



The political economy of donor intervention in Western Balkans and Turkey: mapping and potential for stronger synergies

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*Authors: William Bartlett, Pavlos Kollias,
Jasmina Ahmetbasić, and Dragiša Mijačić*



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Executive Summary

Over the last twenty years, the countries of the Western Balkans¹ have benefited from large inflows of international assistance from both bilateral and multilateral donors. Despite the enormous inflow of assistance, while some progress has been made in the EU accession process, the foundations for sustained economic development and growth have not been established in the Western Balkans, none of which are yet considered to be a functioning market economy. There is a widespread concern that poor government policies and inadequate donor coordination have reduced the effectiveness of international assistance. Growth has been more sustained in Turkey, which is in a somewhat different situation to the Western Balkan countries on account of its size and development processes. Given the diminishing budgets for international assistance in the current European and global economic climate, there is a need for a rapid improvement in aid effectiveness. This is especially important in relation to EC IPA II assistance, which envisages a reinforced link between financial assistance and the accession policy agenda *inter alia* by following a sector-based approach, and stronger ownership by the beneficiaries to underpin improved governance and capacity building.

At the same time, the level of private sector external finance has declined rapidly due to the impact of the economic crisis on private financial flows. Declining FDI inflows, bank deleveraging and the contraction of credit to the business sector have continued in the early part of 2014 and are likely to continue in the near future. Turkey has been in a rather different position, with robust growth during the period of economic crisis, though even there the policy of 'tapering' in the USA has led to an outflow of funds and a decline in growth. Turkey has been both a recipient of EU assistance and a donor to the region in her own right. However, the fall in private finance to the Western Balkans poses problems for future economic growth and social development in the region, and further challenges for the international assistance efforts of the donor countries.

The purpose of the study is to identify lessons learned about creating synergies among donors and provide an improved understanding of differing forms of donor assistance and specialisation in different sectors in the Western Balkans and Turkey in order to enhance efficiency in the use and allocation of official development assistance and promote improved aid effectiveness in the region. The study has explored the political economy of donor interventions in the region both from the side of the donors and public sector financiers that are most engaged in the provision of funds and technical assistance, and from the perspective of the beneficiaries themselves. The research has pursued a mixed methods methodology exploring the large amount of data that is available on donor projects, carrying out interviews with donors, beneficiaries and implementing agencies, and gathering data through original questionnaires delivered to bilateral donors, financial institutions and regional initiatives.

The research has examined the flows of donor assistance based upon an analysis of data on over 18,000 project disbursements that have been carried out in the Western Balkans and Turkey in the

¹ For the purposes of this report, the Western Balkans includes Albania, Bosnia and Herzegovina, Kosovo², The former Yugoslav Republic of Macedonia, Montenegro, and Serbia.

three-year period from 2010-2012 drawn from the OECD/DAC database on official development assistance. The analysis has shown that the total flows of international assistance have been falling over this period. Together with declining private inflows, it is not surprising that the countries have experienced an economic crisis that has found its expression in rising levels of unemployment, soaring youth unemployment, and high and sharply rising rates of non-performing loans in the business sector indicating a highly vulnerable economic and social situation. As mentioned above, Turkey has been somewhat insulated from these developments, as were Kosovo² and Albania for a while, though these countries are now beginning to experience economic downturns too.

Examination of the data shows that the main reason for the fall in international assistance over the period 2010-2012 has been reduced inflows of non-concessional 'other official finance' (OOF), while inflows of official development assistance (ODA) have increased slightly, but not by enough to fill the gap. In this context, we have also found that there are substantial inequalities and imbalances in the distribution of international assistance between beneficiaries. ODA flows per capita have been relatively high in Kosovo though declining, and relatively low in the former Yugoslav Republic of Macedonia. It could be expected that ODA would be inversely related to the standard of living of a country as expressed by the level of GNI per capita (income per capita), and this relationship is found to hold for the Enlargement countries. The analysis reveals that both Albania and the former Yugoslav Republic of Macedonia receive relatively low inflows of ODA compared to what would be expected given their level of income per capita. The reason for this may be the relative isolation of these countries from strong overseas political support— there is no international political constituency that is pressing for increased levels of ODA to these countries. It seems likely that other countries have stronger sponsors among the donor community. For example, 40% of ODA flows to Montenegro are from Germany and 33% of ODA flows to Kosovo are from the USA, both powerful and successful sponsors. On the other hand the largest donor to Albania is Greece a country that has experienced economic crisis in recent years. While the former Yugoslav Republic of Macedonia's strongest supporter is the USA, accounting for a relatively low 20% of its ODA, the second largest inflow is from the UAE (18%), a relatively new donor in the region.

