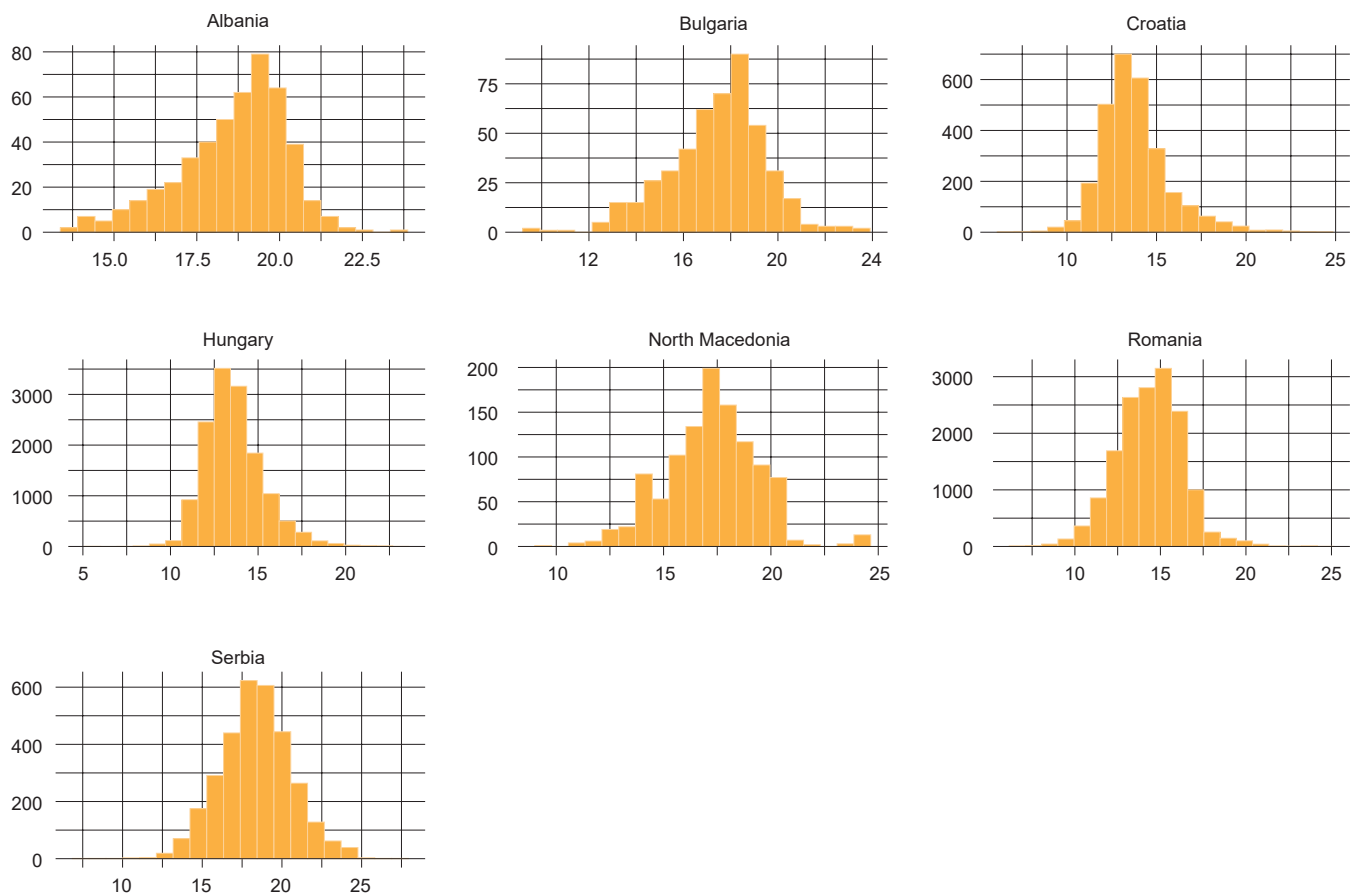
Source: GTI.

<sup>85</sup> E.g. if the winning candidate has 60% of the votes and the next best candidate has 30%, the winning margin would be  $60-30=30\%$ .

<sup>86</sup> Two countries – North Macedonia and Bosnia and Herzegovina – are not included due to limited availability of data on non-winning candidates and parties, so the overall vote share was used instead for these cases.

Total public procurement spending per municipality-year is the main dependent variable used in the models.<sup>87</sup> The distribution in frequencies of the logged dependent variable is shown in Figure 6.<sup>88</sup> With some variation in the distributions, the average range varies from 15 to 22-25 with the peak in number of observations around 17-20. Since each country has its own currency, the logarithmic transformation also ensures the standardization of the values. The majority of observations around 17-20 with a total variation between 10 and 25 implies a central tendency of the original data, with actual values ranging from approximately  $\exp^{17} - 1$  to  $\exp^{20} - 1$ . While some countries have peaks further to the right on the continuum (Bulgaria, Albania, Serbia), others have smaller average values (Hungary, Croatia, North Macedonia, Romania). And while for some countries this difference could be caused by economic reasons, in the case of Croatia the comparative value of contracts is actually higher due to the Euro currency.

**Figure 6. Frequency distribution of logged public procurement spending (municipality-year)**



Source: GTI.

