

## THE STATE OF CAPTURE: THE RISKS TO DISTRIBUTIVE POLITICS IN SOUTHEAST EUROPE

Policy Brief No. 139, November 2023\*

Rising global geopolitical tensions have put the European Union (EU) and its neighbourhoods under increasing stress in recent years, as evidenced by the brutal wars in Ukraine, Nagorno-Karabakh, Israel and Africa. Meanwhile, corruption and **state capture vulnerabilities have become serious threats to economic security**, while simultaneously growing more difficult to tackle, particularly in non-established democracies, as entrenched elites game the system for geopolitical leverage. Addressing these vulnerabilities in Southeast Europe (SEE)<sup>1</sup>, is critical for the further integration of the region into the EU and the survival of the democratic tradition in Europe.<sup>2</sup>

The ongoing overlapping transitions in the technological, economic, and geopolitical realms heighten the significance of the proper **governance of public finances** in SEE. However, when government structures in charge of public finances are abused and integrated into state capture networks, as has been evidenced in many cases in SEE,<sup>3,4</sup> any general considerations about the optimal management design must be modulated through knowledge about the **mechanisms of state capture**. State capture is a sophisticated form of political corruption that attempts, often successfully, to disguise itself as due process. The building blocks of state capture include varied tools such as power over

### KEY POINTS

- The integrity of public finances in Southeast Europe (SEE) is compromised by **shadow networks of clientelism**. This undermines the capacity of the region to cope with a number of converging domestic and international challenges.
- A high degree of **administrative and fiscal centralisation** is a considerable risk factor for state capture; the latter, in turn, further institutionalises this centralisation.
- Integrity measures must be designed with an understanding of the linkages between **unfair use of discretion** in fiscal transfers and outright malfeasance in resource allocation.
- Distortions created by preferential fiscal transfers are further exacerbated by **irregularities in local procurement**.
- Statistical evidence indicates the presence of politically motivated factors in the **distribution of public procurement contracts**. When municipalities are politically aligned with the ruling party at the national level, they tend to receive larger public procurement contracts.
- Prevention policies should target the concurrent abuses of intergovernmental transfers and public procurement. These should focus on reducing the risks from biased funding from the central towards the local level, as well as the misuse or mismanagement of national and foreign donors' funds.
- SEE needs an **evidence-gathering mechanism** to detect distortions in EU spending programmes caused by clientelist allocation of funds.

<sup>1</sup> For the needs of the current analysis SEE includes nine countries: Bulgaria, Croatia, Hungary, Romania, Albania, Bosnia and Herzegovina, Montenegro, North Macedonia, and Serbia.

<sup>2</sup> See further Center for the Study of Democracy, [The Kremlin Playbook in Europe](#), 2020.

<sup>3</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.

<sup>4</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.

\* The current policy brief has been published originally under the R2G4P initiative at the [SELDI.net](https://seldi.net) website.

the design and enforcement of regulations, privileged access to public resources, control over the media and the financial sector, and influence over domestic and foreign policy (Figure 1).