The flows of OOF i.e. non-concessional public loans, are positively correlated with levels of GNI per capita. These flows do not compensate for low levels of income, but on the contrary seek bankable projects in the more prosperous countries. This has several policy implications. First it means that non-concessional OOF loans have a different logic to the flows of ODA that pursue development purposes. Consequently, blending ODA flows with OOF flows may not achieve the desired effects, as such blended loans may be mostly directed towards the more advanced countries of the group. Secondly, from the sector perspective, loans from the IFIs are mainly directed at the Private Sector Development sector, credit lines for the financing of SMEs, and infrastructure investments in the Energy, Environment and Transport sectors. There are far fewer investments in other sectors covered by IPA II such as Employment, Education and Social Sectors. Consequently, where donor funds are committed to blending with IFI loans, there should

² This designation 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.

be strong participation by the relevant actors (NICAPs, RCC, EU Delegation sector experts) in the selection of grant applications in order to ensure a sufficiently wide coverage of sectors.

The study has also assessed the role of donor coordination mechanisms, aid management platforms and associated project databases. Under IPA II, in order to tailor assistance to the needs and characteristics of each country, the preparation of the Country Strategy Papers (CSPs) has been based on partnerships between the EC and the beneficiary countries. This approach is designed to increase the sense of local ownership by ensuring that CSPs and projects are in line with the beneficiaries' own development strategies, and to secure broad consensus on the strategies to be put in place through enhanced participation of beneficiaries in each country.

The EU Code of Conduct on Complementarity and Division of Labour in Development Policy is an important basis for ensuring the complementarity of donor contributions in order to overcome donor fragmentation and increase the efficiency and effectiveness of assistance. It aims at reducing the number of donors in overcrowded sectors and increasing support for 'orphan' sectors, making use of the donors' comparative advantages.

The study has examined various donor coordination mechanisms and databases and has shown that they may in theory be useful tools to inform pre-accession assistance programming, contribute to the objectives of the Enlargement Strategy, complement the Fast Track Initiative on the Division of Labour, and contribute to the 'sector approach' in pre-accession assistance. However, donor coordination mechanisms and information platforms cannot play these roles *per se* but only as part of a wider set of reforms to improve strategic planning and policy design and delivery (including budgeting and resource allocation processes as well as procurement). Sector budget support can play a complementary role in the sector approach and can promote harmonisation and alignment on national policies, contribute to lower transaction costs and encourage results-based approaches. However, most Enlargement countries are not yet in a position to benefit from this, as they have not completed public financial management reforms, and donors are often unwilling to provide funds direct to the recipient budget due to concerns about corruption and potential misuse of funds that have not yet been sufficiently addressed.

Moreover, the various databases that have been set up at national level (developed in response to broader coordination needs) have been found to be inadequate for these purposes, as despite much effort, they are mainly incomplete as they are not regularly updated, lack sufficiently substantial resources and are not specifically designed to deliver the information that is most needed by donors and beneficiaries in order to underpin the process of donor coordination and sector programming. Moreover they use different methodologies that make comparison between them difficult, and hinder peer learning by the key actors in the enlargement process. A possibly more effective approach would be to either redesign them in accordance with precise, country-wide criteria, also bringing them under the respective NIPAC in each country, or to combine the resources directed to fragmented national databases at regional level to set up a regional donor database. The latter would enable a concentration of resources to support an effectively designed database of donor projects at regional level that could be regularly updated. It would provide a unique user-friendly interface that could provide flexible reporting to suit a variety of national needs. At national level, local in-country staff would be released from the need to maintain individual idiosyncratic databases and could be trained to make use of the range of joint regional-level database as well as the various international donor databases, such as the OECD database,

that are publicly available and which already provide detailed data on projects funded by the majority of donors.

In the light of the findings concerning donor coordination mechanisms, the study has analysed the flows of ODA also from the country perspective. The EU Code of Conduct on Complementarity and the Division of Labour in Development Policy sets out the principle of 'focal sectors', which refers to the number of *sectors per donor*, under which each donor should specialise in no more than two sectors. The analysis has shown that in most countries, most donors are active in more than two sectors, and often in many more than two sectors, contradicting the Code of Conduct. While the Code is not mandatory in the Enlargement countries, which are governed by the Enlargement Strategy rather than the development policy, the focus on specialisation seems appropriate especially for the smaller donors in order to improve aid effectiveness. Where donors have an interest in more sectors, the Code of Conduct recommends that they should delegate their funds and responsibilities to a lead donor in those sectors. The findings of this study suggest that there are numerous opportunities for specialisation of donor effort, which would increase the effectiveness of the international assistance in the Enlargement countries.

In addition, the Code sets out the principle of 'appropriate support' in strategic sectors, which refers to the number of *donors per sector*, and recommends that there should be between three and five donors per sector at most. In our analysis we have found many instances where there are more than five donors per sector, suggesting a large potential for rationalisation of donor support and reduction of transaction costs facing beneficiaries who have to deal with a large number of donors per sector.

The study enquired into the role of international assistance in supporting regional cooperation through the regional initiatives sponsored by the Regional Cooperation Council. A questionnaire survey sought detailed information about the relationships between the donors and the regional initiatives. A main finding was that while most of the twelve regional initiatives that responded to the survey communicate with line ministries and coordinate with donors, relatively few communicate with the NIPACs. There is an opportunity here to integrate these regional initiatives into the donor coordination structures at country level by encouraging greater communication and coordination of activities with the NIPACs, especially if these initiatives expect to receive IPA II funding as most, but not all, of them do. Since the SEE 2020 Strategy will be delivered at country level, and will be integrated and aligned with National Development Plans and CSPs, it would seem essential that a greatly improved coordination with the NIPACs should be instituted.

