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Kosovo:
Policy Note on Public Investment Management

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CURRENCY AND EQUIVALENT UNITS
(as of September 25, 2007)

Currency Unit	=	Euro (€)
US$	=	€0.71

WEIGHTS AND MEASURES

ABBREVIATIONS

BO	-	Budget Organisation
DDG	-	Designated Donor Grant
EAR	-	European Agency for Reconstruction
FMIS	-	Financial Management and Information System
FY	-	Fiscal Year
KCB	-	Kosovo Consolidated Budget
KDSP	-	Kosovo Development Strategy Program
KEK	-	Kosovo Energy Corporation
KIPA	-	Kosovo Institute of Public Administration
KTA	-	Kosovo Trust Agency
LPFMA	-	Law on Public Finance Management and Accountability
LPP	-	Law on Public Procurement
MFE	-	Ministry of Finance and Economy
MTEF	-	Medium-Term Expenditure Framework
OSR	-	Own Source Revenue
PFM	-	Public Finance Management
PIP	-	Public Investment Program
POE	-	Publicly Owned Enterprise
PPA	-	Public Procurement Agency
PPRC	-	Public Procurement Regulatory Commission
SRSG	-	Special Representative of the Secretary General
TEC	-	Total Estimated Cost (of a project)

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A. Introduction

1. As Kosovo moves towards resolution of its political status, the attention of the authorities and of the international donor community is increasingly turning towards the need for modernisation of Kosovo's economic and social infrastructure in order to facilitate sustained economic growth and development. However, a marked deterioration in the execution of the capital spending program that occurred in 2006 has raised concerns about the capacities of the authorities to implement an expanded capital spending program. Reflecting this concern the Ministry of Finance and Economy (MFE) undertook in early 2007 a review of the reasons for underspending of the capital spending budget. This note looks further into the underlying causes and the actions that will be required to address them. The main conclusions of the note are that the fundamental causes of underspending on the capital spending program lie in the failure to plan and manage the program within a medium-term context and in the institutional capacity constraints that currently confront the public finance management (PFM) system.

2. The note begins by providing a brief overview of the scale and composition of Kosovo's capital spending program (Section B) and the institutional arrangements for public investment management (Section C). It then goes on to look at the causes of the fall in the execution of the capital spending budget that occurred in 2006 (Section D), and to consider in more detail issues relating to capital investment identification and development (Section E), budget preparation and financing (Section F), and capital budget execution, procurement and monitoring (Section G). The final section summarises the key conclusions and next steps actions (Section H). A summary of the analysis is provided in the assessment framework that is included in Annex I.

B. Public Investment Spending in Kosovo

Levels of Public Capital Spending

3. Since 2000 the Kosovo authorities have established a substantial capital spending program that now accounts for around one fifth of total expenditure under the Kosovo Consolidated Budget (KCB). Total capital outlays which were negligible in 2000 increased to €192 million in 2004 before falling back to €138 million in 2006 (Table 1). The fall in public investment spending in 2005 and 2006 partly reflected an overall dip in public spending as the authorities tightened fiscal management following the sizeable fiscal deficit that was incurred in 2004. It also reflected the switch from non-lapsing commitment-based appropriations to cash-based appropriations that took place in 2005. Previously, Budget Organisations (BOs) had been able to carry forward unspent appropriations into the following fiscal year (FY).

Table 1: Kosovo Consolidated Budget (KCB) Expenditures 2000-2006

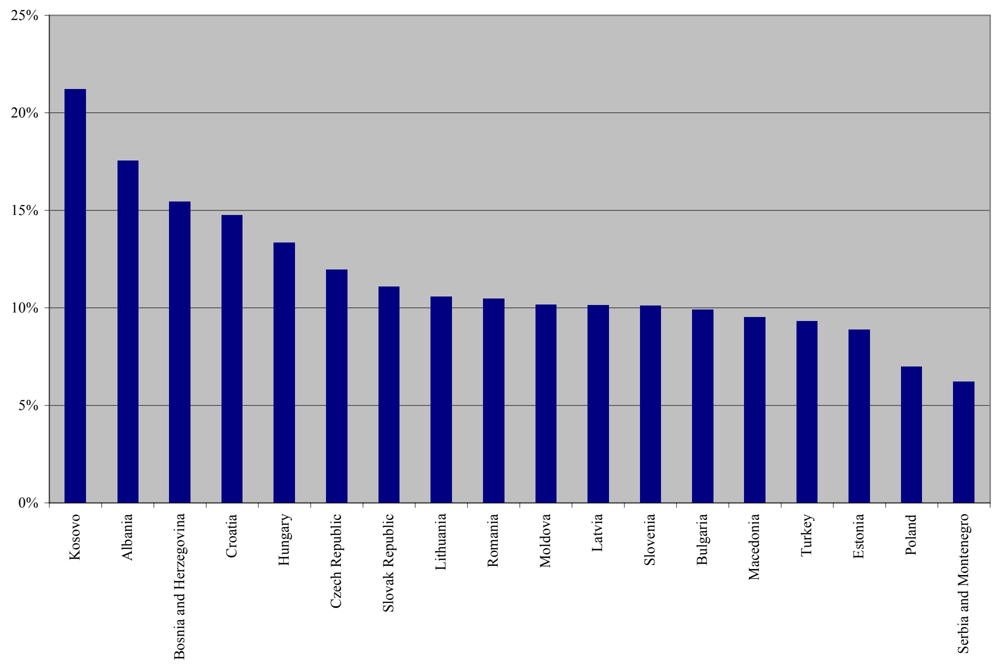
€ million

	2000 Actual	**2001** Actual	**2002** Actual	**2003** Actual	**2004** Actual	**2005** Actual	**2006** Actual
Wages and Salaries	92.3	117.0	131.3	145.7	184.2	194.7	207.0
Goods and Services	73.6	103.7	144.4	185.8	203.7	156.3	153.4
Subsidies and Transfers	68.1	61.6	84.3	127.0	186.2	193.9	157.9
Capital Outlays		6.6	61.9	97.8	191.8	147.2	138.4
Reserves	1.0	0.1	0.0	2.4	3.9		
Total	**235.0**	**289.0**	**421.9**	**558.7**	**769.8**	**692.1**	**656.6**
Capital as % Total	0.0%	2.3%	14.7%	17.5%	24.9%	21.3%	21.1%

Note: Excludes spending undertaken directly by donors outside of Government procedures

4. Compared with other countries in Central and South-Eastern Europe, levels of capital spending outlays in Kosovo are relatively high as a share of total public expenditure (Figure 1). This reflects the considerable priority that has been given by the authorities to public investment spending.

Figure 1: Capital Spending as % of Total Primary Expenditure, Selected SEE and CEE Countries



Notes:
1. World Bank ECA Region Fiscal Database. Data are averages for 2002-04, except for Kosovo which is an average for 2003-05.

Sectoral Composition of Capital Spending

5. The economic matters sector, which includes transport and energy infrastructure, accounted for close to 45.2% of all public capital spending in 2006[1]. Spending on general public services and public order and safety accounted for a further 39% of capital spending, while education and health represented slightly under 7%. Spending patterns thus reflect the immediate priorities of the Kosovo authorities in rehabilitating economic infrastructure and strengthening public governance and rule of law.

Table 2: Functional Composition of Public Capital Spending 2006[#]

	2006 Actual	
	€ million	% of Total
General Public Services	40.6	30.5%
Defense	3.8	2.8%
Public Order and Safety	11.6	8.7%
Economic Matters	60.3	45.2%
Environmental Protection	0.1	0.1%
Housing and Community and Amenities	5.5	4.1%
Health	6.9	5.1%
Recreation, Culture and Religion	1.7	1.3%
Education	2.2	1.7%
Social Protection	0.5	0.3%
Total	**133.2**	**100.0%**

[#]Excludes expenditure financed from Designated Donor Grants and from donor administered grants that fall outside of the KCB.

1 A breakdown of capital spending by function for previous years was not available.

Capital Spending by Level of Government

6. Municipal spending accounts for close to one third of total capital expenditure (Table 3). Since 2005 municipal capital spending has been primarily financed by local government own source revenues (OSRs).

Table 3: KCB Capital Spending by Level of Government#

	€ million			
	2003	**2004**	**2005**	**2006**
Central Government (PISG and UNMIK)	89.3	129.9	106.1	101.3
of which KTA	*58.5*	*18.5*	*15.9*	*28.3*
Designated Donor Grants	4.1	4.2	2.3	5.2
Local Governments	4.4	57.7	38.8	31.9
% financed from Own Source Revenues	*5.5%*	*25.0%*	*66.1%*	
Total	**97.8**	**191.8**	**147.2**	**138.4**

Excludes capital investment spending administered directly by donors outside of the KCB.

Role of External Financing

7. Total external assistance to Kosovo has fallen sharply in recent years from €273.4 million in 2003 to €138.0 million in 2005. The bulk of external assistance is administered directly by the development partners and is not included in the KCB. In 2005 total aid disbursements amounted to €138 million of which €29.5 million (24%) was classified as capital investment assistance. Donor funded capital investment spending in 2005 represented 16.9% of total government capital spending[2].

8. However, the bulk of donor funded capital investment spending takes place off-budget. Designated donor grants (DDGs) for capital spending which are included in the KCB totalled €5.2 million in 2006, accounting for only 7% of total capital spending.

Table 4: Donor Financing of Capital Investment

	Actual Expenditure (€ million)		
	2003	**2004**	**2005**
Technical Assistance	114.6	75.2	99.8
Capital Investment	117.2	68.9	29.5
Other	20.5	15.8	6.5
Trainings	6.5		
Equipment	3.1		
Credit	10.5		0.5
Running Costs	1.2		
Training		2.9	1.7
Total	**273.4**	**162.8**	**138.0**
Capital Investment as % of Total	*42.9%*	*42.3%*	*21.4%*

Capital Budget Performance

9. Prior to 2005 Kosovo operated a non-lapsing commitment based budget for its capital spending program. One consequence of this was that the planned budget included commitments on expenditures that would be incurred during the following year. As a result the budgeted allocations greatly exceeded the executed expenditures. The switch to a cash-based budget in 2005 resulted in a marked increase in the level of implementation of the capital spending program from 61% of budgeted expenditure in 2004 to 87.5% in 2005 although the overall level of capital expenditure fell from €188 million to €145 million (Table 5).

2 Total government capital spending = domestically financed capital outlays from the KCB plus donor financed disbursements on capital projects.

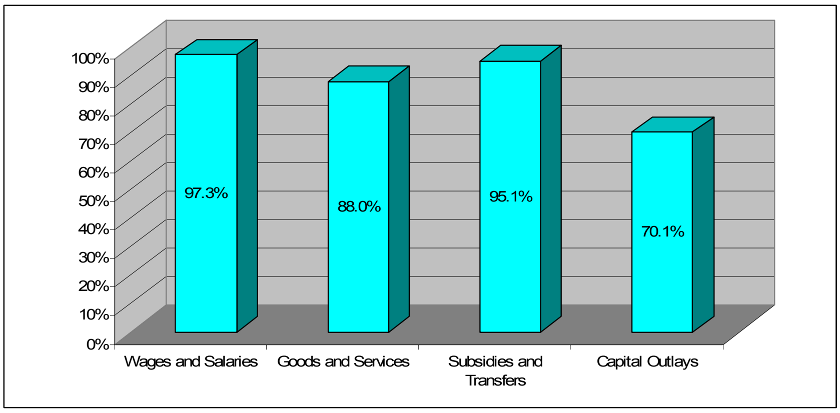
Table 5: Execution of the Capital Spending Budget 2004-06

	2004	€ million 2005	2006
Central Budget (PISG+UNMIK)			
Budgeted	232.9	121.2	139.6
Actual	129.9	106.1	101.3
% Execution	55.8%	87.5%	72.6%
Municipal Budget			
Budgeted	76.9	44.4	50.4
Actual	57.7	38.8	31.9
% Execution	75.0%	87.4%	63.2%
Total			
Budgeted	309.8	165.6	190.0
Actual	187.6	144.9	133.2
% Execution	60.6%	87.5%	70.1%

Note: Does not include capital spending financed by DDGs.