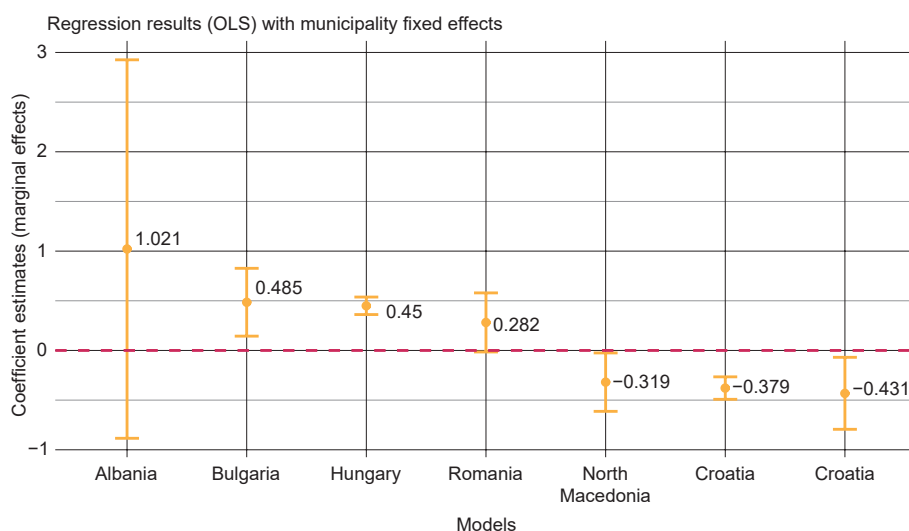
<sup>87</sup> Two countries – Bosnia and Herzegovina and Montenegro – are not included in the statistical analysis due to the lack of good quality public procurement data in these countries. In Albania, due to limited data availability, only municipal government contracts are included, to the exclusion of other potential purchasers registered at the local level (e.g. national ministry funding a road construction in the municipality).

<sup>88</sup> We added plus 1 to the total municipality-year public procurement spending so that we can calculate the logarithm of total spending when there was not a single contract awarded in the particular municipality-year. This ensured that the models aren't biased by skewed distributions in the dependent variable.

### Central-local political alignment and public procurement allocation

The figure below shows the results for political alignment country by country for seven countries. Apart from Albania, the alignment predictor has a significant coefficient in all countries. We can see that in Bulgaria, Hungary and Romania the predictor is positive and significant, and for North Macedonia, Croatia and Serbia it is significant and negative. To interpret these coefficients, we should first consider the logarithmic transformation. Since we are working with log-transformed data, effects can be interpreted as a percentage changes.<sup>89</sup> For example, the Bulgarian coefficient = 0.485, so the percentage change in price associated with the adjustment compared to no adjustment would be  $= (e^{0.485} - 1) * 100 \approx 62.33\%$ . Hence, **when the mayor is from the same political party as the one forming the ruling coalition on the national level the value of public procurement contracts increases by approximately 62% in Bulgaria, 56% in Hungary and 32% in Romania<sup>90</sup>**, holding all other variables constant. For three other countries with statistically significant coefficients – North Macedonia, Croatia and Serbia – the coefficients have a negative sign, meaning that politically aligned municipalities are associated with a decrease in public procurement spending of 38%, 46% and 54% respectively, holding all other variables constant.

**Figure 7. Analysis results for alignment predictor**



**Note:** Bars indicate the 95% confidence interval.  
Dependent variable is logged.

**Source:** GTI.

A number of **policy-relevant insights** can be drawn from these empirical results. First, the fact that all countries, except Albania<sup>91</sup>, have a significant

<sup>89</sup> This is due to using the formula: percentage change in price  $= (e^{\beta} - 1) * 100$ .

<sup>90</sup> Note that the Romanian coefficient is significant at 90% confidence level.

<sup>91</sup> Please note that the collected public procurement data from Albania is considerably less refined and hence reliable compared to the other countries which is likely to inflate confidence intervals, making the models for Albania less reliable.

coefficient means that party-politically motivated distribution of public procurement funds is widespread in the region with profound impacts on the degree to which public spending follows development needs. Second, in Bulgaria, Hungary, and Romania, the statistically significant and positive coefficients suggest that municipalities that are political allies of the national government receive more funds and hence can spend more on public procurement. Bringing in the qualitative evidence, a likely explanation follows a political favouritism logic: **localities which vote with the central government get rewarded for their loyalty** while localities going with the opposition get punished, irrespective of local needs. Nevertheless, the observed empirical patterns could also be explained by benign administrative or bureaucratic reasons: it is **easier to coordinate and agree on projects within the same party**. Third, the statistically significant and negative coefficients for North Macedonia, Croatia and Serbia suggest a different type of mechanism. One of the possible explanations is currying favours with voters: by investing in high profile local projects the governing party(s) at the national level tries to make sure that voters in opposition municipalities attribute these to the national government and governing party(s), rather than local governing party(s).