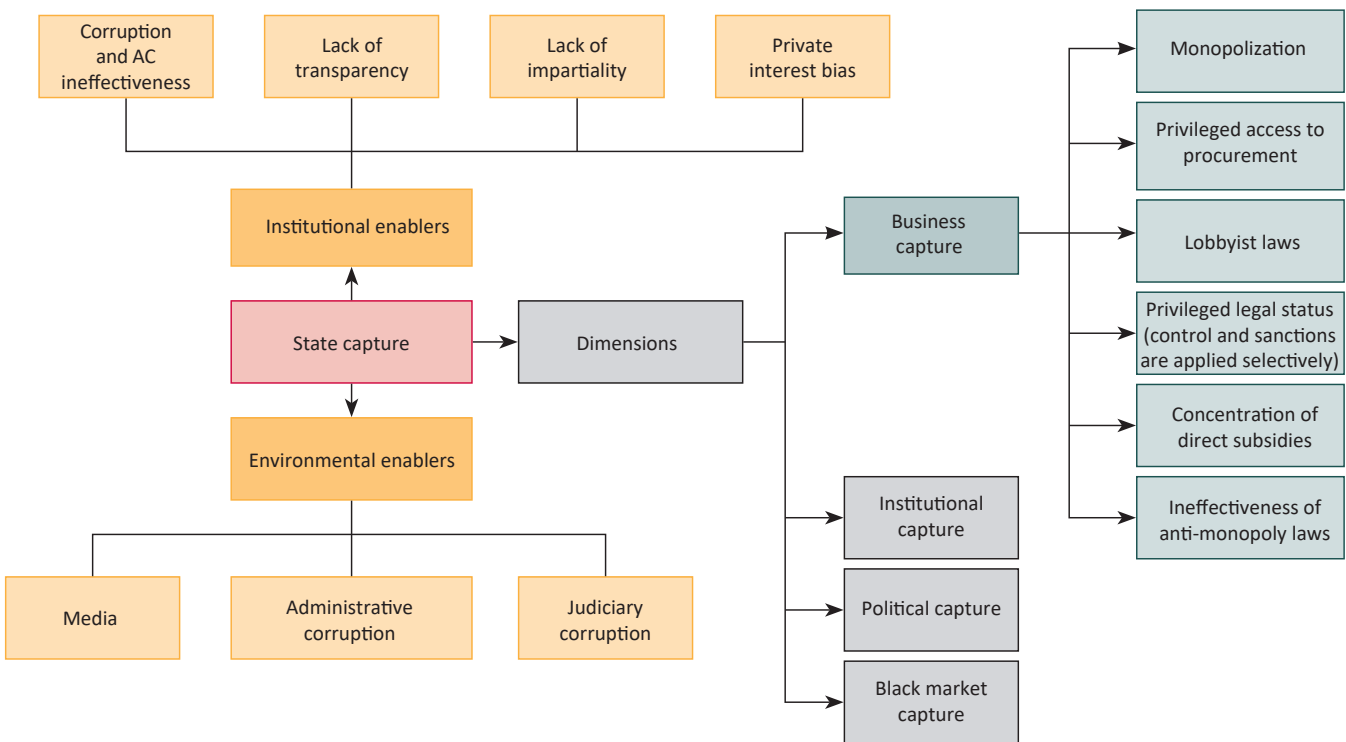
When the machinery of state has been captured by special interests, the real decision-making power over the allocation of public resources resides in the **leaders of patronage and clientelist networks** which shadow official government institutions; these figures are typically are partisan political leaders with long-term access to public resources.

The analysis of the risks entailed by the **misuse of fiscal transfers<sup>5</sup> from central to local governments** in SEE countries shows considerable outstanding need for policy action.<sup>6</sup> 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 grants and subsidies are susceptible to **corruption risks**, which can undermine the effectiveness of these transfers and lead to misallocation or diversion of funds. The distortions created by clientelist transfers are at risk of being further exacerbated by rigged procurement processes at the local government level. 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 extends beyond 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

**Figure 1. Elements of the state capture model**



**Source:** Center for the Study of Democracy. (2019). *State Capture Assessment Diagnostics*.

<sup>5</sup> *Transfers* are the most general term used to denote the funding flows from central to local government level. More specific terms used include also *grants* and *subsidies*. This brief uses these terms interchangeably.

<sup>6</sup> Center for the Study of Democracy, *Bridges to Nowhere. State Capture and Corruption Risks in Fiscal Transfers and Public Procurement in Southeast Europe*, 2023.

promoting balanced economic development. In fact, the same **state capture cliques** typically exploit both intranational budget transfers and EU subsidies for the benefit of special interests. **Uneven data availability** prevents definite conclusions about specific cases and patterns of state capture vulnerabilities in SEE, particularly with regard to EU candidates.