10. In 2006 execution fell to 70% and was well below budget execution rates for other economic categories of expenditure (Figure 2)[3]. This raised concerns in the MFE that capacity constraints and procedural bottlenecks were undermining the implementation of the capital spending program. This led to a study being carried out by MFE in early 2007 into the causes of underspending on the capital budget (see Section D below).

Figure 2: Execution of 2006 Budget by Major Economic Category (Actual Spending as % of Budgeted)



Notes:
1. Does not include expenditure financed by DDGs.

C. Institutional Framework for Public Investment Management

11. The budget process in Kosovo is governed by the Law on Public Financial Management and Accountability (LPFMA), which provides a modern framework for PFM. The law stipulates that revenue estimates and BO resource ceilings should be provided for a three year period and rolled forward annually. It also requires the preparation of a capital spending plan as part of the KCB documentation (Box 1).

3 Some caution is needed in comparing budget execution rates between years and in assessing their significance. For example, the execution rate in 2005 was inflated by large transfers to KEK which were not spent and were carried over to 2006. In 2006 releases to KEK were more tightly controlled. Also procedures for the reallocation of funds between projects in other sectors were tightened in 2006.

Box 1: The Capital Spending Plan

Section 19.11 of the Law on Public Financial Management and Accountability (LPFMA) requires the presentation of a capital spending plan as part of the supporting documentation for the annual budget. The Capital Spending Plan should include:

(a) *A statement setting forth a long-range capital investment plan for Kosovo that identifies and includes the higher priority needs within affordable spending limits.*

(b) *a capital program consisting of proposed capital projects for the upcoming year and the two succeeding fiscal years. Insomuch as is practicable, and recognising emergent needs, the capital program shall reflect the priorities, projects and spending levels proposed in previously submitted capital budget documents in order to provide a reliable long-range planning mechanism for the Assembly and budget organisations;*

(c) *a statement of the purpose of each project;*

(d) *a statement about the proposed site, size and estimated life of the project;*

(e) *estimated total project cost and the cost for each year during which the project is implemented;*

(f) *the source and type of funds proposed; and*

(g) *estimated on-going operating budget costs or savings resulting from the project, including staffing and maintenance costs.*

12. In practice, the LPFMA is not yet fully implemented. Planning and budgeting still tends to be focused on a single year time horizon. While initiatives have been taken to introduce a Medium-Term Expenditure Framework (MTEF) and a Public Investment Program (PIP), these have not always been sufficiently aligned with the annual budget process. The recent Public Expenditure and Financial Accountability (PEFA) assessment of Kosovo noted that the 2006-08 MTEF had been aimed towards the donor community, rather than being seen as an integral part of the budget process. The remainder of this section looks at specific aspects of the budget process and how it impacts on public investment management.

The MTEF and Budget Planning Cycle

13. Kosovo's budget planning cycle is still evolving. An MTEF was first introduced for the 2006 KCB and has been rolled forward for the 2008 KCB. The MTEF is seen as providing the link between the Kosovo Development Strategy Program (KDSP) and the KCB. However, this has yet to be fully achieved due both to the delay in finalising the KDSP and the difficulties encountered in achieving effective synchronisation between MTEF and budget preparation. For example, the 2008-10 MTEF document was not finalised prior to the issuing of the first Budget Circular. There was also considerable overlap between the exercises to prepare sector spending strategies for the MTEF and the BO strategy statements that were to be prepared during the first phase of budget preparation (Box 2).

Box 2: 2008 MTEF and Budget Preparation Timetable

The 2008-10 MTEF

- The 2008-10 MTEF provides the strategic context for the 2008-10 MTEF. The MTEF was finalised by the Macroeconomic Department of MFE during the first four months of 2007. It sets out:
  - ◊ a three year macro-fiscal framework comprising a base scenario and an optimistic scenario that assumes substantial additional door support;
  - ◊ strategic priorities for the budget;
  - ◊ sector spending strategies; and
  - ◊ sector resource ceilings under both the optimistic and pessimistic scenarios.

2008 Budget Preparation Schedule

- BO Strategy Statements. Budget Circular 1 issued on 9th April requires BOs to prepare a strategy statement setting out their requests, covering the period 2008-10, for: (i) the continuation of on-going programs and projects; and (ii) new programs and projects. The Circular also provides information on policy and fiscal priorities guiding budget preparation. BO strategy statements were required to be submitted to the MFE by 4th May.
- BO Budget Requests. Budget Circular 2 issued by 15th May provides BOs with resource ceilings for recurrent expenditure and sets the requirements for submission of the detailed budget requests including capital expenditure projects. BOs' budget requests are required to be submitted to MFE by 15th June.
- Budget Hearings. Following review of BO budget submissions by MFE, formal budget hearings are held from 2nd-30th July. In addition to BO and MFE officials, participants include the Fiscal Affairs Office, Office of the Prime Minister and members of the Assembly Budget Committee.
- Final Budget Requests. Following the budget hearings the MFE issues, by 30th August, the Third Budget Circular containing the final budget ceilings. BOs submit their final budget requests by 15th September.
- Submission of 2008 Budget to Assembly. Following review and approval of the final budget requests by Government and Economic and Finance Committee, the 2008 KCB is submitted to the Assembly by 30th October.

14. The draft 2008-10 MTEF includes only limited analysis of capital spending priorities. The MTEF resource ceilings are broken down between capital and recurrent spending, with the sector spending strategies providing a further breakdown of proposed capital spending allocations between major programs and projects. KCB capital spending allocations are envisaged to increase from €209 million in 2007 to €318 million in 201. Off-budget donor funded spending on capital investment projects is projected to increase from €37 million in 2007 to €39 million in 2010. The MTEF also identifies a requirement for additional capital spending to be financed from donor sources, but for which funding commitments have yet to be secured. This increases from €81 million in 2008 to €135 million in 2010. If the planned spending under the MTEF were fully realised it would result in total capital spending reaching €492 million in 2010, representing an almost threefold increase compared with 2006. It is questionable whether Kosovo would have the capacities to handle such a rapid increase in investment spending.

15. In calling for BO budget requests the MFE only provides resource ceilings for recurrent spending. Requests for capital spending are submitted together with a priority ranking. While the BOs are required to give priority to the completion of on-going investment projects, there is no explicit ceiling on their capital spending proposals, nor is there any requirement to consider the appropriate balance between capital and recurrent spending in their budgets.

The Public Investment Program

16. The Kosovo authorities initially introduced a PIP as a tool for seeking and managing development partner support for public investment and technical assistance projects. The PIP was not consolidated with the general budget. The declining importance of external assistance and the establishment of a substantial domestically financed capital spending program have resulted in the PIP becoming more closely aligned to the budget process and refocused towards domestically financed capital projects. New PIP procedures (Box 3) have been developed with assistance provided by the European Agency for Reconstruction (EAR) and now form the basis for the submission of capital spending proposals to be considered for inclusion in the KCB. The procedures are applied to all investment projects costing more than €5,000. There is some concern that the PIP procedures as currently specified may be too complex and sophisticated for the majority of projects that are proposed for inclusion in the capital spending program. This applies particularly to the emphasis on cost-benefit analysis which is only likely to be applicable to certain types of project. This is an issue that should be looked at in the review of the current state of the PIP process that is being done under the second phase of EAR assistance to the PIP.

Box 3: PIP Procedures

The PIP procedures have been developed with the assistance of the European Agency for Reconstruction (EAR). The PIP system and procedures emphasise four main elements:

Strategy and Priorities

The starting point for the identification of a public investment project is the Government's overall strategy and priorities, and the strategies of the individual BOs. The PIP system holds summary details of the strategy. The PIP procedures require that individual investment proposals contribute to the realisation of Government and BO strategies.

Investment Proposal Development

The PIP procedures specify three steps in the development of an investment proposal

- Identification and formulation of the investment requirement. This requires: (i) identifying the department, function and program in which the investment is to take place; (ii) providing a brief justification for the proposed investment in terms of the problem to be addressed, the reason for government intervention; (iii) specifying the fit with strategic priorities; and (iv) detailing the alternative options to the proposed investment to be considered.
- Appraisal of the different options and recommendation of the preferred option. This requires (i) undertaking a financial and economic appraisal of the different options including a cost-benefit analysis; (ii) identifying non economic and financial considerations; (iii) identifying potential sources of finance; and (iv) selecting and justifying the preferred option.
- Detailing the recommended option. This involves: (i) providing details of the investment including its purpose, scope, costs, management arrangements and start and completion dates; (ii) setting out the expected outputs and outcomes of the investment and the associated targets; (iii) providing a description of the key activities, an activity plan and an assessment of risks; (iv) providing a cross-cutting analysis of market place, environmental, health and employment impacts; and (v) detailing any social impacts and other considerations that might influence the decision on whether to proceed with the investment.

BO Approval and Submission of the Investment Proposal

Following completion of the investment proposal it is then reviewed and approved by the Finance Manager and Department Manager before being reviewed and priority ranked by the Head of the BO. It is then forwarded with other investment proposals to the MFE.

MFE Budget Department Review

The final step is for the MFE Budget Department to undertake its review of the investment proposal. This looks at: (i) whether the investment is appropriate in terms of scale, government involvement and fit with government priorities; (ii) whether it represents a priority for BO and is the most cost-effective option; (iii) whether all costs of the investment have been considered and the affordability of the downstream recurrent spending implications assessed: (iv) whether project success is measurable; and (v) whether the risks and cross-cutting impacts of the project are acceptable.

Following the MFE Budget Department review a decision on whether to finance the project is made in the context of the preparation of the annual budget for the BO.

Capital Spending Allocations in the Annual Budget

17. The LPFMA sets out specific provisions for the presentation of a Capital Spending Plan as supporting documentation to the annual budget (see Box 1 above). These reflect many of the key requirements for effective public investment management. In particular, the Law emphasises a full cost approach to the funding of investment. Thus the Capital Spending Plan is required to provide details of the total cost of each project broken down to show actual or estimated expenditure for each year of project implementation. Such information is vital for managing the forward financing requirements of on-going projects, as well as to provide a meaningful basis on which Parliament can approve the project funding allocations.

18. Currently these requirements are not being met. Schedule 4 to the 2007 KCB contains a full list of the capital investment projects to be financed from the central budget, but only shows allocations for the budget year and any carry-over allocations from the previous year. It does not include details of the total cost of each project or of expenditure in previous years and estimated expenditure in subsequent years.

Budget Execution and Procurement

19. The management of public finances in Kosovo is characterised by a strong liquidity situation and a sound treasury financial management and information system (FMIS) that is comprehensive and able to provide timely analytical reports. Consequently once the KCB is promulgated BOs know their allocations and that the financing will be available to incur commitments and expenditures. This situation is in

marked contrast to that in some other countries in the Region where cash flow rationing has necessitated delays in funding releases which have fallen disproportionately on capital spending.

20. At the beginning of the year BOs are required to submit an annual cash-flow plan to the Treasury Department. This forms the basis for the Treasury Department to authorise the allocation of funds against the BOs' appropriation. This authorisation, which is issued without delay, is required before the BO may enter into a spending commitment and initiate tendering procedures on capital investment projects. Delays in the preparation of the cash-flow plan can therefore have a knock-on effect on the start of implementation of the capital spending program.

