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REPUBLIC OF KOSOVO

TECHNICAL ASSISTANCE REPORT—PUBLIC INVESTMENT MANAGEMENT ASSESSMENT

April 2016

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FISCAL AFFAIRS DEPARTMENT

Republic of Kosovo

Public Investment Management Assessment

Johann Seiwald, Richard Allen, Duncan Last, and Isabel Rial

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F I S C A L A F F A I R S D E P A R T M E N T

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GLOSSARY

AMP	Aid Management Platform
BO	Budget Organizations
EDE	Emerging and Developing Europe
EME	Emerging Market Economies
ERO	Energy Regulatory Office
GFSM	IMF's Government Financial Statistics Manual
IPS	Integrated Planning System
KFMIS	Kosovo Financial Management Information System
LLGF	Law on Local Government Finances
LPFMA	Law on Public Financial Management and Accountability
MED	Ministry of Economic Development
MEI	Ministry of European Integration
MoF	Ministry of Finance
NDS	National Development Strategy
OPM	Office of the Prime Minister
OSP	Office of Strategic Planning
PIP	Public Investment Program
PIU	Project Implementation Unit
POE	Publicly-Owned Enterprises
PPP	Public Private Partnerships
PPPC	Public-Private Partnership Committee
SBA	Stand-By Agreement
SPC	Strategic Planning Committee
SPSG	Strategic Planning Steering Group
TSA	Treasury Single Account
WBIF	Western Balkans Investment Framework

PREFACE

At the request of the Minister of Finance, Dr. Avdullah Hoti, a mission from the IMF's Fiscal Affairs Department visited Kosovo during the period December 9–22, 2015 to conduct a Public Investment Management Assessment and advise the government on improving management practices for public investment. The mission was led by Johann Seiwald of the Fiscal Affairs Department and included Isabel Rial (FAD), Duncan Last (Regional Advisor), and Richard Allen (FAD expert).

During its stay, the mission met with Dr. Avdullah Hoti, the Minister of Finance; Mr. Agim Krasniqi, Deputy Minister of the Ministry of Finance; senior staff of the Ministry of Finance from the Budget Department, Department of Municipal Budget, Department of Joint Services and Finance, Macro Department, and PPP unit; and senior staff from the Prime Minister's Office of Strategic Planning, Ministry of Economic Development, Ministry of Education, Ministry of European Integration, Ministry of Health, Ministry of Infrastructure, Ministry of Local Government, Ministry of Public Administration, and Ministry of Trade and Industry. Meetings were also held with the Office of the Auditor General, the Municipality of Pristina, and the Municipality of Prizren.

The mission also briefed representatives of the respective donors on the mission objectives, including the European Bank for Reconstruction and Development (EBRD), Gesellschaft fuer Internationale Zusammenarbeit (GIZ), KfW Development Bank, the European Union Office in Kosovo, the State Secretariat for Economic Affairs (SECO), USAID, and the World Bank. The representatives expressed interest in a debriefing on the mission's findings in January 2016, which can be conducted by the Regional Advisor, Mr. Duncan Last.

The mission would like to thank the Kosovo authorities for their cooperation in the course of its work. It is especially grateful to Ms. Sanije Himai for organizing the mission schedule and for her close cooperation throughout the mission. The mission wants to express its gratitude to the IMF Resident Representative in Kosovo, Mr. Ruud Vermeulen, and his staff, and Ms. Merita Kernja for coordinating an extensive agenda of meetings. The mission would also like to thank the interpreters Mr. Ukshin Ahmetaj, and Mr. Hyjnor Jasiqi for their support during the mission.