## Fiscal decentralisation

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 SEE countries have made substantial progress during the last 10 years, **fiscal decentralisation remains a challenge** for all of them to varying degrees. Most local governments remain highly dependent on the central government, with a **significant share of grants and subsidies compared to tax revenue**. Their own revenues represent an 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.

Central funding through grants and subsidies, however, can undermine local fiscal autonomy. This is understood as the ability of subnational governments to raise tax locally to finance expenditures while also decreasing local leaders' motivation to increase the tax burden in

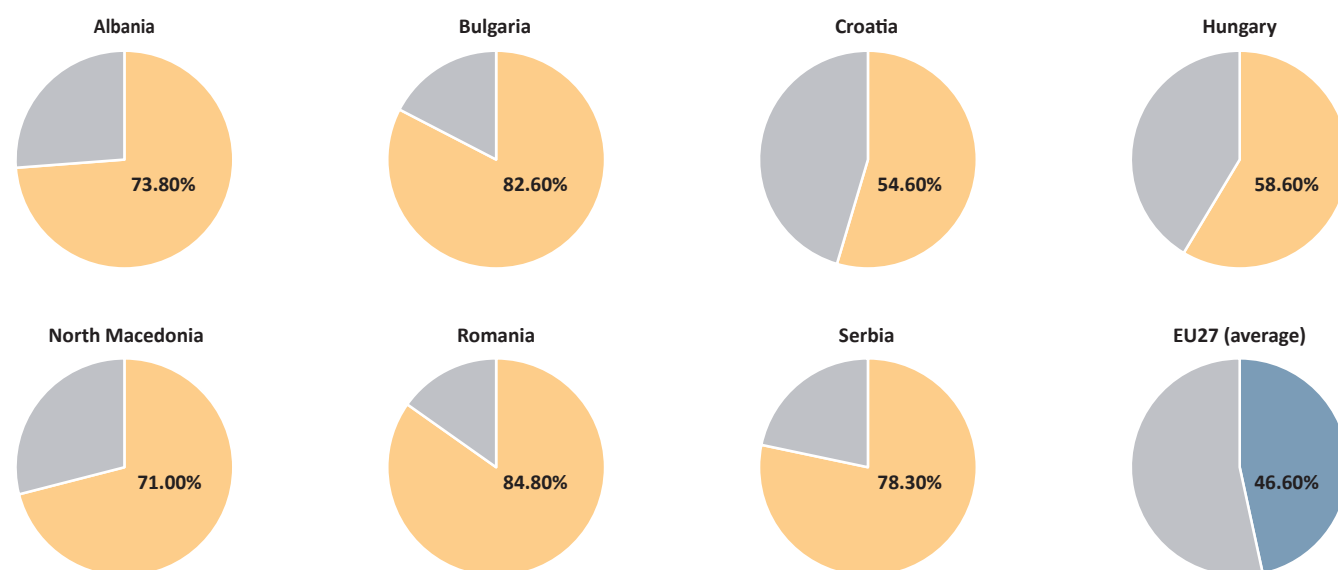
their jurisdictions due to the provided transfers from central government.

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, the distribution of transfers from the central government is the primary instrument keeping local services functioning in all other SEE countries. Combined with the common lack of transparency and predictable intergovernmental system, this trend makes local authorities in SEE **vulnerable to clientelist or electorally motivated interventions**. In the long term, this becomes a negative loop whereby high dependence on budget support disincentivises accountability and encourages local governments to resort to clientelist arrangements.

## Corruption risks

A high degree of administrative and fiscal centralisation can pose 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.