21. Procurement is regulated by the Law on Public Procurement (LPP) which was promulgated in February 2004 and amended in June 2007. The LPP defines open tendering as the standard method for public procurement. It also provides for: (i) a restricted tender process in situations where it is efficient to review the qualifications of potentially interested suppliers prior to submission of tenders; and (ii) a sole-source negotiated procedure for when there are compelling technical reasons to award a contract to a particular supplier. The minimum period between issuing of a Contract Notice and the deadline for receipt of tenders for contracts in excess of €250,000 was reduced from 52 to 40 days under the amended legislation. The LPP also specifies a complaints procedure that allows interested parties to submit complaints up to 8 days following the issuing of a Contract Award Notice. In 2006 a total of 220 procurement operations were subject to complaints. Procurement is undertaken by the Procurement Department in each BO. A Procurement Officer holding a 'professional procurement certificate' is designated for each particular activity. A separate Public Procurement Agency (PPA) undertakes procurement of a list of common use items. It also undertakes specific procurement operations at the request of a BO.

D. Causes of Capital Budget Underspending

22. As was noted earlier there occurred in 2006 a sharp fall in the execution of the capital spending budget with expenditure falling to 70% of budgetary allocations compared to 87.5% in 2005. This raised concerns that that the authorities are not in a position to manage an expanded capital spending program and that this could jeopardise Kosovo's ability post-status to access opportunities for increased external assistance.

What Should be Considered a Normal Level of Underspending?

23. Even in highly developed budget systems, there is a tendency to underspend on the capital spending program compared to operational budgets. Projects may experience delays for a variety of reasons beyond the control of their managers. A well managed public spending program will allow budget managers to switch resources from stalled projects to those on which implementation can be accelerated, thereby partially offsetting the impact on the overall capital spending program of such delays. In countries where a substantial share of public investment comprises externally financed projects, levels of underspending have tended to be significantly higher due both to the complexity of development partner procedures and to the lack of flexibility to switch resources between projects when delays occur. Overoptimistic and unrealistic budgeting are other frequently cited reasons for capital budgets being underspent.

24. What is of concern in Kosovo is therefore not that underspending on the capital budget occurs, but that the level of underspending increased so sharply during 2006 and that this occurred despite the very low level of external financing and in a situation where PFM capacities are being built up. Noting this issue the draft 2008-10 MTEF sets an objective of reducing the level of underspending to 10% by 2010. This represents a challenging target which, if realised, would put Kosovo among the better performing countries in the region. Achieving such a reduction will require Kosovo to address a number of bottlenecks to smooth and timely capital project implementation.

The MFE Study of Underspending

25. In response to the concern about the deterioration in the execution of the 2006 capital spending program, the MFE carried out, in early 2007, a detailed review of the causes of underspending (Box 4).

Box 4: Reasons Identified for Underspending in the MFE Study

Following the sharp fall in the execution of the capital spending program in 2006 to 70% of appropriated allocations compared with 87.5% in the previous year, the MFE undertook a detailed investigation of the possible reasons for the deterioration in execution performance. The study investigated eight possible causes of underspending of the capital investment budget:

(i) Poor procurement planning.	▪ BOs do not prepare for procurement prior to the start of the FY. ▪ BOs do not utilise scope for making procurement commitments against future year budgets.
(ii) Procurement law and procedures	▪ Time requirements for tender procurement/tendering procedures (at least 50 days for larger projects). ▪ Requirements for three bidders cannot always be met. ▪ Time taken to resolve protests by unsuccessful bidders.
(iii) Project delay due to external factors	▪ Poor weather may delay construction. ▪ Delays in delivery of imported goods due to the low inventories held by local firms. ▪ Delays in delivery of goods and materials – standard contracts do not penalise late delivery.
(iv) Weaknesses in project planning	▪ Lack of strategic vision in BOs. ▪ Projects developed to satisfy Call Circular rather than business planning requirements. ▪ Planning done by Budget and Finance Divisions rather than project managers. ▪ Planning focused on single year with few BOs planning for the future.
(v) Weaknesses in project management	▪ Project management responsibility may not be assigned to a specific individual. ▪ Responsibility for authorizing expenditure may not be held by program manager. ▪ Limited financial reporting to central administrative offices. ▪ Central or Municipal Assemblies may not track implementation progress. ▪ No consequences for individuals or organisations when a project is not implement-ed on schedule. ▪ Limited accountability for implementation performance.
(vi) Cash-based appropriations	▪ Difficulties in accurately estimating annual expenditure on a cash basis. ▪ Prior to 2007 budget no flexibility to carry forward unspent appropriations. ▪ End of year arrears have to be met from next year's appropriations, requiring budget amendment. ▪ Municipal own source revenue (OSR) can only be appropriated as it is collected.
(vi) Project Coding Structure	▪ Treasury control of expenditure on project codes limits funding flexibility. ▪ Takes time to reallocate between projects, if needed.
(viii) Failure to Follow Expenditure Rules	▪ Planning of cash-flow forecasts does not adequately take account of capital spending program. ▪ Planned expenditure commitments may not be used in the planning of funding allocations.

26. A survey of 15 BOs was undertaken to assess the relative importance of these different factors. The two major causes that were identified were delays in the procurement process (42% of projects surveyed) and delays during project implementation (32% of projects). A study of the individual cases suggests that in many cases delays were attributable to: (i) inadequate project planning particularly in resolving issues relating to land ownership and preparing detailed design specifications; and (ii) failure of the tender process due to the limited number of suitably qualified suppliers. In the case of municipal projects delays in the allocation of funding pending the collection of OSRs, which are the main source of financing for capital spending, was also cited as a significant factor since it prevented initiation of the procurement process. Lower than estimated collection of OSRs meant that, in many municipalities, capital spending allocations had to be significantly cut.

Addressing the Underspending Issue

27. The MFE study provided a thorough analysis of the immediate reasons for underspending on capital projects. It was somewhat less specific and detailed on the underlying causes and the actions required in order to improve budget execution performance. The following sections of this note look in more detail at these issues, focusing on three main areas: (i) the procedures for project identification, preparation and

approval; (ii) the processes of budget preparation and financing; and (iii) the arrangements for capital spending program implementation, procurement and monitoring. Underlying each of these areas are the capacity constraints that affect all aspects of the PFM system.

E. Capital Investment Identification and Development

28. Several of the reasons for underspending on the capital spending program that were identified in the MFE study can be traced back to weaknesses in the processes for capital project identification and development. As was noted above the Kosovo Authorities have made progress with strengthening project identification and planning processes. However, a number of issues remain that result in poorly specified and designed investment projects getting included in the KCB. These include (i) the weak strategic basis for investment planning; (ii) an insufficiently sequenced approach to project identification and preparation; (iii) the absence of a resource constraint against which BOs can identify and select investment projects for detailed preparation and appraisal; (iv) the single year focus of the PIP; and (v) the requirements for sound project planning and appraisal being subordinated to the deadlines of the annual budget process.

Strategic Basis for Investment Planning

29. There is not yet in place a well articulated set of strategic policy and program priorities at sector level that can guide capital investment planning. As a result the capital spending program lacks strategic focus. This issue has begun to be addressed through the KDSP process and the plans to develop the policy and planning functions in line ministries[4]. It was also recognised in the 2008-10 MTEF and the Budget Circular for the 2008 KCB which placed an increased emphasis on aligning resource allocations to strategic priorities. Linkage to strategic, sectoral and BO policies and priorities is also emphasised in the PIP procedures.

30. Developing the processes and capacities required to establish more effective alignment between policies, strategies and budgetary resource allocations will take some time. While these are issues that are largely beyond the focus of this note, the key requirements will be:

- further development and harmonisation of the KDSP and MTEF processes in order to ensure better linkage between strategic priorities and budgetary allocations;
- establishing a specific requirement for BOs to identify capital spending priorities from their respective sector policies and strategies;
- at an early stage in the project development process, requiring that all investment proposals are evaluated for consistency with Kosovo's policies, strategies and priorities; and
- for MFE to develop procedures for policy-led budget planning and appraisal and training of budget staff in the BOs in the application of these procedures.

31. Kosovo could learn from the experience of other countries in the region that have begun to address similar problems of weak policy and strategy processes and their lack of integration with the budget planning process. The experience of Albania in introducing an integrated planning system may be of particular relevance to Kosovo as it moves towards final status (Box 5).

[4] The recently initiated EAR funded 'Technical Assistance to the Kosovo Development Strategy and Plan' is supporting the development of policy and planning capacities in line ministries.

Box 5 Albania's Integrated Planning System

Recognising that Albania's policy and financial planning systems have been fragmented and disjointed the Government of Albania in November 2005 committed itself to the implementation of an Integrated Planning System (IPS). The IPS provides a planning and monitoring framework for the government's core policy and financial processes. Within the IPS framework two main processes are specified: (i) the National Strategy for Development and Integration which will provide a single comprehensive strategy covering all sectors; and (ii) the MTEF/budget process requiring line ministries to elaborate their medium-term expenditure plans so to deliver the their policy objectives and goals within each ministry's expenditure plan. The IPS also emphasises a requirement for stronger strategic direction from the Council of Ministers (CoM) which will in future approve the initial fiscal framework and resource ceilings for the MTEF and Budget as well as the strategies developed by each ministry.

Three structures are being established to oversee implementation of the IPS: (i) an inter-ministerial strategic planning committee chaired by the Prime Minister; (ii) a Government Modernisation Committee chaired by the Deputy Prime Minister; and (iii) the Department of Strategy and Donor Coordination (DSDC) located within the CoM Secretariat and responsible for coordinating IPS across government. Implementation of the IPS is being undertaken as a phased process. The initial focus during 2006 was on establishing the central structures and developing the basic IPS methodologies and processes. During 2007 the aim is to extend the basic IPS processes to all ministries with broadening and deepening of these processes taking place in subsequent years.

Source: Albania Restructuring Public Expenditure to Sustain Growth – a Public Expenditure and Institutional Review, World Bank, December 2006

Sequencing of Project Identification and Preparation

32. The PIP procedures specify the key stages of investment identification, formulation, appraisal, and design that are involved in the preparation of a project proposal. However, the procedures could be improved through the adoption of a more stepped approach in which investment proposals are screened and developed to the identification stage at which point a decision is made whether to proceed to detailed preparation and appraisal. Such a procedure would also allow for consideration of the requirements for detailed feasibility and design studies to support preparation and appraisal so that funding could be made available for these tasks. By considering investment preparation and appraisal requirements at the conclusion of the identification stage it would be possible to ensure that these were appropriately specified and adapted to the type and scale of the proposed investment. It would also help to ensure that BO resources were not allocated to the preparation of projects that should have been excluded at the earlier identification stage. Albania's new procedures for identification and appraisal of public investment projects provide a good example of such a stepped process (Box 6).