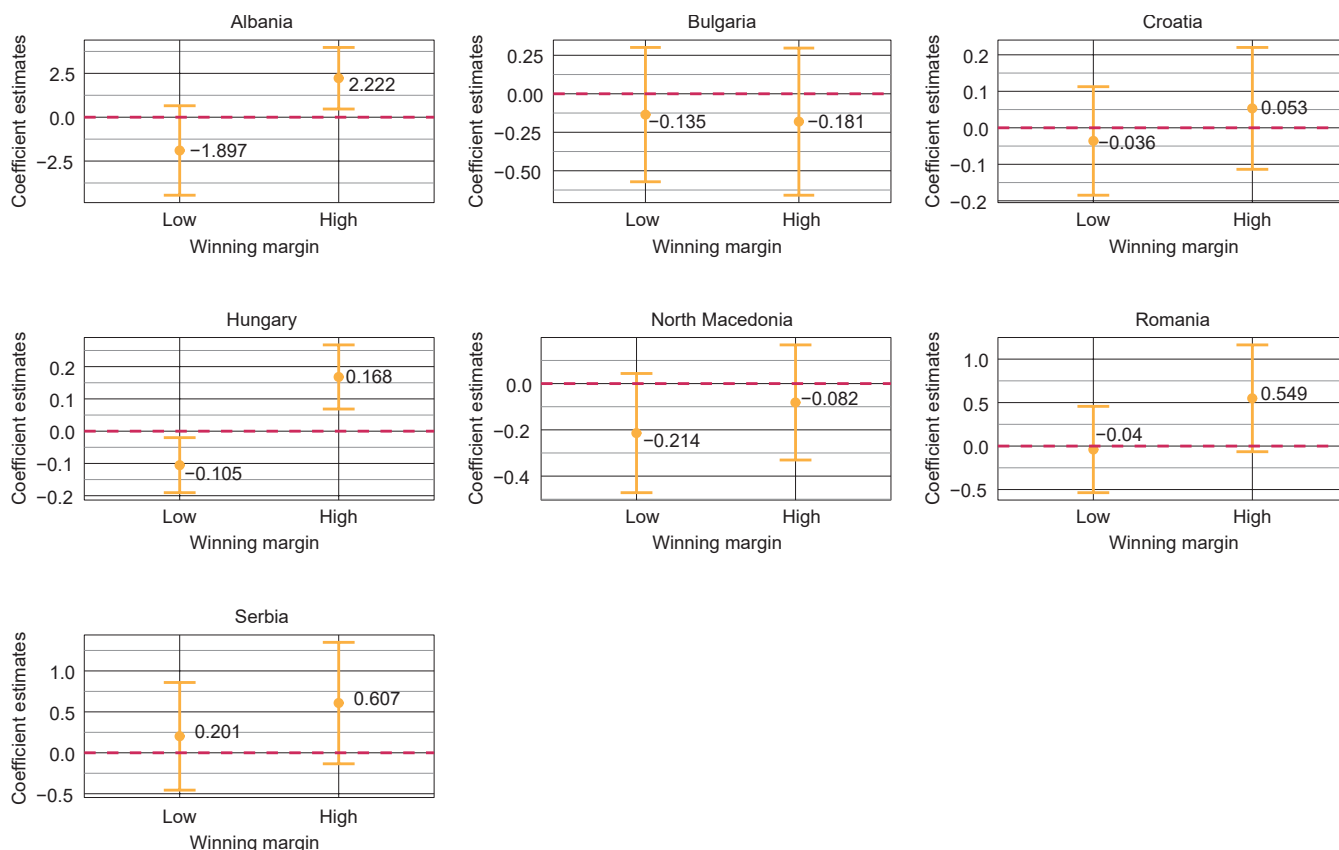
### Electoral competition and public procurement allocation

The effect of electoral competition should now also be added to the above findings of the results for central-local co-partisan alignment. The figure below shows the results for the analysed countries, including the coefficients and the estimation errors around them. The independent variable was divided into three categories based on the quantile distribution of the values, with the “High” category accounting for the highest average winning margin per municipality (lowest political competition) and “Low” for the lowest average winning shares and highest competition, while “Middle”, as a reference category, is what remains between High and Low winning shares.

While many countries do not show significant coefficients, we observe a general trend similar across almost all countries in the region (results are significant at the 95 level in Albania and Hungary; and coefficients are significant at the 90% level in Romania and Serbia). It seems that a higher winning margin and hence **less competition are associated with higher public procurement spending**. Conversely, a low winning margin, indicating a highly competitive and uncertain political environment, is associated with less procurement spending. These patterns suggest that municipalities with more political turbulence and less certainty of electoral outcome receive less public procurement allocation, at least as it can be inferred from observed contract award values. The only exception from this general pattern is Bulgaria, where the sign and size of the coefficients for low and high winning margins are almost the same, so we see little “directed” public procurement spending reflecting electoral considerations. The insignificant coefficients could be due to data limitations (the electoral data is at the level of provinces, which could potentially blur the coefficients). Alternatively, relative lack of highly competitive local elections and the relative safety of most mayoral and

local government party positions could cause absence of significant effect due to low variation.

**Figure 8. Analysis results for winning share predictor**



Source: GTI.

### Political alignment, electoral competition and public procurement allocation

Given that electoral winning margin and political alignment are likely to both influence politically motivated public funds allocation, the above two factors are best interpreted jointly. Taken together the results from the alignment models and the winning margin models, we can identify different patterns or types of political favouritism in public procurement. First, **Hungary and Romania, and to some degree Albania too**, show signs of strong political loyalty-driven local public procurement allocation. There is a large effect of allocating money to the most reliable municipalities: both politically aligned with the central government and having the least electoral contestation (i.e. voters most predictably supporting the same party). In addition to the interpretation evoking political favouritism, politicians in reliably aligned municipalities find it easier to organise corrupt schemes (e.g. identifying the privileged companies, devising reliable methods to informally allocate bribes) and thus increase the prices of public contracts.

The case studies also demonstrate this point. In Hungary, since the election of a Fidesz mayor and a Fidesz majority in the local council of Győr, three companies – Strabag, VILL-KORR Kft. and KIFÜ-KAR Zrt. – with political ties to the ruling Fidesz party, won an overwhelming number of tenders. These companies had remarkably high odds of winning contracts, suggesting a pattern of abuse in public procurement that also leads to price gouging in public contracts.<sup>92,93,94,95</sup> In Romania, in Gorj County, Senator Ion Iordache's involvement in a 210 million lei (EUR 42 million) contract with SC Ydail Construct SRL, a company he founded and later transferred to his son, raises concerns about potential corruption and conflicts of interest given his political role in the region. The company has secured numerous public contracts, many of them directly with the authorities in Gorj, where Iordache previously served as mayor, accumulating nearly 300 million lei (EUR 60 million) in revenues<sup>96</sup>. Similarly, in Olt County, the extensive declaration of interest of the member of parliament Emil Florin Albotă reveals numerous public contracts between him and his mother, through direct procurement and signed by the mayor in the county, totalling over 10 million lei (EUR 2 million)<sup>97</sup>. The personal ties established at the local level with local actors, which are stable over time, increase the price of public contracts due to corruption.