**Figure 2. The centre holds the purse: the share of grants and subsidies in the budgets of subnational units in SEE**



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

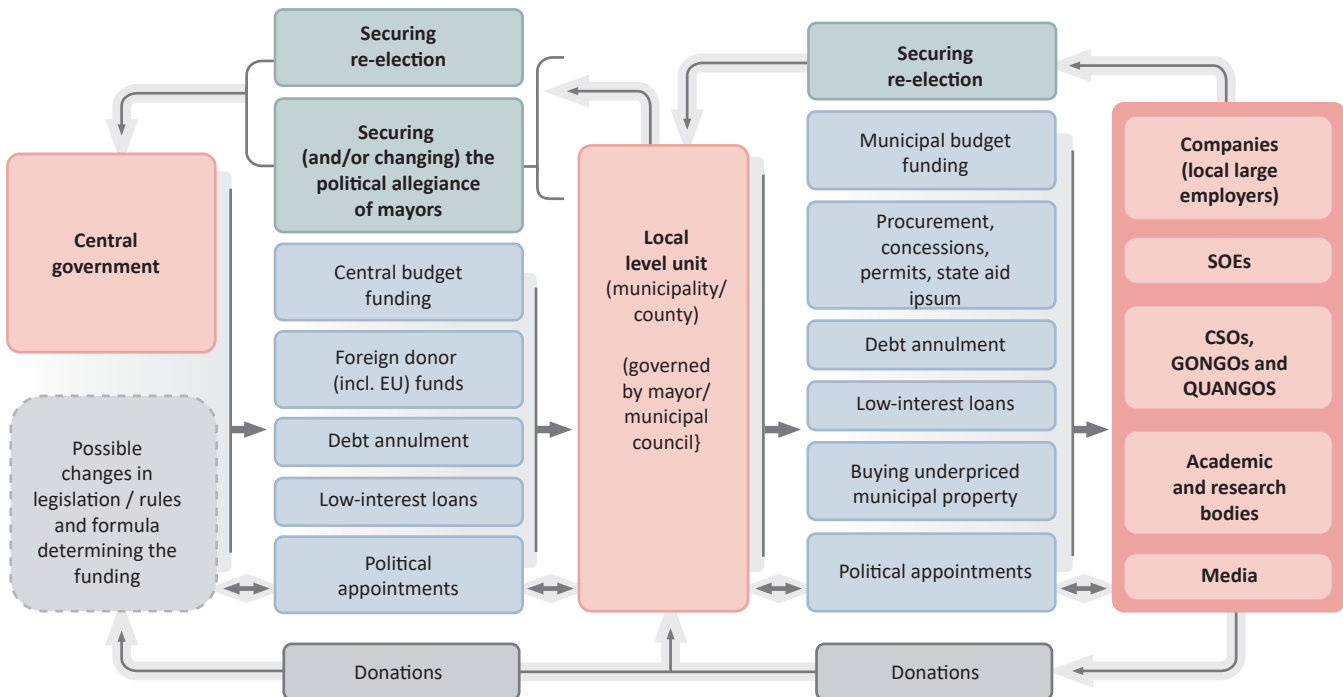
**Conditional grants** allow central governments more latitude and provide less discretion for municipalities with regard to spending transferred money than unconditional grants. However, because their allocation depends on the result of intergovernmental negotiations, they provide local level leaders with margin to manoeuvre and 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.

With **unconditional grants**, the grantor’s discretion is more limited, since the amount received by each municipality 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 grant value determined by the formula and the actually distributed amounts. Reducing formula complexity and increasing its transparency during and after implementation is a logical step for SEE countries to avoid or **moderate policy indiscretion and political capture**. The simpler the transfer formula is to apply, the easier the oversight of its implementation.