33. The MFE should therefore consider introducing such a stepped process for the approval of investment proposals. This should provide for:

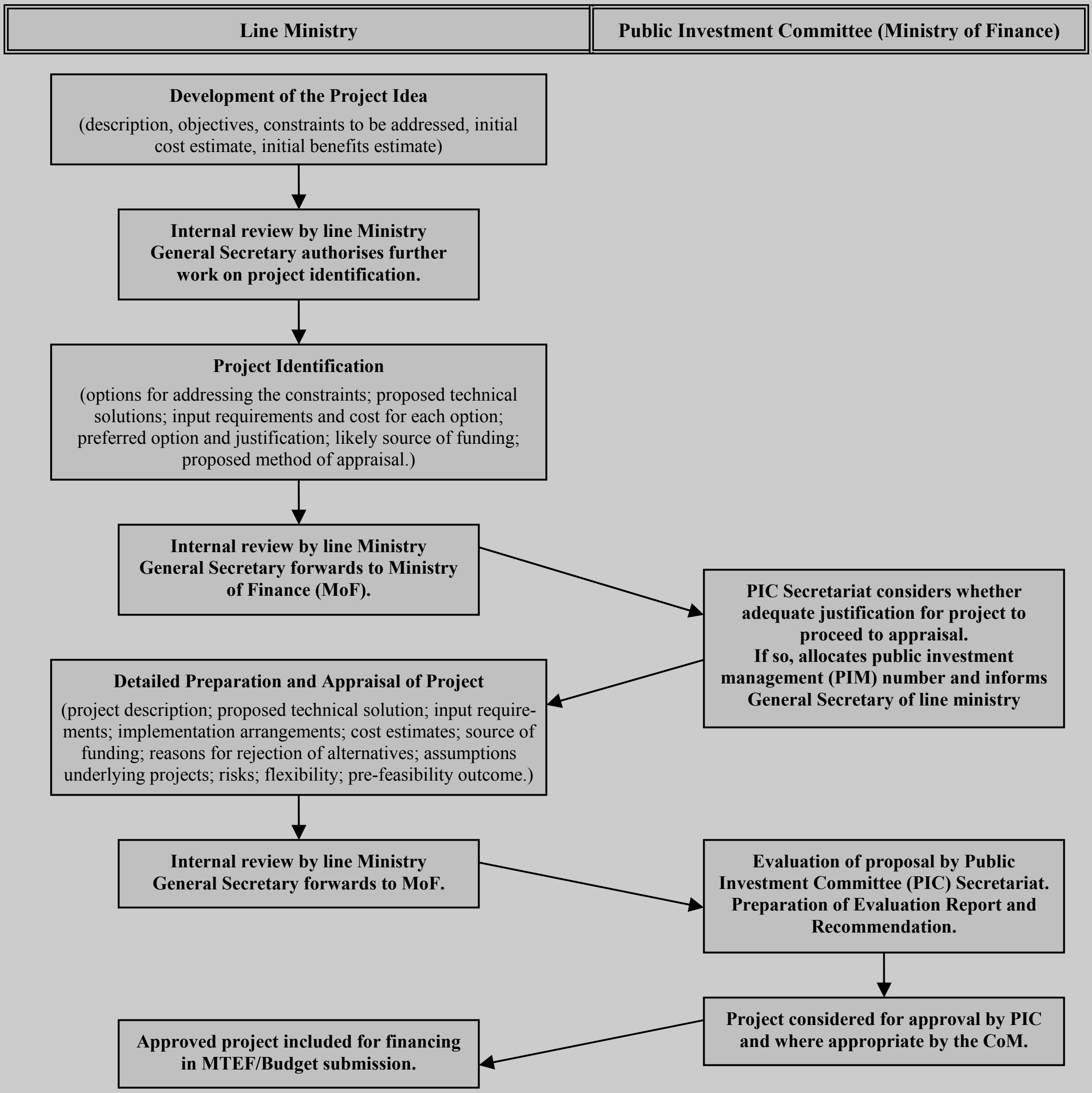
- Screening of the project concept by the BO. This screening should focus on the purpose and scope of the proposed investment, its consistency with the ministry's policies and priorities, and whether it is likely to represent an effective and efficient use of limited public resources.
- Preliminary approval based on a simplified investment identification format that allows for the investment to be included in the BO's forward capital spending program. Preliminary approval from MFE would provide the go-ahead to proceed with committing resources to the detailed design and appraisal of the project and for commissioning any feasibility and design studies. It would also allow projects to be programmed into the forward MTEF spending plans, subject to total capital spending demands remaining broadly consistent with the MTEF resource ceilings[5].
- Full approval of the project prior to its inclusion in the KCB. This should require the presentation of an investment proposal that includes a detailed specification of the project, an appraisal assessment and an implementation plan covering the full period during which the project is to be implemented.

34. Such a process could be accommodated with only minor modifications to the present PIP procedures. It is recommended that the requirements should be considered during the review of the requirements for further development of the PIP process that is being undertaken under the second phase of EAR assistance to the PIP. Consideration should also be given to establishing a Capital Investment Committee chaired by

5 In practice, total capital spending demands might be allowed to exceed the MTEF resource ceiling by 20%-25%. This would help to ensure that there was a pipeline of approved projects available should additional capital spending resources become available for example from the development partners.

the MFE that would meet 3-4 times during the year to review investment proposals and provide provisional and final approval for all capital investment projects[6].

Box 6: Albania: Procedures for Identification and Appraisal of Public Investment Projects



Source: Albania Restructuring Public Expenditure to Sustain Growth – a Public Expenditure and Institutional Review, World Bank, December 2006

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6 In addition to senior staff from the Macroeconomic and Budget Departments in MFE, the Committee could include representation from the Prime Minister's Office, the Public Procurement Agency and government bodies able to advise on the engineering and environmental aspects of investment proposals. Line ministries would be asked to attend meetings at which their proposed investment proposals were to be discussed.

Absence of a Resource Constraint

35. The procedure for project identification and preparation is open-ended in that BOs are not required to prioritise their investment proposals against a realistic resource constraint before submitting them to the MFE. Consequently, there is no incentive for BOs to limit the investment proposals that they prepare and submit to MFE to what could be realistically expected to be financed. As a result:

- The costs of the project proposals submitted by BOs end up greatly exceeding the available funding. For example:
  - ◊ the Ministry of Transport and Communications identified a capital spending requirement for 2008 of €125 million against its allocation of €24 million in the 2007 KCB;
  - ◊ the Kosovo Trust Agency (KTA) submitted a capital spending requirement covering all publicly owned enterprises of €207 million compared with its allocation of €50 million in the 2007 KCB; and
  - ◊ the Ministry of Health submitted a capital spending request totalling €29.0 million for the 2007 KCB against which only €9.2 million was eventually allocated.
- The PIP system becomes clogged with a huge number of projects. 1,179 project requests were submitted for the 2007 KCB.

36. Such an open-ended process has a number of adverse impacts on the public investment management process. BOs spend considerable time preparing project proposals that stand little or no chance of being financed. Analysts in the BOs and MEF have very limited time to review and analyse each investment proposal. One consequence is that those investments that do get financed have often been inadequately prepared and appraised. Poor preparation and appraisal was identified in the MFE study as a significant factor contributing to delays at the subsequent implementation stage.

37. BOs should therefore move to a procedure where they only prepare investment proposals that have a realistic chance of being financed from within their medium-term budget resource ceilings. This would be facilitated by setting an overall MTEF resource ceiling for a ministry disaggregated into indicative allocations for recurrent and capital spending. Requiring such prioritisation would encourage BOs to consider the most effective use of the resources at their disposal and could be expected to result in an investment program that was better matched to the BOs' strategic priorities and which made more efficient use of the available resources. It would also enable the limited capacities within BOs for investment preparation and appraisal to be concentrated on projects that have a realistic chance of being financed.

Single Year Focus to Investment Planning

38. Capital investment proposals are generally identified and prepared as single year projects. While this approach may have been appropriate in the post-emergency phase when resource limitations meant that priority had to be given to small critical investment aimed at restoring existing infrastructure, it is no longer appropriate to the normalised situation where the emphasis needs to be on implementing a more strategic capital spending program geared to the development of a modern infrastructure necessary to support Kosovo's future economic development.

39. The PIP procedures are bringing a more strategic approach to investment planning and explicitly provide for multi-year projects. However, the concept is still not well established within the BOs, while current procedures require PIP investment proposal forms to be submitted for on-going as well as new capital spending proposals. As a result larger investments tend to get broken down into smaller single year projects and related but distinct activities (such as construction and equipping of a facility) often get funded as separate projects. This has a number of adverse consequences for public investment management:

- The capital spending program becomes fragmented resulting in a loss of strategic focus.
- Procurement and implementation operations become disjointed by being limited to a single year rather than covering the total cost of the investment. As a result:
  - ◊ implementation is disrupted and delayed due to the need to divide the investment into a number of separate annual contracts; and
  - ◊ management costs are substantially increased and the demands on limited management capacities unnecessarily stretched.

- Uncertainty is created over the funding of follow-on or related investment activities. This exacerbates the risks of facilities being left uncompleted or without equipment.

40. The MFE should therefore stress in the PIP instructions the importance of a strategic approach to the identification and planning of investment proposals. Specifically, this should emphasise that:

- Investment proposals should be defined at a comprehensive and consolidated level with project proposals specified to cover the total estimated cost of the entire investment with costs phased over the full implementation period;
- project costs and the phasing of expenditure should be updated with each subsequent budget cycle; and
- revised and updated PIP investment proposal forms should only be required if the total estimated cost of the project is to be changed, or if there is a significant change in the activities to be financed.

Subordination to the Time Deadlines of the Annual Budget

41. The MFE has rightly emphasised the importance of aligning and integrating the PIP procedures with the requirements of the budget planning system. One response has been that the PIP investment proposal forms are now being used for the submission of capital spending estimates for inclusion in the KCB. However, there are a number of problems with this approach:

- It risks subordinating the requirement for sound procedures for the planning and appraisal of public investment projects to the tight timetables and deadlines of the budget process. The identification, planning and appraisal of investment proposals should be seen as on-going activities that take place throughout the year and which ensure that there is a well prepared and prioritised set of investment proposals available to be considered for financing from the KCB.
- It concentrates the preparation of investment proposals during a short period of the year and risks overloading the limited capacities for project planning and appraisal in the BOs. It also concentrates demands on budget analysts in the MFE to review and analyse PIP investment proposals at a time of year when they already face heavy demands on their time.
- By linking the PIP procedures so tightly to those of the annual budget, there is a risk of accentuating the current single year focus of the PIP, rather than emphasising the development of a more strategic medium-term capital spending program.

42. MFE should therefore take steps to ensure the investment proposals are only accepted into the KCB when they have been subjected to a full preparation and appraisal process, and when the necessary management arrangements are in place to facilitate timely implementation. This would be facilitated by the three stage project approval process outlined above (see para 33), with only approved investment projects considered for financing from the KCB. Delinking the process of identifying and developing investment proposals from the timetable for the preparation of budget submissions would also allow the tasks of project preparation and appraisal to be better geared to the requirements of the particular investment.

F. Budget Preparation and Financing

43. The way in which the KCB is prepared and financed has also impacted on the level of budget execution. A number of issues can be identified here including: (i) the inclusion of inadequately prepared projects into the KCB; (ii) the large number of small investment projects; (iii) the time horizon of the capital spending program; (iv) the switch from commitment-based to cash-based appropriations; and (v) the financing of municipal capital spending programs. Additional issues are the integration of increased external financing into the KCB, and the financing of POE investments.

Inclusion of Inadequately Prepared Projects into the Budget

44. Projects are often included in the KCB without having been fully prepared and specified. A key factor behind the poor quality of preparation and appraisal is that investment proposals tend to be developed in response to the budget circular rather than as part of the business processes of the BO. A further factor is the undue politicisation of the project selection process. As a result projects are introduced into the KCB without technical designs having been finalised and project management arrangements worked out, or, as

has occurred with a number of projects, without land allocation issues having been finalised. Because investment proposal preparation is driven by the budget process, it has in some BOs been led by the Budget and Finance Divisions rather than by technical departments responsible for subsequent implementation.

45. This situation typically results in significant implementation delays and underspending of the original budget allocation. The weak basis of the original cost estimates can also result in subsequent cost overruns. Inadequate appraisal can lead to the adoption of inappropriate design standards and poor quality works.

46. Ensuring better prepared projects will require: (i) emphasising through the PIP procedures that project preparation is a year round activity; and (ii) improving the quality of project preparation through implementation of the measures outlined in the previous section to introduce a stepped approach to project identification and development with projects approved by a Capital Investments Committee before being considered for inclusion in the KCB.

Large Number of Small Investment Projects

47. The KCB contains an excessive number of small capital projects. This leads to a loss of focus in the capital spending program and weakens linkages with sector level policies and strategies. In the 2007 KCB a total of 171 out of 315 new projects in the central budget received allocations of less than €0.2 million, with 54 projects receiving allocations of less than €50,000. Projects in municipal budgets tend are on average much smaller with many little more minor works contracts. Excessive fragmentation of the capital spending program increases the complexity of procurement processes and the number of procurement operations. It also places increased demands on the management of the capital spending program.