Second, **Croatia, North Macedonia and Serbia** tend to have a different type of political favouritism in local public procurement allocation. The non-aligned, i.e. opposition, localities in these countries tend to get more money for public procurement than aligned ones. At the same time, the effect of electoral competitiveness (winning margin), is weak and largely insignificant (coefficients for the categorical winning margin predictor in Serbia are close to significant, while coefficients in Croatia and North Macedonia are insignificant). Nevertheless, public procurement spending may be higher in municipalities with less competitive elections, that is more certain electoral outcomes, particularly in Serbia and Croatia. The results suggest that non-aligned territories where the opposition is almost certain to win (so there is not much unpredictability in it) get more money through public procurement. This could be explained by the central government's efforts to co-opt consistently opposition municipalities by allocating extra funds to them. Alternatively, it

<sup>92</sup> Erdélyi, K., Bövöl a Duna Aszfalt birodalma, 4 új céget alapított a jachtokról elhíresült Szíjj László [*The empire of Duna Aszfalt expands, László Szíjj, famous for yachts, founded 4 new companies*]. Átlátszó, 19 May 2022.

<sup>93</sup> Katus, E., Megtaláltuk a „tenderkirály” cégeket és a várost, ahol több száz megbízást nyertek [*We found the “tender king” companies and the city where they won hundreds of contracts*]. Átlátszó, 15 February 2023.

<sup>94</sup> Péter M., 556 közbeszerzésen indult, mindet megnyerte [*He entered 556 public procurements and won them all*], 444, 8 February 2023.

<sup>95</sup> Zeisler, J., *Tender Champions: The performance of companies profiting from public resources and owners' involvement in public offices*, in Transparency International, pp. 5, 2023.

<sup>96</sup> Libertatea, Băiatului Președintelui PNL Gorj a câștigat contracte cu statul de 300 de milioane de lei cu firma înființată de tatăl lui; ar putea câștiga de 5 ori mai mult [*The son of the PNL President Gorj won contracts with the state worth 300 million lei with the company founded by his father; could earn 5 times more*], 18 July 2023.

<sup>97</sup> Libertatea, Mama, tata și soția produc zeci de milioane de euro. Rețeta banilor obținuți de familiile deputaților prin contracte cu statul [*The mother, father and wife produce tens of millions of euros. The recipe for the money obtained by the families of deputies through contracts with the state*], 13 July 2023.



may also be the case that the opposition spends more proactively when it is in a vulnerable position in relation to the national level party. However, such a statement is very much dependent on two factors: how much of the fiscal and administrative power is at the local level, as well as what is the share of public procurement contracts distributed at the local level vs. national level.

This seems to be the case for Croatia. The share of contracts awarded by local and regional government units in the country is 29% and they are the second largest group of public purchasers. They are also the second largest group of public purchasers in terms of volume and value of contracts.<sup>98</sup> However, in the case of Serbia, when it comes to the share of public procurement in the total value, the national authorities awarded 21.51% of the total public procurement contracts, while the authorities of autonomous provinces and local self-government units had a share of 27.66% (with the number of contracts at the municipal level being twice as low as at the national level).

On the other hand, the cases of local corruption in public procurement from these countries suggest some systems of cooperation between different local actors. For example, in Croatia, in a case investigated by the Office for the Suppression of Corruption and Organized Crime (USKOK), the Mayor and Deputy Mayor of Požega engaged in corruption by attempting to manipulate a public tender for energy certificates and renovation projects. They tried to favour certain contractors by instructing the utility company to send invitations to select bidders and coordinate their bids, ultimately maximising prices co-financed by the Environmental Protection and Energy Efficiency Fund. Both officials were convicted.<sup>99</sup> In addition, USKOK filed charges against two police officers allegedly involved in providing information to the mayor during the investigation.<sup>100</sup> Therefore, **the predictability of election results could be important not only for sustaining projects, but also for local networks used for corruption.** If there is a break in a well-established network, there is less room for manoeuvre to cooperate in corrupt schemes.

Third, Bulgaria displays another pattern of political favouritism in local public procurement. Here, localities aligned with the central government are able to spend considerably more on public procurement while electoral competitiveness appears to have no effect on public procurement allocation whatsoever. This may be due to the relative lack of highly competitive local elections and the relative safety of most mayoral and local government party positions. In such a context, central governments do not differentiate among localities prior to elections, only when results are known and alignment can be established.

<sup>98</sup> Ministry of Economy and Sustainable Development, [Annual Statistical Report on Public Procurement](#), 2022.

<sup>99</sup> Index.hr, USKOK pokrenuo istragu protiv gradonačelnika Požege i njegovog zamjenika [[USKOK launched an investigation against the mayor of Požega and his deputy](#)], 22 January 2021.

<sup>100</sup> Jutarnji.hr, Bivši gradonačelnik Požege i njegov zamjenik osuđeni za namještanje poslova oko energetske obnove zgrada [[The former mayor of Požega and his deputy were convicted of rigging deals related to the energy renovation of buildings](#)], 7 April 2023.



## Conclusions

The above empirical analysis informs some robust lessons and allow the following conclusions:

- **Significant coefficients for political alignment.** In most of the countries studied, significant coefficients on the alignment predictor suggest that there is a politically motivated distribution of public procurement spending rather than one based on impartial allocation, reflecting public needs. When municipalities are politically aligned with the ruling party of the national level, they tend to receive larger public procurement contracts.
- **Significant coefficient of winning margin.** Higher winning margins, which are used as indication of less political competition, are generally associated with a greater chance of winning larger contracts. This suggests that municipalities with predictable electoral outcomes tend to allocate more public procurement spending. This is possibly due to a higher likelihood of corruption or abuse. Case studies from Hungary and Romania provide concrete examples of how political networks can lead to abuse of public procurement processes, including favouring certain firms with political connections and inflating contract prices. These cases highlight the potential for corruption and conflict of interest in local government in these countries.
- **Combined effects of political alignment and electoral competition.** The directions of the relationships between these two factors vary across countries. Positive coefficients in some countries (e.g., Bulgaria, Hungary, and Romania) may indicate that politically aligned municipalities receive larger contracts, which could be due to political motivations or administrative efficiency. In contrast, negative coefficients in other countries (e.g., North Macedonia, Croatia, and Serbia) suggest that politically aligned municipalities receive smaller contracts, possibly as a strategy to obtain loyalty or support. When it comes to winning margins, Croatia, North Macedonia and Serbia show a different dynamic, where non-aligned territories or territories with less political competition receive more money from public procurement. This may be related to the proactive nature of the opposition in vulnerable positions or to the distribution of fiscal and administrative power at the local level.
- **Importance of local networks and context.** Corruption in public procurement is often facilitated by well-established local networks. The predictability of election results may affect these networks, and a disruption of such networks may reduce opportunities for corrupt cooperation. It is also important to consider the specific context of each country, including the share of public procurement at the local versus national level and the degree of fiscal and administrative decentralisation.

# THE WAY FORWARD: REDUCING THE RISKS FROM CLIENTELISTIC INTERGOVERNMENTAL TRANSFERS

There are a number of policy measures, that could reduce the risks from discriminatory and biased funding from the central towards the local level, as well as the misuse or mismanagement of national and foreign donors' funds.

## Improve strategic planning and evidence-based decision-making

The first step involves the recognition of the problem in strategies, plans and counter-measures. Once the problem is recognised, the process could move towards the establishment of clear and transparent criteria for funding allocation, made on objective grounds, and not based on political (or personal) considerations. Any discretionary and politically biased decisions-making mechanisms should be limited. The prevention, detection, and countering of these risks should also be included in the obligations and mandate of:

- the national parliaments and their budgetary, economic and anticorruption committees;
- the ministries of finance, ministries of regional/local development, and managers of national and EU funds supporting the municipalities;
- the national audit offices, financial police and inspectorates;
- the ethical and anticorruption committees to the municipalities, integrity managers, and the municipal councils.<sup>101</sup>

The effective fiscal oversight in particular should involve **collaboration among multiple public bodies** in order to ensure transparency, accountability, and equitable distribution of resources between central and local governments.

The ministries of finance should establish practices to require an independent external due diligence audit of the accounts of the local self-government unit before the approval of long-term debt.

Officials responsible for making funding decisions need to be trained to recognise and react to cases of preferential treatment and bias, while municipal officials should be equipped to detect public procurement irregularities and use

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<sup>101</sup> See also: OECD, [Corruption Prevention at Local Level in Eastern Europe and Central Asia](#), 2021.

electronic tendering procedures. Civil society could help with the organisation of such training, as well as the introduction of electronic procurement.

### **Establish a regular public-private mechanism for monitoring funding decisions**

Putting in place mechanisms for public oversight and accountability should start with strengthening the capacities and functions of:

- the anti-corruption agencies;
- the audit offices, financial police and inspectorates;
- the associations of municipalities;
- the civil society and the media.

These bodies should review decisions related to budget transfers and assess any potential bias, discrimination, or conflict of interest. The audit offices and financial inspections institutions should establish procedures for random and regular inspections, in addition to the ad hoc checks performed based on requests, referrals and complaints (e.g. submitted by the prosecution, the Council of Ministers, the Ministry of Finance or the Public Procurement Agency).

The review of the budget transfer decisions should:

- Consider the choice between unconditional transfers and conditional transfers;
- Detect the corruption risks associated with formula-based transfers such as manipulation of the formula criteria, data falsification, formula complexity and political interference in formula design;
- Check the accuracy of data inputs for the formula and the fairness of the allocation process;
- Recommend steps towards the reduction of formula complexity and the increase of transparency during and after its implementation to avoid and reduce policy indiscretion and political capture.

A pre-condition for efficient oversight is for governments to clearly state the objectives of their transfers and design their intergovernmental transfer system in a way that allows a separation of objectives and independent steering and control of grant characteristics that contribute to each of these objectives.

Governments should also avoid the over-reliance on self-assessment, such as the self-evaluations performed by the municipalities in the integrity plans. The civil society sector, the academia and the investigative journalism could have

invaluable role in this respect. The civil society in particular should support the development of legislation, rules and procedures related to the budget allocation and spending, e.g. the formula used for formula-based transfers and budget transfers.

### **Apply regular corruption risk assessment methods**

In addition to the financial audits and the self-evaluation reports of the integrity plans, it is also recommended for the governments at central and local level use a wider range of corruption risk assessment (CRA) mechanisms, in order to develop a comprehensive approach towards tackling all corruption and conflict of interest threats. A number of CRA tools, developed by civil society, international or public bodies, are available and ready for transfer and introduction in other countries, sectors, or government institutions.

**The Monitoring Anticorruption Policy Implementation (MACPI) tool**<sup>102</sup> assesses, monitors and facilitates the enforcement of anti-corruption measures and policies at the level of individual public bodies, including municipalities. Since 2015, MACPI has been implemented in more than 30 public organizations in North Macedonia, Italy, Spain, Romania, Hungary, Bulgaria, Bosna and Herzegovina, Serbia, Albania, Montenegro, Croatia, and other European countries.

**The State Capture Assessment Diagnostics (SCAD)** is a tool, based on anonymous online survey among a large pool of experts, which evaluates the dimensions, enablers, drivers, effects and outcomes of state capture.<sup>103</sup> The application of the State Capture Assessment Diagnostics at Sectoral Level Integrated Tool (SCAD-SLIT) in 2021 confirmed that the municipalities are often associated with lack of integrity and impartiality.<sup>104</sup>

**Analysis of public procurement risks.** The Corruption Risk Indicators (CRIs), created by the Government Transparency Institute (GTI), are equipped to measure the corruption risks of public procurements, while the Opentedner website provide comprehensive public procurement information free of charge in an easy-to-use format.<sup>105</sup>

**The Corruption Monitoring System (CMS)**<sup>106</sup> was designed and developed by the Center for the Study of Democracy, Bulgaria in 1998. CMS provides victimisation and perception data in the corruptness of municipal councillors and municipal officials.