**Box 1. The result of state capture: vanity trains**

Approximately EUR 2 million from EU funds were used to finance a tourist train connecting Viktor Orbán’s hometown, Felcsút, to a neighbouring hamlet. Envisioned to ferry hundreds of passengers daily, the vintage carriages often operate nearly empty, rendering the endeavour financially unviable. The allocation of European funds was premised on the expectation of serving an average of 2,500 daily passengers and bolstering local tourism. However, data spanning from April 2016 to January 2017 shows a meagre average of 113 passengers actually utilizing the railway per day, with intermittent periods of zero ticket sales.<sup>7</sup> This scenario has prompted concerns regarding potential corruption, favouritism, and embezzlement of EU funds within Hungary. The lack of robust oversight and transparency in public procurement procedures has notably facilitated the alleged siphoning of funds, highlighting a significant procedural gap.<sup>8</sup>

**Figure 3. Lateral funding: the ecosystem of clientelist access to public finances**



**Source:** Center for the Study of Democracy / R2G4P, *Bridges to Nowhere. State Capture and Corruption Risks in Fiscal Transfers and Public Procurement in Southeast Europe, 2023.*

<sup>7</sup> Christopher, A., (20/09/2017) “EU financial inspectors find everything in order with train in Orbán’s village”, *Hungarian free press*, 20 September 2017.

<sup>8</sup> Rankin, J (12/02/2018) “How Hungarian PM’s supporters profit from EU-backed projects”, *The Guardian*, 12 February 2018.

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 winning re-election. Intergovernmental transfers in SEE have often 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 most likely to win the upcoming elections. When a given municipality is politically aligned with the incumbent party(s) of the central government, it tends to benefit from **higher allocations from central budget funding and/or foreign donor (including EU) funding** compared to similarly sized municipalities run by the opposition. Local companies, usually large employers, and particularly SOEs, benefit from **non-competitive awards of municipal budget funding**.

## Oversight and transparency

Most municipalities in SEE comply with transparency requirements only partially. Information on local government finances is public in name only, and is rarely 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. Associations of municipalities

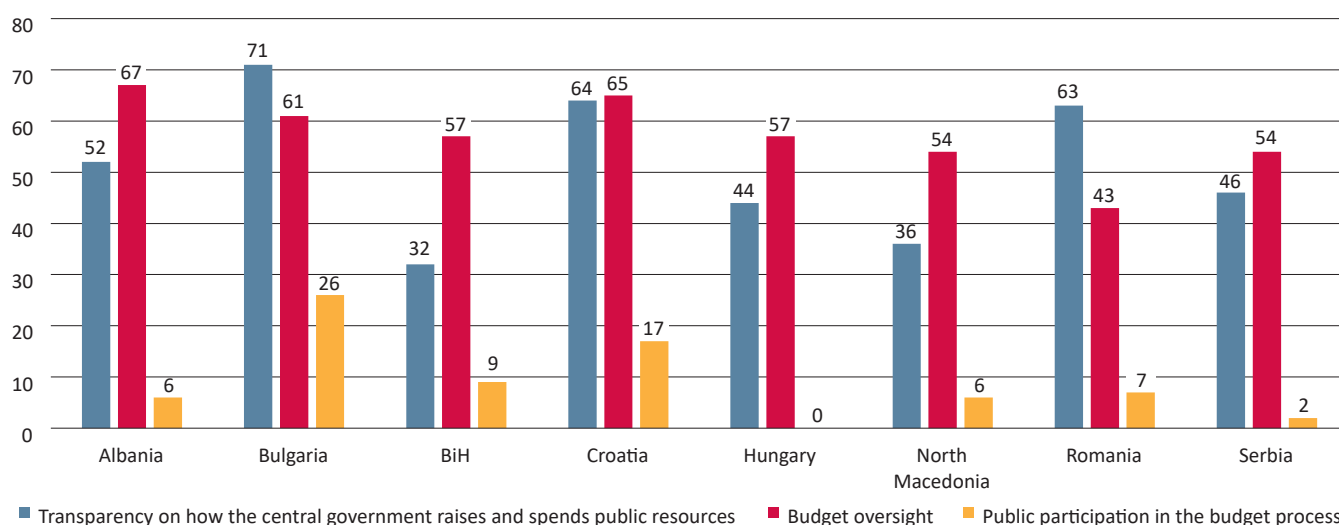
are sometimes involved in these processes, but their recommendations are often not taken into account.