48. The MFE should consider measures to consolidate the capital spending program around fewer larger projects. This could be achieved by: (i) grouping related investment costs, such as the construction and equipping of a school, within a single project; (ii) grouping smaller capital investments, such as rehabilitation of schools in a municipality, within a programmatic project; and (iii) introducing a separate provision for a minor capital works projects covering the smallest investments at BO or department level that would not be subject to the full PIP procedures. MFE should determine an appropriate upper threshold for minor capital works projects, say €200,000 and specify the maximum proportion of the BOs capital spending program that could be allocated to such projects, which might vary between ministries.

Time Horizon of the Capital Spending Program

49. The KCB only shows project financing requirements for a single year. Schedule 4 of the Budget Law sets out the details of the capital spending program and shows the funding allocations for each project financed from the central budget. However, the Budget Law is not supported by a more detailed capital spending plan, as is required in the LPFMA, setting out of the purpose of each project, the total estimated cost of the investment, the phasing of costs over the full implementation period, and the downstream recurrent costs of operating and maintaining the facility.

50. The absence of these details has a number of adverse consequences for public investment management:

- The information provided on the capital spending program is inadequate to inform parliamentary discussion. An annual funding allocation for a project has little meaning unless it is set within the wider context of the total cost of the project and what has been spent previously.
- There is no recording of the future funding requirements necessary to complete on-going investment projects. This limits the forward focus of the capital spending program and makes it more difficult to determine what balance of resources will be available to finance new investment operations.
- Project management tends to be focused around the annual budget allocation and work plan, rather than the implementation of the project as a whole against its total estimated cost. This can result in increased costs and longer implementation periods due to fragmented implementation planning and the need to tender on-going capital works programs on an annual basis.

51. MFE should introduce the Capital Spending Plan as specified the LPFMA. This could either be as a separate document or by expanding Schedule 4 the Budget Law to provide more detailed information on each project covering:

- the objectives of the project;
- the total estimated cost of the project;
- total expenditure in the years preceding the current budget year;
- the revised estimate of expenditure for the current year;
- the estimated expenditure for the next year (for which budgetary approval is sought);
- estimated spending for each of the following two years; and
- any balance of spending required to complete the project beyond the current MTEF.

In the planning of the budget, the funding requirements for on-going projects should be treated as a first call on available capital spending allocations although subject to a review of the performance and status of each project. The focus of the PIP and the project approval process would then be on the allocation of the balance available to finance new capital projects.

Cash-Based Appropriations

52. The switch to cash-based appropriations that occurred in 2005 has undoubtedly made it more difficult for BOs to implement their capital spending budgets. Effectively, the previous commitment-based system allowed BOs to implement projects over a two year period, or in some cases even longer, provided that the funding commitment was made in the year of appropriation. The change to cash-based appropriations in a situation where the capital spending program comprises predominantly single year projects compressed the time frame for both commitment and implementation to within a twelve month period. It also created additional pressures on limited project management and procurement capacities by imposing a similar implementation timetable across the whole capital spending program.

53. The problem is not cash-based appropriations, but the combination of cash-based appropriations and the single year focus of investment projects. Planning capital spending based on a realistic and more optimal implementation schedule spread over more than one year could be expected to significantly reduce the level of underspending on individual projects. Many countries successfully handle the funding of multi-year investment projects through successive annual appropriations which are managed and monitored against the approved total estimated cost of the project. With a well functioning FMIS Kosovo is well placed to manage the funding of capital projects in this way.

Financing of Municipal Capital Spending

54. In 2006 the level of budget execution on municipal capital spending programs averaged 63.2% of total appropriations. It was thus significantly below the level of execution on the central budget. Municipalities cite their reliance on OSRs for financing capital spending projects as the major reason for the low level of execution. They argue that this is because they are not permitted to commit funding from OSRs until after the revenues have been collected. Since the collection of OSRs is heavily skewed towards the second half of the FY, procurement cannot be completed until late into the year, leaving little time for project implementation before the funding lapses at the end of the year[7].

55. However, the real reasons would appear to lie elsewhere. Since unspent OSRs can be carried forward to the following year, municipalities should be in position to commit funding and initiate procurement early in the FY. The problem of availability of own source funding would therefore appear to be more related to other factors including:

- expenditure allocations being based on over-optimistic revenue projections – in 2006 municipalities collected only 82% of the forecast amount of OSRs;
- insufficient resources being devoted to improving OSR collection by municipalities; and
- OSRs being used to cover end of year arrears on the recurrent spending program.

[7] For example in Peja Municipality in 2006 expenditure was only incurred on 34 out of 76 capital funding commitments made during the year. Total capital program spending amounted to €1.05 million against commitments of €1.69 million and a funding allocation of €1.98 million.

56. Addressing these issues would require that municipalities: (i) adopt more conservative forecasts for OSRs and their capital spending program; and (ii) strengthen their own internal financial management in order to 'protect' capital spending allocations from being diverted to cover payment arrears and funding shortfalls on the recurrent spending program. These requirements should be considered in the wider context of the development of municipal budget management capacities.

Externally Financed Capital Investment Projects

57. External concessional financing of the capital spending program has been very limited in recent years. Spending on externally financed capital projects included in the KCB in 2005 totalled €2.3 million, accounting for around 1.6% of total capital expenditure[8]. In the same year, spending on off-budget externally financed capital projects was estimated at €27.2 million. Kosovo is thus fortunate in avoiding the situation that occurs in many other aid-dependent countries where the major share of government capital spending is financed directly by the development partners and remains off-budget. Such a situation undermines the comprehensiveness and integrity of the investment planning and budgeting processes and leads to a significant loss of budget transparency.

58. Post-status it is possible that Kosovo will receive significantly increased levels of external financing and that a major share of these resources will be used to finance improvements in the capital infrastructure necessary to improve provision of public infrastructure and services. The Government has indicated its intention to work with the donor community to establish the mechanisms that would allow donor resources to be provided increasingly through budget support and sector-level basket funding arrangements[9]. Where these resources are provided through such arrangements they will be allocated and managed through the PIP, budget and treasury systems. However, significant amounts of resources can also be expected to be provided as project assistance, particularly in the infrastructure sectors. To the extent possible these resources should also be brought on-budget and managed through Kosovo's PFM systems and procedures. The Government should emphasise these requirements in its discussions and negotiations with its development partners.

Financing Arrangements for Investments by Publicly Owned Enterprises

59. To date investment allocations for publicly owned enterprises (POEs) have been provided in the form of capital grants from the Central Budget. In 2006, capital spending by POEs totalled €28.2 million accounting for 21% of total KCB spending. Since POEs are commercial enterprises, the authorities are concerned that the present financing arrangements provide little incentive to address the underlying causes of the weak financial performance of most POEs. It is therefore proposing a shift towards loan financing of POE investments and is planning to provide a €83 million investment loan to the Kosovo Energy Corporation (KEK) in 2007 for the rehabilitation of mine machinery and mine expansion.

60. However, the underlying lack of financial profitability of most POEs means that there is a need for caution in moving to loan financing, if the Authorities are to avoid building up a portfolio of non-performing loans. Under these circumstances:

- Further investment in POEs should be linked to business plans that demonstrate the financial sustainability of the POEs' operations. In the case of public utilities operations, business plans should address requirements for: (i) reducing technical and non-technical losses; and (ii) moving to economic tariffs. Further grant subsidies from the KCB should be of an interim nature, and as such tightly linked to meeting these two sets of requirements, so that the business plans of the POE are not undermined on the one hand, and incentives to implement these plans are maintained on the other.
- Capital investment loans should only be provided to those POEs that have a relatively strong cash flow. Such lending should be at market rates. Where cash flow cannot sustain the full cost of the loan, an element of the financing should be provided as a capital grant rather than through an interest rate subsidy. Credit financing should be appropriated through the budget process and expected costs should be estimated and reserved starting with the first year in which credit is extended for a particular purpose.

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8 In 2006 externally financed capital projects included in the KCB increased to €5.2 million accounting for 3.2% of total capital expenditure.

9 See 'Aid Management in Kosovo – Discussion Note June 2007', Office of the Prime Minister (Donor Coordination Centre).

G. Capital Budget Execution, Procurement and Monitoring

61. The previous two sections showed that inadequately developed and aligned procedures for the identification, planning and budgeting of capital spending projects underlie subsequent delays that occur in project implementation and are major causes of underspending of budgeted allocations. The impact of these factors is both reflected in and multiplied by the more immediate problems that become evident during subsequent budget implementation. These include: (i) weaknesses in project management; (ii) inadequate preparation for project implementation; (iii) delays in the commitment of funding; (iv) the length of the procurement process; (v) the limited use of multi-year contracts; (vi) the ability to respond to unexpected delays; and (vii) the arrangements the monitoring of the capital spending program.

Project Management

62. The PIP procedures emphasise the key role of the project manager in both developing and implementing investment projects. However, in practice investment projects get included in the KCB with little thought having been given to their subsequent implementation. The MFE study identified that projects were often included on the initiative of the BO budget and finance departments without project managers having been designated. Arrangements for project management may also be inappropriate. For example, hospital construction programs are managed by Regional Hospital Directors rather than by a dedicated project management team. As a result project management takes a secondary role to the day-to-day running of the hospital and the necessary skills and experience to manage a construction project are lacking. Monitoring of project implementation varies considerably between BOs. More use could be made by BOs of the FMIS for monitoring commitments and expenditures against appropriations. Arrangements for the monitoring of project implementation vary considerably among BOs, but are often inadequate to ensure that timely remedial actions are taken when delays in project implementation occur.

63. The consequences of weaknesses in project management are: (i) delays in implementation and underspending of budgeted allocations; (ii) increased costs resulting from implementation delays and weak management oversight; (iii) technical specifications and standards not being met due to inadequate technical supervision; and (iv) failure to initiate timely remedial actions due to inadequate monitoring information. Addressing these issues will require that adequate project management arrangements are put in place before funding is made available. This could be facilitated by the development of guidelines for capital project management and implementation monitoring and the organisation of training courses for project managers. Since training in project implementation procedures will be an on-going requirement and is relevant to other aspects of public sector program management, it could be done in collaboration with the Kosovo Institute of Public Administration (KIPA).

Preparation for Project Implementation

64. Although the draft budget is finalised and submitted to the Assembly by 30th October, BOs often do not finalise technical designs, prepare tender documents and issue procurement forecasts until the start of the new FY in January. This delays the start of the procurement process and increases the risk of procurement hold-ups due to hastily prepared tender documentation. As a result the tender process extends further into the new FY, reducing the time available for contract implementation, thereby increasing the likelihood that the contracted works cannot be completed before the end of the FY.

65. The guidelines for capital project management and implementation should emphasise the importance of finalising technical designs and tender documentation by the end of the preceding FY, so that the tendering process can proceed without delay. BO procedures for monitoring of the capital spending program should be extended to include projects that are scheduled to start implementation in the following year. BOs should develop a schedule for the next FY setting out a timetable for planned procurement activities. This should take account of the capacity constraints and the technical demands on ministry procurement departments.

Delays in the Commitment of Appropriated Funds

66. Delays in the allocation and commitment of funding at the start of the FY result in significant delays to the initiation of procurement activities for capital projects. At the beginning of the year a BO prepares its annual cash flow plan for the current FY and submits it to the MFE. This forms the basis for the MFE to issue the authority to incur expenditure, which is required before a BO may make a spending commitment

and initiate procurement though the issuing of a Contract Notice[10]. In practice the immediate priority of BOs at the beginning of the FY is to settle any payment arrears, and until this is done they are not in a position to prepare their annual cash flow plan. Consequently, it is often not until February that the annual cash flow plan is submitted to MFE. As a result BOs are typically unable to start procurement until towards the end of the first quarter of the year.