<sup>102</sup> Center for the Study of Democracy / R2G4P, [Monitoring Anticorruption Policy Implementation \(MACPI\): Training manual](#), 2022.

<sup>103</sup> Center for the Study of Democracy / R2G4P, [State Capture Assessment Diagnostics at Sectoral Level: Training manual](#), 2022.

<sup>104</sup> Center for the Study of Democracy, [Assessing State Capture Vulnerabilities at the Sectoral Level](#), 2021.

<sup>105</sup> R2G4P, [Analyzing Public Procurement Risks: Training manual](#), 2022.

<sup>106</sup> Center for the Study of Democracy / SELDI, [CMS Methodology](#).

Enhancing and deepening the process of **checking asset declarations** of mayors and municipal officials is also an indispensable tool for detecting potential risks. It is highly recommended that a unified checking procedure is introduced across all public bodies, based on a set of red flags and indicators. Such comprehensive list of risk indicators for checking asset declarations is presented in the 2023 R2G4P report “Rolling Back State Capture in Southeast Europe. Implementing Effective Instruments for Asset Declaration and Politically Exposed Companies”.<sup>107</sup>

The monitoring of the progress and policy recommendations could further be supported by initiatives such as the Local Transparency Index calculated by Transparency Serbia<sup>108</sup>, the interactive transparency map maintained by the Bulgarian Access to Information Programme Foundation<sup>109</sup>, and the clientelism map maintained by Expert Forum in Romania.<sup>110,111</sup> Monitoring analysis could further be based on semi-structured interviews and desktop research (e.g. 2022 International Republican Institute’s analysis of corruption risks in ten Bulgarian municipalities).<sup>112</sup>

A coherent set of red flags should be incorporated in the CRA, including, but not limited to the detection of:

- Legislation allowing large shares of the national or foreign donors’ budget to be distributed discretionary;
- Frequent changes in the formula or criteria determining the funding for municipalities;
- Any exceptions from the competitive procedures in procurement and investments;
- Spending of national budgets or foreign donors’ funds for organizing election campaigns;
- Party donations from large employers – recipients of budget funds or contracts;
- Large employers buying underpriced municipal property, obtaining concessions or state aid;
- Illegal lobbying;

<sup>107</sup> Center for the Study of Democracy / R2G4P, [Rolling Back State Capture in Southeast Europe. Implementing Effective Instruments for Asset Declaration and Politically Exposed Companies](#), 2023, p 41.

<sup>108</sup> Transparency Serbia, [Local Transparency Index \(LTI\) 2015-2021](#).

<sup>109</sup> Bulgarian Access to Information Programme Foundation, [Transparency Map](#), 2000-2021.

<sup>110</sup> Expert Forum, [Special: Local investment programs and politics](#), 2022.

<sup>111</sup> Expert Forum, [Report: How do we fix PNDL?](#), 2022.

<sup>112</sup> International Republican Institute, [Assessing Municipal Vulnerabilities to Corruption in Bulgaria | An Examination of Ten Bulgarian Municipalities](#), 18 July 2022.

- Cases of revolving doors, incompatibility of functions, and conflicts of interest;
- Cases of suspicious debt annulment or provision of low-interest loans to municipalities or to large employers;
- Recruitment based on political party affiliation in the municipalities or state-owned enterprises.

### Ensure budget transparency

The full disclosure of all relevant fiscal information in a timely and systematic manner is crucial for the performance of government and civic oversight, as well as for increasing the trust in the public institutions at national and local level. In that respect, government bodies should follow the best international standards, including, but not limited to the IMF's Manual on Fiscal Transparency<sup>113</sup>, OECD's Best Practices for Budget Transparency<sup>114</sup>, the guidelines of the Public Expenditure and Financial Accountability (PEFA)<sup>115</sup>, and the High-Level Principles on Fiscal Transparency, Participation, and Accountability issued in 2012 by the Global Initiative on Fiscal Transparency (GIFT).<sup>116</sup>

### Clearly state the objectives of transfers

Intergovernmental transfers often have more than one objective – such as financing sub-national services and investments, subsidisation and equalisation. Therefore, governments should clearly state the objectives of their transfers and design their intergovernmental transfer system in a way it allows a separation of objectives and independent steering and control of grant characteristics that contribute to each of these objectives.

### Increase the integrity of public procurement at local level

- State **clear commitments and set deadlines for public procurement reforms** in strategic documents (action plans, National Recovery and Resilience Plans<sup>117</sup>, etc.)
- Establish **regular and systematic monitoring** of political favouritism between the national and local governments in public procurement building on the tools developed in this study.

<sup>113</sup> International Monetary Fund, [Manual on Fiscal Transparency](#), 2007.

<sup>114</sup> Organization for Economic Cooperation and Development, "[Best Practices for Budget Transparency](#)," OECD Journal on Budgeting, Volume 1, Number 3, 2001.

<sup>115</sup> [Public Expenditure and Financial Accountability \(PEFA\)](#) website.

<sup>116</sup> Global Initiative on Fiscal Transparency (GIFT), [High-Level Principles on Fiscal Transparency, Participation, and Accountability](#), 2012.

<sup>117</sup> E.g. the Bulgarian [National Recovery and Resilience Plan](#) foresees that the country reduces the negotiated procedures without notice, from 26% by the end of 2021 to 7% by the end of 2025, in order to reach the EU average. In addition, Bulgaria will reduce the share of award procedures with only one bid to the EU average.