In terms of oversight, 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 a **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; national integrity strategies only mention them in a generic, non-specific manner, if at all.

**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 generic in nature and not tailored to local circumstances.

**Figure 4. An open budget procedure is a prerequisite but not enough to prevent capture**



Source: Open Budget Survey 2021.

\* On a scale from 0 (worst) to 100 (best). No data available for Montenegro.

## Local procurement

Equalisation policies pursued through intergovernmental transfers can only achieve their ostensible goals 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 has one of the **highest corruption risks** of any government activity in SEE, due to the large amounts of money distributed through procurement procedures. When decision-making has been captured by clientelist networks, the allocation of procurement contracts tends to be noncompetitively awarded.

The types of **public procurement irregularities** identified in the region include favouritism and clientelism, overpricing of contracts, tailored tender specifications, conflicts of interest in the tendering process, high shares of non-open procedures, short advertisement periods, contract modification, and delivering sub-standard service in the implementation phase.

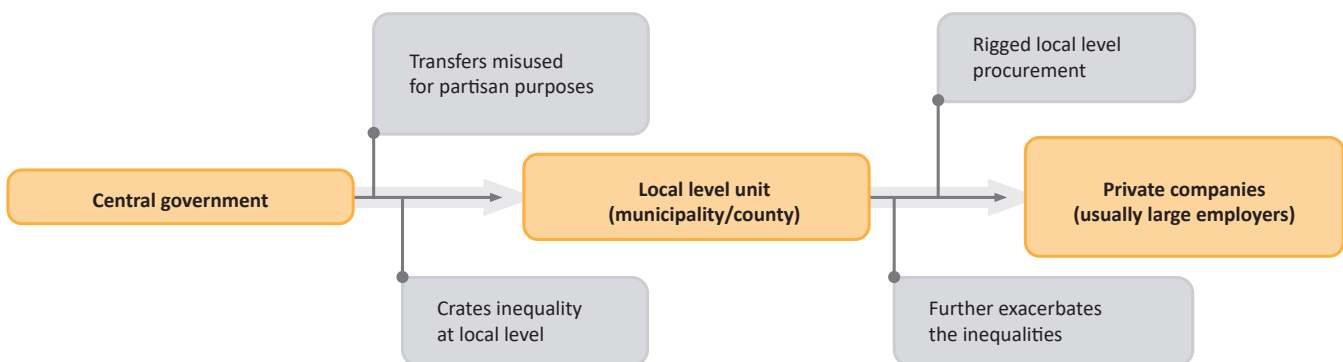
The transparency of procurement contracts is usually ensured through the launch of dedicated online procurement portals. Still, the quality and extent of information provided by the local authorities in these portals differs across SEE countries. Transparency requirements are largely optional, and there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

### Box 2. Political shortlist: a small circle of companies wins most contracts

In Croatia, a significant part (around half) of the total contract value is won by bidders which are not private entities, but companies partially or fully owned by the state. Furthermore, many private companies whose owners are closely linked with high-ranking politicians win public procurements that are almost exclusively tailored for their profiles. In Hungary, with the help of a two-thirds supermajority in the parliament, the ruling Fidesz party has created a new economic elite that is fully loyal to the incumbent government over the last 11 years. In return, their corporations receive large subsidies in sectors such as tourism, and are also very successful in the broader procurement market. Clientelism is also a large issue in Montenegro, where, in recent years, specific companies owned by well-connected families received almost a third of the procurements in their corresponding markets. These business owners have family ties with actors involved in major public corruption scandals, but no abuse in securing public procurement deals has been proven in court.<sup>9</sup>

The **lack of public procurement integrity systems at the municipal level**, along with the prevalence of mechanisms not tailored to local needs, renders the existing national systems ineffective. The evaluation and assessment of public procurement procedures and the effectiveness of prevention measures usually rely on self-assessment using descriptive and

Figure 5. The cumulative distortions of public finance allocations



Source: R2G4P.