67. The MFE should work with BOs to minimise delays in the issuing of funding releases. There is no reason why BOs should not prepare their cash-flow plans once the Budget has been passed and prior to the start of the FY. However, this issue may need to be considered in the context of the arrangements for clearing any outstanding payment arrears.[11]

Length of the Procurement Process

68. The length of the tendering process is frequently cited by BOs as a major cause of delay to project implementation. For tenders over €250,000 the minimum time taken from the issuing of a Contract Notice to receipt of tender was previously 52 days. Thereafter, tender evaluation and contract award typically takes around 14 days. Following publication of the Tender Award a further 8 days is allowed for interested parties to submit complaints about the conduct of the tender. In the event of a claim being lodged a further seven days may be taken for an independent expert to establish the validity of the claim. In practice, these procedures mean that it can be expected to take around three months for the tendering process to be completed.

69. Revisions to the LPP that were promulgated in June 2007 have reduced the minimum length of time between issuing of Contract Notice and opening of tender from 52 days to 40 days (Box 7). The LPP also provides for a reduced minimum tender period of 24 days (previously 36 days) for contracts where the procurement has been covered by an Indicative Procurement Notice issued not less than 40 days prior to the issuing of the Contract Notice. Since an Indicative Procurement Notice can be issued 'immediately after the approval of the planning of concerned works project' and does not have to wait until the start of the FY this facility could be used to further reduce the time taken to complete the procurement process.

Box 7: Tendering Time Limits (June 2007)

Tender Procedure		Contracts <€250,000 (Minimum Period)	Contracts >€250,000 (Minimum Period)	Remarks
Open Tender Normal Procedures				
Requests to Participate		-	-	Contract Notice can be issued once cash flow plan approved
Tender		25	40	
	Total	**25**	**40**	
Open Tender Following Indicative Notice				
Indicative Notice		-	40	Indicative Notice can be issued before start of FY
Tender		-	24	
	Total	**0**	**64**	
Restricted Tender				
Requests to Participate		15	25	Applies where it is more efficient to review the qualifications of interested contractors prior to submission of tender. Contract Notice can be issued once cash flow plan approved
Tender		20	40	
	Total	**20**	**40**	

70. BOs also complain about the cancellation of procurement due to the inability to obtain three tenders, or the additional time taken to obtain a waiver to this requirement from the Public Procurement Regulatory Commission (PPRC)[12]. In 2006 the PPRC received 491 requests for waivers, covering both works and supply contracts, of which 345 were accepted. The shortage of suitable bidders is a particular problem for tenders involving the supply of highly specialised equipment where often there may be only one or two

[10] The LPP requires that procurement can only be initiated provided that *'funds have been appropriated for the concerned procurement in an amount sufficient to fulfil any financial obligation that may arise during the then-current fiscal year as a result of such procurement'* (Section 20.1 conditioned by Section 8.2). The principle that funds should be appropriated before procurement is initiated is sound PFM practice. The benefits of revising the LPP to allow procurement to commence following promulgation of the annual Budget Law/Regulation would be limited.

[11] The issue of settlement of payment arrears was not raised during the consultant's visit, but is referred to elsewhere. It was therefore not clear to what extent this represents a significant problem and whether BOs are required by MFE to clear their payment arrears before preparing their cash-flow plan.

[12] Under the revised LPP promulgated in June 2007, responsibility for the granting of waivers has been moved to the Public Procurement Agency.

qualified suppliers. The largest number of waiver requests (70) were lodged from the KEK of which only just over half (37) were approved. The relatively high rejection rate for waiver requests from KEK indicates other problems with the tendering process. Around a quarter (129) of all waiver requests were submitted by municipalities. A study should be undertaken by MFE and the PPA to identify the main reasons for the shortage of bidders. Factors such as poor contract specification, the limited capacities of contractors, and the concentration of procurement operations during the first half of the year are all likely to have an impact. Addressing those factors over which the authorities have some control could be expected to reduce the number of cancelled procurement operations.

71. The tender periods specified in the LPP are not excessive by international standards and the recent amendments to the LPP have streamlined procedures further. Instead the constraint lies more with the limited capacities to manage procurement operations which results in delays between the different stages of the procurement process. This is accentuated by: (i) the large number of relatively small procurement operations; (ii) the concentration of procurement operations during the early months of the year which is accentuated by the predominance of single year projects; and (iii) the failure to plan and prepare for procurement operations in advance, which could enable greater use of the shorter tender period for contracts covered by an Indicative Notice. The MFE Budget Department should work with the PPA and the BOs to improve the planning for and preparation of procurement operations. It should also monitor implementation of new procedures/time limits under the revised procurement legislation to identify causes of significant delays and possible remedial actions.

Multi-Year Contracts

72. There is currently only very limited use made of procurement contracts that span more than one FY. This reflects the focus in the capital spending program on single year projects. However, even in the case of projects with longer implementation periods multi-year contracts are rarely used since these are seen as incompatible with an annually appropriated budget and the cash-based budget management procedures that have operated since 2005. This is despite specific provision in the LPP covering the award of multi-year procurement contracts that give rise to appropriation demands in subsequent years (Box 8).

73. The reliance on single year contracts has a number of adverse impacts on the management and implementation of the capital spending program. It results in higher contractor costs on projects where construction activities have to be split into a series of single year contracts with resulting interruption to project implementation and the need for contractors to retender and remobilise for follow-on contracts. It creates additional costs and capacity demands on BOs in having to organise successive procurement operations on the same project. It contributes to the concentration of procurement activity during the first half of the year thereby exacerbating capacity constraints within the procurement system. It encourages overambitious implementation planning as BOs try to squeeze implementation within a single FY.

Box 8: Multi-Year Contracts

Section 8.3 of the Law on Public Procurement (LPP) sets out the arrangements and conditions under which BOs may enter into procurement contracts that extend beyond a single FY.

> *8.3 If the concerned procurement will give rise to financial obligations that are to be satisfied from appropriations expected in future fiscal years, the contracting authority shall (i) ensure that the existing Medium Term Expenditure Framework, as developed under the Law on Public Financial Management and Accountability, provides a reasonable basis to expect that sufficient funds will be appropriated to it for the purpose of satisfying such obligations; and (ii) include in the concerned public contract a provision that clearly conditions the enforceability of such obligations on the availability, under future appropriations legislation, of funds for the purpose of satisfying, and in an amount sufficient to satisfy, such obligations.*

This section has been amended in the revised LPP to make specific reference to the Medium-Term Expenditure Framework. The requirement to demonstrate that sufficient funding can be expected to be available could also be met by including in Schedule 4 of the Annual Budget the total estimated cost of each project and the phasing of these costs by year.

74. There are thus strong reasons for the Kosovo Authorities to make much greater use of the provisions under the LPP covering the award of contracts extending beyond a single FY. The measures outlined in the previous sections to reduce the single year focus of the capital spending program and require that

projects are specified and approved on the basis of the total estimated cost of the planned investment should also facilitate the greater use of multi-year contracts.

Factors Beyond the Control of BOs

75. The MFE study noted that in a number of cases, factors beyond the control of the authorities had resulted in delays to project implementation and the underspending of budget allocations. The main reasons cited included bad weather, limited local supply inventories, unanticipated technical problems, poor contractor performance and the failure of contractors. Such problems affect capital spending programs in all countries and are a significant reason why budget execution tends to be lower on capital spending programs. Such problems are likely to be more significant in a territory such as Kosovo where contractor capacities are still being built up and where many supply firms are only recently established and have limited experience and access to finance. The impact of such delays is exacerbated where it leads to the contract lapsing and having to be re-tendered in the following FY.

76. Pro-active management of the capital spending program can help to reduce the impact of such delays by for example switching funding from projects where implementation is stalled to those where it can be accelerated. The provisions in the LPFMA covering the in-year reallocation of funding allow considerable flexibility to respond to such situations (Box 9). Greater use of multi-year contracts would also make it easier for projects to 'recover' from unanticipated implementation delays.

Box 9: Flexibility in Managing the Capital Spending Program

Investment spending is difficult to plan and schedule accurately, so there is a need for considerable flexibility to reallocate funds from projects that are delayed to projects on which spending may be proceeding ahead of schedule.

The LPFMA provides such flexibility:

- For a reallocation between projects within a single program there is no restriction since the projects fall into a single appropriation category (capital outlays).
- For a reallocation between appropriations of a single BO up to an amount of 20% of the negatively affected appropriation the authorisation of the Minister for Finance and Economy is required.
- For reallocation of between 20% and 40% of the negatively affected appropriation the authorisation of the Government and SRSG is required
- For reallocations of above 40% of the negatively affected appropriation the authorisation of the Assembly and SRSG is required.

Monitoring of Capital Spending Program Implementation

77. Monitoring procedures for the capital spending program are still evolving. The MFE undertakes a mid-year review of the implementation of the KCB. Following this review any necessary adjustments required to the Budget are introduced and if required a Revised Budget is prepared for authorisation by the Assembly and SRG. Additionally, following the MFE study of underspending the MFE has taken steps to strengthen monitoring arrangements for the capital spending program. Reports from the FMIS are being used by MFE budget analysts as a basis for meetings with BOs to monitor project progress and identify actions to be taken in order to address implementation delays.

78. The MFE should build on this initiative and establish a requirement for BOs to organise quarterly monitoring meetings to review capital spending program implementation. MFE desk officers should attend the meetings and a report of the discussion, its conclusions and recommended actions should be provided to MFE. The financial reports generated from the FMIS should provide the basis for monitoring of the investment program. The BO should agree with the MFE what additional reporting on physical implementation progress should be provided by Project Managers.

H. Conclusions and Next Steps

The Underlying Causes of Underspending

79. The main conclusion of this note is that Kosovo has an appropriately elaborated legal and regulatory framework for public investment management and public procurement. Capacities to implement the specified procedures are limited. As a result full use is not being made of the procedures elaborated under

the LPFMA and the LPP is not being made. In practice, the reasons for underspending on the capital spending program traverse a range of issues relating to the way in which public investment projects are planned, budgeted and implemented. Behind these reasons two underlying causes of underspending can be identified:

- The single year outlook that underlies key aspects of public investment management, including the way in which the PIP procedures operate, the approach to budgeting of the capital spending program, and the operation of public procurement procedures. This impacts on the implementation of the capital spending program in a number of ways:
  - ◊ It severely limits the time over which investment projects can be implemented. Allowing for the time taken for procurement and contractor mobilisation, it becomes virtually impossible for any significant level of implementation to be achieved during the first 4-5 months of the year.
  - ◊ It concentrates investment of specific project cycle activities at certain times, rather than spreading them over the year. Thus project identification and preparation activities tend to be concentrated during a relatively short period linked to the deadline of 15th June for the submission of PIP forms and Budget Submissions for the next budget year. Similarly procurement activities are concentrated during the period March to September. This creates peak demands that exacerbate capacity constraints leading to projects being less well designed and prepared and contributing to delays and hold-ups in the procurement process.
  - ◊ It fragments the capital spending program into a large number of small projects to be implemented within a single year. In extreme cases this results in what ideally should be considered a single investment operation being divided up into a number of one year projects. The resulting need to repeat the tendering process annually creates unnecessary capacity demands, increases investment costs and further reduces the time available for implementation thereby pushing back project completion.

  This single year outlook does not derive from deficiencies in the conceptual and legislative framework covering public investment spending. The LPFMA specifies that the capital spending program should be reflected in the KCB in a way that specifically recognises that investment projects should be expected to be implemented over periods that exceed a single FY. Consistent with this, the PIP format has been designed to cover multi-year investment projects. Similarly, the LPP makes specific provision for the award of tenders on contracts that span more than one FY and which will need to be covered by appropriations in subsequent budgets. Rather it is the application of these procedures that reflects a short-term planning and management outlook which is unsuited to the type of public investment that is now needed to support the medium and longer term development of Kosovo's economy.