In relation to regional cooperation in infrastructure investment, the Western Balkans Investment Framework (WBIF) is seen by many to be a good example of effective regional cooperation in practice. The WBIF has coordinated a large programme of much needed infrastructure investment in the Western Balkans. Despite the success of the WBIF, it has inevitably encountered a number of problematic issues. One difficulty has been a sense of disconnection between the central management of WBIF in Brussels and the in-country EU Delegations (EUDs). This should change following the creation of a single pipeline of projects under IPA II, which will provide a more transparent basis for ranking projects according to their greatest economic and social benefits. This should do much to reduce the information asymmetries that have enabled actors to game the system, occasionally resulting in investments with little real social benefit. One lesson is that at submission stage a letter of endorsement from the Ministry of Finance or equivalent would be

beneficial to indicate a clear commitment beforehand while a wide range of local interests including NGOs should be involved in the post-submission screening of investments,

The study also focused on the geopolitics of donor interventions through a case study of the Energy sector, which examined the gas supply industry. The case study showed that the emerging gas supply network to the Western Balkans and Turkey could be seen as a welcome development for the countries of the region as it promises to boost their energy supplies. At the same time it also presents an intense geo-political competition between the countries involved in the supply of gas. Less transparently, Russia and Azerbaijan have also made some donor-type interventions in the region but at a much lower scale, and have mainly concentrated on commercial contracts. All of this provides a strong incentive for the continued involvement of these countries in providing financial assistance to the region in order to solicit local political support for their gas supply projects. This may lead to a potentially wasteful duplication of infrastructure that may eventually drive up energy costs in the region. Therefore the extension of an effective regulatory arrangement that would encompass non-EU suppliers in an open and competitive market seems necessary as a complement to the donor interventions in this sector. Whether this will be possible in the current climate of international political discord seems however unlikely for the time being. A second case study of the Transport sector revealed the strong and growing involvement of new and emerging donors.

New and emerging donors are increasingly active in the region; they have more relaxed conditionality than the traditional donors that are aligned with the EU Enlargement process. There is a risk that new donors may reduce the effectiveness and 'transformative power' of EU conditionalities, although this risk is currently low, as the scale of the interventions by new donors is limited. However, efforts should be made to involve the new donors in existing donor coordination mechanisms and to adopt a more flexible approach to conditionalities to reflect the realities of the new donor landscape.

Responses to a survey of donor organisations in the Enlargement region have revealed a range of motivations of donor organisations, the most important of which are to support the EU accession and social and economic development of the beneficiaries. Less important aims are to support the prestige, commercial trade or foreign investments of the donor, although these factors do have a role to play.

In order to identify differences in behaviour of beneficiaries the survey asked about the extent to which beneficiaries comply with donor interventions. Most donors replied that beneficiaries are fully compliant with their interventions while there were no cases of reluctant compliance. However, there is evidence that some beneficiaries only partly comply with donor interventions. Significantly, most replies confirming partial compliance were from Bosnia and Herzegovina, the least advanced in EU accession, while a minority were from Albania.

In a situation of ambiguous compliance and with multiple donors pursuing different objectives and offering uncoordinated policy advice, there is ample opportunity for beneficiaries to play donors off against each other. While this can be interpreted as a negative aspect of donor fragmentation, it can also be interpreted as healthy competition that favours the consumers of donor services. Donors tend towards the former interpretation, viewing partial compliance as a result of opportunistic behaviour by the beneficiaries, and supporting the case for applying a 'results framework' that rewards compliance and penalises opportunism. It should however be also recognised that the degree of legitimacy of donor interventions is a complicating factor that may

undermine compliance in cases where legitimacy is low, irrespective of the extent of rewards and penalties that are imposed.

A comparison of priority sectors identified by beneficiaries with the allocation of assistance by donors has shown that there are substantial gaps between beneficiary priorities and donor allocations. It is often said that reform is “donor-driven” and our findings seem to support that perspective³. There is therefore ample scope for improving the matching of donor assistance to domestic priorities. The sectors where this is most apparent are in social policy, human rights and minorities, and in agriculture and rural development.

The survey revealed that donor coordination is a priority for most donors, outweighing competition between donors. However there are numerous obstacles to operationalising the donor coordination principle through Sector Working Groups. Experience with these institutions reveals that often the interests of donors are not aligned with one another and that donor coordination meetings often achieve little more than information sharing rather than improving strategic plans, division of labour or complementarity of efforts. Genuine donor cooperation within a sector approach is a complex process and should be approached cautiously to enable the sector approach to fulfil its potential.

³ This may partly explain the relatively high lack of willingness to comply in Bosnia and Herzegovina noted in the analysis in section 4.3 .


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BERLIN • PARIS • BOSTON • TOKYO

TORSTRASSE 92 • D - 10119 BERLIN
TEL.: ++49 (30) 200 89 20-0 • FAX: ++49 (30) 200 89 20-79
E-MAIL: INFO@POHL-CONSULTING.ORG

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