- In order to better support regular monitoring of such policy-relevant phenomena, **improve e-procurement data collection and publication**, collecting more comprehensive data by, for example, lowering reporting thresholds and making public data more readily accessible for societal actors (e.g. data download options).
- Further **strengthen the policies for transparent and fair allocation** of public procurement contracts by increasing publication of call for tenders, making tendering terms more pro-competitive, diminish the use of non-open procedure types, and break up dominant market position of incumbent firms often having strong political connections.
- Improve **oversight of public procurement at the local level**, including review of anti-competitive tendering terms, to constrain the strategic use of public procurement for rewarding political actors for their loyalty.

# ANNEX 1.

## KEY OVERSIGHT INSTITUTIONS

### IN SEE COUNTRIES

Albania	<ul style="list-style-type: none"> <li>• <b>Ministry of Finance and Economy</b> (Responsible for deciding on the total spending for the delegated functions and also specifies the purpose for which it can be spent at local level)</li> <li>• <b>State Supreme Audit</b> institution (informs the public &amp; the Albanian Parliament about the use of resources with economy, effectiveness and efficiency by the central and local government and other public entities, as well as promoting accountability throughout the public sector)</li> </ul>
Bulgaria	<ul style="list-style-type: none"> <li>• <b>Ministry of Finance</b> (allocates financial resources between the central and local government levels, defines standards for financing state mandated activities, the mechanisms for allocating transfers from the central budget, including monitoring and analysing the information from the Central Municipal Debt Register, information on the capital expenditures of municipalities, current implementation of the municipal budgets and the overall financial situation of municipalities)</li> <li>• <b>National Bulgarian Audit Office</b> (controls the implementation of the budget and the management of public funds and activities through carrying out audits)</li> <li>• <b>National Assembly</b> (e.g. Budgetary Committee, Committee on Regional Policy, Public Works and Local Self-Government, etc.)</li> <li>• <b>Ministry of Regional Development and Public Works</b></li> <li>• <b>General Inspectorate at the Council of Ministers</b></li> <li>• <b>Inspectorates within ministries and agencies</b> dealing with the local level,</li> <li>• <b>Anti-fraud coordination service (AFCOS)</b> (protection of the European Union Financial Interests Directorate)</li> <li>• <b>National Association of the Bulgarian municipalities</b></li> </ul>
BiH <sup>118</sup>	<ul style="list-style-type: none"> <li>• <b>Fiscal council of BiH</b> (Overseeing all fiscal activities of the various entities and ensuring their compliance with the budgetary calendar. The fiscal council has representatives from all entities in BiH and is chaired by the Council of Ministers)</li> <li>• <b>Ministries of Finance</b> (FBiH and RS) (Overseeing budgetary matters, responsible for revenue collection (taxes and fees), and the distribution of funds to the respective municipalities or cantons within their entity)</li> <li>• <b>Cantons (FBiH)</b> (Responsible for managing and distributing funds allocated to the cantonal level)</li> </ul>
Croatia	<ul style="list-style-type: none"> <li>• <b>Ministry of Finance</b> (Developing an internal financial and control management system within the public sector, as well as internal audit, inspectional supervision of the legality, purposefulness and timeliness of the use of State Budget funds within central, regional and local self-government units)</li> <li>• <b>National State Audit</b></li> <li>• <b>Inspectorates</b></li> <li>• Other <b>relevant ministries</b> and <b>regional self-government units</b></li> </ul>
Hungary	<ul style="list-style-type: none"> <li>• <b>National Assembly</b> (Approving the annual budget of the central government and sets the framework for local government revenues and expenditures.)</li> <li>• <b>Ministry of Interior</b> (Dealing with local government issues)</li> <li>• <b>Ministry of Finance</b> (Managing the Regional Development Fund that supports local governments)</li> <li>• <b>State Audit Office</b> (Monitors the financial management and performance of local governments)</li> <li>• <b>Hungarian State Treasury</b> (Supervising the transfers allocated to local governments considering the findings and recommendations from the State Audit reports)</li> </ul>

<sup>118</sup> In Bosnia and Herzegovina, the decisions regarding the distribution and transfer of the central budget, EU funds, and ad-hoc budget and funding towards the local level units such as municipalities and communes are made by different public bodies at various levels of government. Subnational fiscal rules in BiH are determined at the entity level (FBiH and RS) and apply only in the territory of a particular entity.



Montenegro	<ul style="list-style-type: none"> <li>• <b>Ministry of Finance</b> (Developing guidelines for subnational government budgets, overseeing the subnational government budget deficits). The Ministry is withholding the transfer of the appropriate part of the funds from the State Budget to the subnational government, in case the subnational government exceeds the budget deficit ceiling in a given year without the Ministry of Finance's approval. Further, municipalities in Montenegro are required to submit an annual activity report to the Directorate for Central Harmonization of the Ministry of Finance and Social Welfare, on the implementation and improvement of management and control functions. They are also obliged to report quarterly to the Ministry of Finance on the state of their finance, outstanding liabilities and budget indebtedness.</li> <li>• <b>Secretary for Finance</b> in line with the Guidelines of the Ministry of Finance for the preparation of the budget of local governments.</li> <li>• <b>Ministry of Economy</b> (Supervising the capital expenditure by subnational governments)</li> </ul>
North Macedonia	<ul style="list-style-type: none"> <li>• <b>Ministry of Finance</b> (Conducting oversight in line with the Law on Financial Discipline, the Law on Reporting and Recording Liabilities. Managing, monitoring, controlling and auditing national public and EU funds)</li> <li>• <b>Committee for Monitoring and Development of Local Government Finance System</b> with members are issued from national and local governments.</li> <li>• <b>State Audit Office</b> (Performing audit of financial statements, compliance audit and performance of central and local public entities)</li> </ul>
Romania	<ul style="list-style-type: none"> <li>• <b>Ministry of Finance</b> (Supporting the preparation of local budgets through mainly communicating the distribution criteria and algorithm and total amount to be allocated via equalization transfers and the transfers with special purpose, overseeing the accuracy of the calculations made by local and country councils)</li> <li>• <b>Inter-ministerial technical committee for decentralisation</b> and the <b>working groups for the decentralisation of competences</b></li> <li>• <b>Fiscal Council</b>, created under the <b>Fiscal Responsibility Law</b>, as an independent body (Supporting the Romanian Government and Parliament in designing and implementing the national fiscal policy and in promoting the public finances' transparency)</li> <li>• <b>Supreme Audit Institution</b> (Auditing the management of funds related to financial assistance granted to Romania by the EU in line with the national and EU legislation)</li> </ul>
Serbia	<ul style="list-style-type: none"> <li>• <b>Ministry of Finance</b> (Responsible for taking decisions regarding the distribution of the central budget, EU funds and ad hoc budget and funding towards the local-level units)</li> <li>• <b>Local Government Financing Commission</b> (known also as the "Commission for Intergovernmental Finances") (As a joint body between central government and local government, the Commission is set up to monitor the implementation of the intergovernmental finance system and recommend certain improvements in this area)</li> </ul>