- Capacity constraints that adversely affect the planning, management and implementation of the capital spending program. These are reflected in:
  - ◊ The absence of strategic focus to the capital spending program with investment proposals developed in response to the budget circular rather than as a part of the on-going business processes of the BO. This can result in projects being included into the KCB that are insufficiently specified and poorly costed. Project management arrangements are often insufficiently considered during project preparation, leading to problems and delays at during subsequent implementation.
  - ◊ Inadequate preparation prior to the start of the FY. Insufficient use is made of the period between finalisation of the draft KCB and the beginning of the FY to prepare for project implementation. Tasks such as finalisation of detailed designs and the preparation of tender specifications are typically left to the beginning of the FY thereby significantly delaying the initiation of procurement activities.
  - ◊ Preparation of the annual cash flow plan left until after the start of the FY. This results in the late funds release thereby delaying the initiation of tender procedures. The tight deadlines that result from the single year focus of the capital spending program further compound the impact of delays in the start up of the project implementation.

  Addressing capacity constraints has proved problematical. While considerable technical assistance and training support has been provided in recent years, this has tended to focus on project preparation procedures. The development of capacities for capital spending program and project management in the BOs has received less attention. Relatively low salaries mean that rates of attrition among trained staff are high particularly for scarce technical and financial skills for which there are good opportunities for employment outside of the public sector. Looking to the medium and longer term it will be important, in a situation of continued attrition of skilled staff, that training capacities covering the range of aspects of public investment management are institutionalised within KIPA.

Next Steps

80. In tackling the issues relating to underspending of the capital budget, the MFE should distinguish between those measures that could be expected to have an immediate effect on the implementation of the 2007 and 2008 Budgets, and those which would primarily impact on the implementation of the capital spending program in 2009 and beyond. These are summarised below.

- <u>Immediate Measures</u> (impacting on the 2007 and 2008 budgets).
  - ◊ Finalisation of the 2008 capital spending program:
    - – BOs should be encouraged, where possible and appropriate, to group small investment activities into larger projects in order to increase the strategic focus of the capital spending program.
    - – MFE should revise the format of Schedule 4 of the Annual Budget to show for each project its total estimated cost together with a breakdown of the phasing of these costs over the full implementation period of the project.
    - – MFE should provide guidance to municipalities on improving the realism of their forecasts for OSRs in order to ensure that capital budgets are set against a more realistic resource framework.
  - ◊ Preparation for procurement operations under the 2008 capital spending program:
    - – BOs should, after finalisation of the Budget, develop a schedule for the coming year that sets out a timetable for planned procurement activities. This should take account of the capacity constraints and the work demands on the Procurement Department. The procurement schedule should identify those projects for which the award of multi-year contracts would is required.
    - – BOs should ensure that, to the extent possible, technical designs and tender documentation are finalised before the start of the FY.
    - – BOs should issue Indicative Contract Notices during November 2007 for the most urgent procurement operations so that use can be made of the shorter 24 day tender period.
    - – MFE, in its monitoring of the capital spending program implementation during the last quarter of 2007, should also focus on the preparatory activities for the implementation of the 2008 capital spending program.
  - ◊ Ensuring more timely funding release:
    - – MFE should work with BOs to identify and resolve the causes of delays in preparation and submission of the annual cash flow plan and securing funding release. The aim should be to have the cash flow plan prepared by the end of the December, so that implementation of the 2008 Budget can commence immediately.
  - ◊ Implementation of the revised public procurement procedures.
    - – The MFE Budget Department should work with the PPA and the BOs to improve the planning for and preparation of procurement operations. It should also monitor implementation of new procedures/time limits under the revised procurement legislation to identify causes of significant delays and possible remedial actions.
- <u>Medium-Term Measures</u> (focused on the 2009 Budget and beyond)
  - ◊ Integration and further development of PIP procedures.

- MFE should further strengthen the linkage and alignment of the PIP and budget processes. The PIP procedures should be further developed to facilitate planning and management of a multi-year capital spending program linked to the MTEF forecasts. In particular, the PIP procedures should emphasise the prioritisation of BO capital spending plans against a realistic medium-term resource framework for capital spending.
- MFE, in developing the PIP procedures, should give particular emphasise to improving the quality of project preparation. This would be facilitated by the introduction of a more stepped process in which projects were subject to an initial screening at the concept stage, preliminary approval following identification and appraisal, and full approval following detailed design and preparation involving, where needed, feasibility and design studies. The MFE should establish a Capital Investments Committee that would meet 3-4 times during the year in order to review investment proposals and grant provisional and final approval to projects. Only capital projects that have received final approval should be considered for inclusion for funding under the KCB.
- MFE, should raise the current threshold of €5,000 above which capital spending allocations are subject to the full PIP procedures. It should determine an appropriate limit for this threshold well as for the maximum proportion of a BO's capital spending program that could be allocated to minor capital works projects. A simplified format should be developed for presenting such projects as part of a ministry's budget submission.

◊ Strengthening institutions and capacity building.

- BOs should designate a specific project manager for each project under development or implementation;
- MFE should develop guidelines for managers of capital investment projects. Training material should be developed and training courses organised in collaboration with KIPA.
- KIPA in collaboration with MFE should establish a twinning arrangement with a European training institution to provide support for the development and introduction of a training program on public investment management as part of wider PFM training function. Development partner support should be sought for this initiative.
- MFE should ensure that there is more effective coordination of development partner assistance to the KDSP, the MTEF, budget planning and management and the PIP. It should consider the introduction of an integrated approach to technical assistance work program planning across these areas.
- MFE should consider moving management responsibility for MTEF preparation to the Budget Department reflecting the role of the MTEF as the strategic stage of the budget preparation cycle.

Annex I

Assessment Framework

Area/Issue	Analysis	Impact on Public Investment Management	Recommended Actions
1. Capital Investment Identification and Preparation			
1.1 Weak strategic basis for investment planning.	▪ Absence of a well articulated set of policy and program priorities to guide investment planning. However: ◊ through KDSP process an overall policy and strategy framework is being put in place, with policy and planning units to be established; and ◊ increased emphasis in 2008-10 MTEF on linking resource allocations to strategic priorities. ▪ Links to strategic, sectoral and BO policies and priorities emphasised in PIP procedures.	▪ Capital spending program does not adequately reflect the Kosovo Authorities' strategic priorities. ▪ Reduces impact and effectiveness of capital spending.	▪ Strengthen linkages between policy, planning and budgeting processes through: ◊ further development of KDSP and MTEF initiatives; ◊ requiring BOs to start identify capital spending priorities from their sector policy and strategies. ◊ evaluating project proposals for consistency with Kosovo's policies, strategies and priorities ◊ training of BO budget staff in policy-led budgeting procedures.
1.2 Project identification and preparation could be better sequenced	▪ PIP procedures do not allow for decisions to be made at key points during the development of an investment proposal as to whether it should proceed to the next stage. ▪ No provision for considering requirements for detailed feasibility and design studies. ▪ Concern that PIP procedures may be too complex and sophisticated for the majority of projects.	▪ Considerable time spent on developing investment prop-osals for projects which should have been rejected at an earlier stage. ▪ Projects may be approved without having been adequately specified and designed, leading to subsequent implement-ation difficulties and delays.	▪ Introduce stepped process into the PIP procedures for the approval of investment proposals involving: ◊ screening of the project concept by the BO; ◊ preliminary approval at conclusion of project identific-ation stage that: (i) allows project to be included in BOs forward capital spending program; and (ii) provides go-ahead for proceeding with detailed design and appraisal. ◊ final approval by MFE of the project prior to it be considered for inclusion in the next Budget. ▪ Establishment of Capital Investments Committee under MFE responsible for reviewing and providing provisional and final approval of capital investment projects.
1.3 Open-ended project identification and preparation procedure which does not require BOs to prioritise their investment proposals against a realistic resource constraint..	▪ No initial capital spending ceilings are provided to BOs in Budget Circular 01. ▪ Project proposals submitted to the MFE greatly exceed the available funding. For the 2008 Budget ◊ Ministry of Transport and Communications identified capital spending requirement of €125 million against an allocation of €24 million in the 2007 KCB; ◊ KTA identified a requirement of €207 million against an allocation of €50 million in the 2007 KCB. ▪ Excessive number of capital project proposals in PIP system (1,179 for the 2007 Budget cycle).	▪ BOs spend considerable time on preparing project prop-osals that have no chance of financing from the KCB. ▪ Analysts in BOs and MFE have very limited time to review each project proposal. Emphasis on processing rather than analysis.	▪ Improve the realism of investment planning by: ◊ disaggregating MTEF resource ceilings between indicative current and capital spending elements; ◊ requiring BOs to prioritise their investment proposals against their medium-term resource ceilings taking into account the financing demands of on-going projects; ◊ limiting the approval of new capital investment projects to what has a reasonable prospect of being funded (say no more than 20% above the MTEF resource ceiling).
1.4 Capital investment proposals tend to be identified as single year projects.	▪ The concept of multi-year projects is being introduced with introduction of PIP procedures, but still not well established: ◊ larger investments tend to get broken down into a series of smaller single year projects; ◊ related but distinct activities (e.g. construction and equipping of facility) often treated as separate projects; and ◊ results in excessive number of projects in PIP system.	▪ Loss of strategic focus to PIP and capital spending program due to fragmentation of investment activities. ▪ Procurement process fragmented as limited to single year rather than total cost of investment. ▪ Piecemeal implementation of major investments results in higher costs and implementation delays. ▪ Creates uncertainty over the funding of follow-on investment - danger of facilities remaining uncompleted or without equipment.	▪ Emphasise in the PIP instructions that: ◊ capital projects should be defined at a more strategic and consolidated level; ◊ PIP project proposals should be specified to cover total estimated cost (TEC) of the proposed investment; and ◊ project costs should be phased over the full implement-ation period. ▪ Phasing of project expenditure should be updated with each subsequent Budget. ▪ Revised/updated PIP project proposal forms should only required if project TEC is to be changed.