<sup>9</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, p. 24

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.

## Political favouritism

When local procurement follows partisan interests, to the result is contract allocation according to political loyalty and electoral considerations. Statistical evidence indicates the **presence of politically motivated factors in the distribution of public procurement contracts**. 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 in line with these trends.

**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 that reflects public needs. When municipalities are politically aligned with the ruling party at the national level, they tend to receive larger public procurement contracts.

### Box 3. The 80:20 rule of political cronyism

In 2016-2018, 26 municipalities controlled by opposition parties in Albania received approximately 20% of the country's Regional Development Fund, which distributes conditional grants, while 34 municipalities politically aligned with the central government were awarded the remaining 80% of the Fund.<sup>10</sup>

**Winning margins in elections pay off.** Higher winning margins in local elections, indicators of lower levels of political competition, are generally associated with a greater chance of winning larger contracts. This suggests that municipalities with predictable electoral outcomes tend to receive 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, such as 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.

## Policy options

Government integrity policies in SEE are based on a general approach, which prevents them from reaching the level of sophistication achieved by interventions in other policy fields. As a result, measures are designed with little understanding of the loci of potential corruption, the circumstances that give rise to it, or the motivation of the involved actors. This is particularly relevant in public finance governance, where integrity measures must be designed with an understanding of the linkages – but also the distinction – between unfair use of discretion in fiscal transfers and outright malfeasance in resource allocation. The critical juncture between these two practices is the influence of political alignment between central and local governments on local public procurement.

A number of policy measures can be employed to target the concurrent abuses of intergovernmental

<sup>10</sup> Albanian Association of Municipalities, [Report on Local Government Financing Instruments \(2016 – 2018\)](#), 2019.

transfers and public procurement. These should focus on reducing 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 should move towards the establishment of clear and transparent criteria for funding allocation. Furthermore, 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 must 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, associations of municipalities, civil society, and the media should all review decisions related to budget transfers in order to 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 grants and conditional grants;
- Detect the corruption risks associated with formula-based grants 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 from a historical perspective, examining at least the last two local election cycles, as part of the annual budget procedure.

### Apply corruption risk assessment methods

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

- The *Monitoring Anticorruption Policy Implementation (MACPI)* tool,<sup>11</sup> 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 initial application of this mechanism to selected countries in Europe has revealed different sources of risk and levels of governance vulnerabilities.<sup>12</sup>
- The Corruption Risk Indicators (CRIs), which measure the corruption risks of public procurements.<sup>13</sup>
- The *Corruption Monitoring System (CMS)*<sup>14</sup>, which provides victimisation and perception data in the

<sup>11</sup> Center for the Study of Democracy / R2G4P, [Monitoring Anticorruption Policy Implementation \(MACPI\): Training manual](#), 2022.

<sup>12</sup> Center for the Study of Democracy / R2G4P, [State Capture Assessment Diagnostics at Sectoral Level: Training manual](#), 2022.

<sup>13</sup> R2G4P, [Analyzing Public Procurement Risks: Training manual](#), 2022.

<sup>14</sup> Center for the Study of Democracy / SELDI, [CMS Methodology](#).



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 the 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 to monitor 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, methods such as 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 as a means to reward political actors for their loyalty.

#### **Monitor the effect on EU's financial interests**

All sub-national territories in the SEE region are eligible for EU funding under cohesion objectives. Accordingly, any distortions in EU spending programmes in SEE caused by clientelist allocation in erode the capacity of the Community to act as a promoter and guardian of good governance and economic development among its current and prospective members. It is critical, therefore, that the distribution of all EU financial support, national procurements, investments, and state aid, are carefully monitored by the public authorities, civil society, and investigative journalists, in order to ensure that these funds are spent efficiently and to the benefit of the public.