Source: R2G4P.

# ANNEX 2.

## LEGISLATION COVERING FISCAL RELATIONS BETWEEN CENTRAL AND LOCAL GOVERNMENT IN SEE COUNTRIES

Country	Key legislation covering fiscal relations between central-local level	
Albania	<ul style="list-style-type: none"> <li>• Law no. 68/2017 on local self-governance finance</li> <li>• Law no. 9632/2006 on local taxes</li> <li>• Law no. 9896/2008 on LGUs' borrowing</li> </ul>	This legal framework sets the basis to ensure the adequacy of financial resources to municipalities for the financing of their functions and competences and brought together the principles and rules of fiscal autonomy, especially the revision of conditional transfers and shared taxes between local and central government
Bulgaria	<ul style="list-style-type: none"> <li>• Constitution (amended in 2007 to grant taxing powers to municipalities)</li> <li>• Local Self-Government and the Local Administration Act</li> <li>• Local Taxes and Fees Act</li> <li>• Public Finance Act</li> <li>• State Budget Act (annually approved)</li> </ul>	The Public Finance includes the legal basis for preparation of the autonomous budgets of municipalities. It emphasizes that exclusive municipal responsibilities are financed through local taxes, whereas delegated activities are financed by transfers from the national budget. It also stressed that local councils may allocate additional resources from its own revenue to finance the provision of delegated tasks.
BiH	<ul style="list-style-type: none"> <li>• Law on Budget of Bosnia and Herzegovina</li> <li>• Law on Financing of Local Self-Government Units</li> <li>• Law on Public Revenue allocation in FBiH</li> <li>• Law on the Budget System in RS</li> </ul>	The Law on Budget of BiH regulates the overall budgetary framework at the national level. The Law on Financing of Local Self-Government Units governs the financing and budgetary aspects of local self-government units, including municipalities and communes. Entity-level laws and regulations that further specify the distribution and transfer of funds within their respective jurisdictions.
Croatia	<ul style="list-style-type: none"> <li>• Budget Law</li> <li>• Law on Local and Regional Self-Government Financing</li> </ul>	This legislation defines sources for financing for the counties, the towns and municipalities, including the various types of taxation, non-tax revenues and the equalisation fund distributed among the different levels and non-tax income.
Hungary	<ul style="list-style-type: none"> <li>• The Fundamental Law (the Constitution of Hungary)</li> <li>• Cardinal Local Government Law</li> <li>• Public Finances Law</li> </ul>	This legal framework recognises the local self-government, including the fiscal autonomy of municipalities, including the new vertical division of powers and fiscal autonomy of local governments.
Montenegro	<ul style="list-style-type: none"> <li>• Law on Local Self-Government Finance</li> <li>• Law on Budget and Fiscal Discipline</li> </ul>	The legislation is describing the different types of resources of municipalities, the financial equalisation mechanisms and the use of conditional transfers.
North Macedonia	<ul style="list-style-type: none"> <li>• Law on Local Government Finance</li> </ul>	The legislation determines that municipalities are financed through own-source revenues, shared revenues, transfers from the central budget, EU funds transfers and borrowing. This law abolished the previous Law on Limitation of Own Source Revenues, transferring full responsibility in administering and collecting local taxes and establishing the rights of municipalities to receive either a share of or all tax revenues collected within their respective jurisdictions by the central government.

Country	Key legislation covering fiscal relations between central-local level	
Romania	<ul style="list-style-type: none"> <li>• Law no. 215/2001 on local public administrations</li> <li>• Law on decentralisation no 195/2006</li> <li>• Law no 273/2006 on local public finances</li> <li>• Title IX of the Romanian Fiscal Code (Law 571/2003 and amendments)</li> <li>• Law no 51/2006 on public services.</li> <li>• Governmental Ordinance no. 15/1992</li> <li>• Law no 69/2010 on Fiscal Responsibility</li> </ul>	<p>This legal framework is adding financial competencies to local autonomy, transferring new responsibilities to subnational governments, determining assignments of revenue to local governments and further defining the intergovernmental transfer system, and particularly the equalization transfers, the shared taxation system and the local debt issues. It increased local government control over their own revenues and allowed local councils to administer their own taxes.</p>
Serbia	<ul style="list-style-type: none"> <li>• Constitution</li> <li>• Budget Law</li> <li>• Law on local self-government finance</li> <li>• Law on financing the autonomous province of Vojvodina</li> <li>• Law on tax procedures and tax administration</li> <li>• Law on property taxes</li> </ul>	<p>The legislation is determining the funding from central government to municipalities and the autonomous province of Vojvodina. It regulates the public finance of subnational governments in Serbia, rationalise transfers and revenue-sharing mechanisms, defines the calculation method etc.</p>

Source: R2G4P.



## Implemented by:



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