Area/Issue	Analysis	Impact on Public Investment Management	Recommended Actions
1.5 Subordination of public investment planning to the tight time deadlines of the annual budget.	▪ MFE has rightly emphasised the importance of aligning the PIP procedures with the requirements of the budget planning system. ▪ BOs now using PIP proposal forms for submission of budget estimates. ▪ But identification, planning and appraisal of investment proposals often takes considerable time and resources and should be seen as a task that is on-going throughout the year.	▪ By linking the PIP procedures to tightly to those of the annual budget there are risks of: ◊ compressing the development of investment proposals into a relatively short period of the year adversely affecting the quality of project design and preparation. ◊ accentuating the current single year focus of the PIP, rather than emphasising the development of a more strategic medium-term capital spending program.	▪ De-link the process of identifying and developing investment proposals from the timetable for preparation of the annual budget. ▪ Only consider projects that have be thoroughly prepared and appraised, and which have been approved by MFE under the procedures outlined under 1.2 above for inclusion in the KCB.
2. Capital Budget Preparation and Presentation			
2.1. Projects can be included in the KCB without having been fully prepared and specified.	▪ Projects developed and planned in response to budget circular rather than as part of business process of the BO. As a consequence projects may be included in the KCB without: ◊ technical designs having been finalised; ◊ land allocation issues having been resolved. ▪ Project planning may be done by Budget and Finance Divisions rather than by technical/implementing departments.	▪ Can result in: ◊ implementation delays while detailed designs and specification are prepared; ◊ implementation delays due to inadequately defined management arrangements for the project; ◊ inappropriate design standards and poor quality of works, and ◊ cost overruns due to weak basis of original cost estimate.	▪ Emphasise in PIP procedures that project identification and preparation is a year round function. ▪ Require projects to be approved by Capital Investments Committee before they can be included into the KCB (see 1.2 above).
2.2 Large number of small capital projects included in the Annual Budget.	▪ In the 2007 Budget 171 out of 315 new projects in the central capital spending program had a total allocation of €200,000 or less, with 54 projects costing €50,000 or less. ▪ Municipal project allocations often little more than minor works.	▪ Loss of strategic focus in the planning and evaluation of budget submissions for the capital spending program. ▪ Increased complexity and number of procurement operations creating additional risks of implementation delay. ▪ Increases demands on capital spending program management.	▪ Increase strategic focus of capital spending budget by reducing number of projects in the KCB through: ◊ grouping related investment costs (works, equipment etc.) within single project; ◊ grouping smaller capital investments into programmatic projects; ◊ introducing a category of minor capital works projects that would not be subject to the full PIP procedures; ◊ establishing an appropriate maximum threshold for minor capital works projects and a maximum share of a BO's capital spending program that could be allocated to such projects.
2.3 Budget only shows single year resource allocations for capital projects.	▪ Budget documentation does not include information on total cost of project and planned phasing of expenditure. ▪ The LPFMA requires the MFE to include a Capital Spending Plans as part of the Budget document. This should inter-alia specify 'estimated total project costs and the cost in each year during which the project is implemented'.	▪ Projects tend to be managed against their annual budget allocations rather than the TEC of the investment. This results in: ◊ increased costs and longer implementation periods due to fragmented implementation planning; and ◊ weaker management control over project costs. ▪ Limited forward planning of capital spending program as future funding requirements for on-going projects not explicitly recorded in the Budget.	▪ Listing of capital projects in the annual budget documentation should include a schedule showing: ◊ Total Estimated Cost (TEC) of the project; ◊ expenditure in previous years; ◊ revised estimate of expenditure for current year; ◊ estimate of expenditure for next budget year; ◊ estimated spending for two further years ◊ balance of spending required to complete the project. ▪ Treat future funding requirements on on-going projects as a first call on outer year MTEF capital spending allocations.

Area/Issue	Analysis	Impact on Public Investment Management	Recommended Actions
2.4. The switch to cash-based appropriations has made it more difficult for BOs to implement their capital spending program.	▪ Commitment-based appropriations that operated prior to 2005 allowed projects to be implemented over a two year period or longer provided that a funding commitment had been made in the year of appropriation. ▪ Cash-budget budgeting introduced in order to reinforce control over fiscal aggregates. Funding commitments now lapse at the end the end of the FY.	▪ Reinforced the single-year focus on the capital spending program and reduced time available for contract implementation. ▪ This has accentuated the impact of commitment and procurement delays and contributed to reduced execution of the KCB.	▪ Shift focus of capital spending program and management to multi-year projects and make greater use of multi-year contracts. ▪ Manage successive annual appropriations for projects against TEC.
2.5. Execution rates on municipal capital spending programs are significantly lower than for central BOs.	▪ Level of execution of municipal capital spending program in 2006 was 63% significantly below that for the central capital spending program. ▪ Municipal capital spending budgets are primarily financed from OSRs. Treasury procedures require that revenues must be collected before they can be committed and procurement initiated. ▪ OSRs can be carried forward to finance spending in the next year. ▪ OSRs significantly overestimated in municipal budgets. In 2006 OSR collections reached only 82% of forecast levels.	▪ Municipalities consider that because revenue collection occurs mainly during the latter part of the year, this prevents timely initiation of procurement procedures and results in significant underspending of the capital spending budget. ▪ However, since OSRs can be carried forward, this is primarily an issue of the management of municipal OSRs. ▪ Overestimation of OSRs results in cut-backs in the funding available for commitments contributing to underspending of original budget appropriations.	▪ Strengthen PFM capacities in municipalities to improve management of budgetary resources including provision of training and guidance on: ◊ planning and management of municipal capital spending programs. ◊ management of cash flow and OSRs; ◊ revenue estimation and the adoption of conservative budget forecasts.
2.6 Inclusion of externally financed capital investment within the KCB.	▪ In 2006, externally financed projects accounted for only 7% of total capital spending in the KCB. ▪ Limited off-budget financing of capital projects undertaken through directly administered externally financed projects. However, in 2005 this totalled €29.4 million, accounting for only 24% of total external assistance.	▪ Post-status, it is expected that Kosovo will receive additional external assistance for budget support and financing of capital investment projects. ▪ PEFA assessment found that 'the quality of Kosovo's PFM systems was good enough to allow Kosovo's external development partners to channel their assistance through the Government's financial management machinery'.	▪ The authorities should take a strong position that all external assistance for capital projects should be on-budget and channelled through Kosovo's own financial management procedures. ▪ Implementation measures identified in this report aimed at strengthening the planning, budgeting and implementation of the capital investment program should improve execution of the capital spending program and build the confidence of development partners to channel funding through the KCB.
2.7 Budgetary financing for POE capital investment projects.	▪ KCB financing for capital projects currently provided in the form of capital grants. ▪ Proposed to finance from the KCB a €83 million invest-ment loan to KEK for rehabilitation of mine machinery and mine expansion. ▪ Tolerance of theft of, and non-payment for, service undermines financial viability of public utility enterprises.	▪ Lack of financial profitability means that POEs are not generally in a position to borrow for capital investment. ▪ Financing POE investment through capital grants prov-ides little incentive to address underlying causes of weak financial performance of POEs (tolerance of theft and non-payments, inadequate business planning, weak management etc.)	▪ Consider channelling KCB funding through capital loans to those POEs that have a relatively strong cash flow: ◊ lending should be at market rates; ◊ where cash flow cannot sustain full cost of loan, provide an element of the financing as a capital grant rather than use interest rate subsidies. ▪ Adopt timebound program to eliminate theft and non-payments in public utilities and incorporate into business plans for POEs. Link interim budgetary subsidies tightly to these plans so that POE business plans are not undermined but incentives exist to implement them.

Area/Issue	Analysis	Impact on Public Investment Management	Recommended Actions
3. Capital Budget Implementation and Procurement			
3.1 Inadequate arrangements for project management.	▪ Project managers not always designated or empowered to take decisions. ▪ BO structures not always well suited to management of capital spending program (e.g. construction program in health managed by regional hospital directors). ▪ More use could be made of the FMIS for monitoring of implementation of projects in BOs. ▪ Arrangements for reporting on physical implementation progress not consistently developed across BOs.	▪ Weaknesses in project management contribute to: ◊ delays in implementation and resultant increased costs; ◊ technical standards not being met due to poor quality supervision; ◊ underspending of capital spending appropriations. ▪ Lack of monitoring information and weak monitoring procedures makes it difficult for BO management and MFE to identify poorly performing projects and initiate timely remedial actions.	▪ Develop guidelines for capital spending project management and implementation. Develop training material and organise training courses in collaboration with KIPA. ▪ Use FMIS to provide monthly financial reports on individual projects to BOs and MFE desk officers.
3.2 BOs fail to prepare adequately for project implementation.	▪ Finalisation of technical designs, preparation of tender documentation issuing of procurement forecasts typically not initiated until start of FY.	▪ Can contribute to: ◊ delays start of procurement process; ◊ increased risk of procurement hold-ups due to hastily prepared tender documentation; and ◊ reduced time for project implementation during FY contributing to underspending of appropriation.	▪ Where possible finalise technical designs and tender documentation before start of FY. ▪ BOs should develop a schedule for the next FY setting out a timetable for planned procurement activities. This should take account of the capacity constraints and the technical demands and the Procurement Department. ▪ Monitoring of capital spending program during final quarter of year should also focus on preparatory activities for projects being launched in following year.
3.3 Delays in the commitment of budget funding and in the initiation of procurement on capital projects.	▪ Delay in BO submission of annual cash flow plan at start of year results in delay in MFE issuing authority to incur expenditure (funding release) which is required before a BO can initiate a procurement tender. As a result BOs typically unable to start procurement until towards the end of the first quarter.	▪ Delays procurement process and shortens period for project implementation thereby contributing to underspending on capital projects. ▪ Concentration of capital spending during the last quarter of the year. ▪ Concentrates contractor/supplier workload during a more limited period – leading to capacity constraints and increased costs.	▪ MFE should work with BOs to minimise delays in issuing of funding releases. BO's should prepare cash-flow plan prior to end of preceding FY.
3.4 Length of and delays in the tendering process.	▪ Tender procedures have taken a minimum of 52 days. LPP has been revised to reduce minimum tender periods (to 40 days of contracts >€250,000, 25 days for contracts <€250,000). Additional time can be taken by tender appeals process. ▪ Tendering period can be reduced to 24 days by use of an Indicative Procurement Notice which can be issued once the project has moved into the planning phase. ▪ However public procurement procedure reflect international good practice and are not significantly longer than those in other countries. ▪ Tenders frequently fail or approval delayed due to failure to attract three bids. The provision for granting waivers to the requirement is well used.	▪ The time taken for procurement significantly reduces the period available for subsequent execution of works contracts (when weather constraints are also factored in, this may result in less than six months being available for contract implementation). ▪ This is particularly problematical for single year procurement contracts since it contributes to : ◊ delays in project implementation; ◊ partial completion of works contracts necessitating re-appropriation and re-tendering in subsequent years; ◊ underspending against capital budget appropriations. ▪ Additional delays and costs when to procurement has to be repeated following the failure of a tender..	▪ Monitor implementation of procedures/time limits under revised procurement legislation. Identify causes of significant delays and possible remedial actions. ▪ Make greater use of multi-year procurement contracts (see below) in order to reduce impact of length of tendering process. ▪ Make greater use of Indicative Procurement Notice both to forward plan procurement operations and allow use of reduced tendering period.

Area/Issue	Analysis	Impact on Public Investment Management	Recommended Actions
3.5 Limited use of multi-year contracts results in the need to re-tender in subsequent years.	▪ Limited use of multi-year contracts. Although LPP provides for the issuing multi-year procurement contracts, this facility is not widely used.	▪ Single year contracts lead to unnecessary splitting up of project implementation activities resulting in: ◊ higher costs as construction activities have to be split into a series of single year contracts; and ◊ additional costs and implementation delays due to need to repeat procurement in subsequent years; ◊ over-ambitious implementation plans in order to fit within single year contract. ◊ concentration of procurement activity during early part of financial year exacerbates capacity constraints within procurement system.	▪ Streamline procedures to allow multi-year contracts wherever this is likely to represent the most effective and best value approach to implementation of the project. ▪ Implement recommendations above to reduce single year focus of investment project planning (1.4) and budgeting (2.3).
3.6 Implementation delayed by exogenous factors beyond the control of BOs.	▪ Delays caused by a range of factors including: ◊ bad weather; ◊ limited local supply inventories; ◊ unanticipated technical problems; ◊ failure of contractors etc.	▪ Delays in project implementation and increases in project costs. ▪ Impact exacerbated where contract has to be re-tendered in subsequent year.	▪ Proactive management of capital spending program can help reduce impact of delays by for example allowing: allocations to be switched to other projects on which implementation can be accelerated. ▪ Greater use of multi-year contracts would make it easier to 'recover' from impact of delays.
3.7 Monitoring arrangements for the capital spending program as a whole are still evolving.	▪ Adjustments to budget made following a mid-year budget review for each BO. ▪ No separate monitoring arrangements for the capital spending program in place. ▪ Following the MFE study of underspending, MFE budget analysts have met with BOs to monitor project progress and identify actions to be taken in order to address implementation delays.	▪ Weaknesses in monitoring results in failure to take action to address implementation delays to switch resources to projects on which implementation could be accelerated.	▪ Use FMIS reports as basis for MFE monitoring of investment program. ▪ Organise quarterly capital spending program monitoring meetings in BOs to review progress on capital projects and identify necessary follow up actions to ensure timely implementation. MFE should be represented at these review meetings.