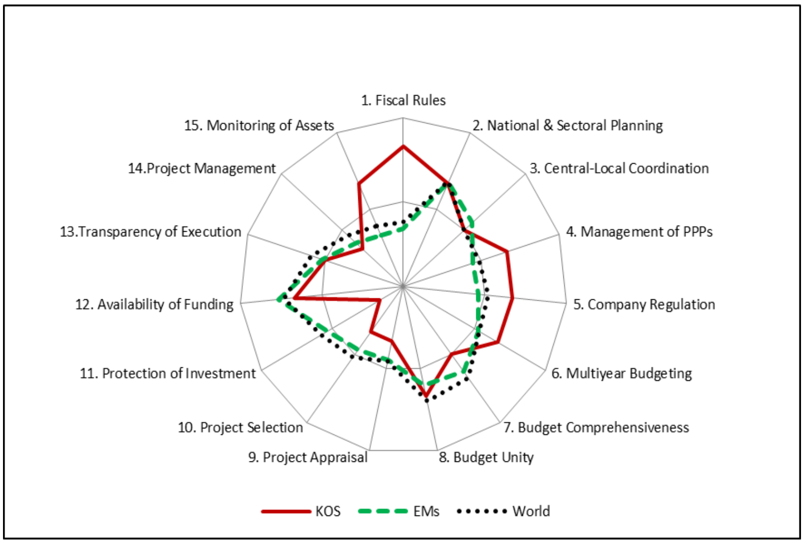
Executive Summary

Kosovo's public investment levels have exceeded comparator counties' over the last four years, partially due to the need to build up its relatively low level of capital stock. Post-conflict, approximately, one-third of total public spending was allocated to finance the procurement of basic infrastructure needs. Public investment peaked at 11 percent of GDP in 2012 on the back of the construction of a new highway to Albania and reversed back to 2008 levels of about 8 percent of GDP in 2014. Kosovo's public capital stock has remained fairly stable at around 50 percent of GDP, slightly below regional average of 60 percent.

Despite the high level of spending, the efficiency of Kosovo's public investment is relatively low. The efficiency of public investment in Kosovo is well below comparator countries with an efficiency gap of 45 percent compared with a regional average of 30 percent and Emerging Market Economies (EME) average of 40 percent. Significant investment in roads and economic infrastructure have begun to pay off, but quality of education and health infrastructure is well below regional standards. Analysis indicates that much of the efficiency gap could be reduced through strengthening public investment management institutions.

Most of Kosovo's public investment institutions are of good or medium strength on paper, but much weaker in their practical implementation. As summarized in Figure 0 and Table 0, compared to peer countries, fiscal rules, management of public-private-partnerships (PPPs), company regulation of infrastructure state-owned enterprises, multi-year budgeting, and monitoring of assets score relatively better, but institutions relating to budget comprehensiveness, project selection, project management, and protection of investment are weaker. Many institutions, however, have weaknesses in implementation, which reduce their effectiveness.

Figure 0. Institutional Strength of PIM Institutions



Source: Staff estimates.
Planning institutions: 1-5, allocating institutions: 6-10, implementing institutions 11-15.

Planning institutions for investment are comprehensive but not fully effective (Section III.A). Specifically:

- Kosovo has a debt (since 2009) and a deficit rule (since 2014) with an escape clause, an automatic correction mechanism, and an investment clause that under certain conditions exempts public investment financed by privatization receipts and external donors from the deficit ceiling of 2 percent of GDP. While the deficit stayed within the margins allowed for by the rule, it exceeded the ceiling by 0.4 percent of GDP in 2014, the first year of implementation.

- A National Development Strategy (NDS) is being prepared. Around 80 sectoral strategies are published, which include performance indicators and costings for major projects, but many costings are not comprehensive.

- Central and municipal investment plans (amounting to one fifth of capital spending) are consolidated and discussed formally during the budget process, but no comprehensive rule-based system for capital transfers to municipalities is in place.

- PPPs (capital stock of 1.7 percent of GDP in 2014) are guided by a PPP strategy and reviewed for value-for-money money by a PPP unit in the Ministry of Finance (MoF).

- The legal and regulatory framework supports competition in markets for economic infrastructure, and prices are set by four independent regulators. Oversight of the 18 publicly owned enterprises (POEs) is focused primarily on operational performance.

Systems for allocating funds for capital investment are assessed good or medium, with some implementation gaps (Section III.C). Specifically:

- The rolling medium-term expenditure framework (MTEF) incorporates indicative ceilings for capital expenditure for a three-year period, but lacks information on multi-annual commitments. Substantial forecasting errors occur for the two outer-years of the MTEF (23 percent two years ahead, and 10 percent one year ahead).

- The budget provides a relatively comprehensive picture of capital spending. Only projects funded by external grants, amounting to less than 3 percent of total investment, and PPPs are not included.

- The presentation of capital and current expenditure is in line with the IMF's Government Financial Statistics Manual (GFSM) 2001 standards, but 5 percent of capital expenditure was misclassified in 2014.

- A Public Investment Program (PIP) Manual provides comprehensive guidance on project appraisal (including cost benefit analysis). However, many budget organizations (BOs) do not carry out the required procedures, and risk assessment is not conducted.

- Project selection is mainly in the hands of BOs, based on criteria laid down in the PIP Manual. Two pipelines of investment projects have been established, but provide limited guidance on the inclusion of projects in the budget and MTEF.

The government's investment implementation institutions are rated medium on average but contain significant gaps (Section III.D). Specifically:

- Appropriations for capital investment are annual, virements from capital to current spending are allowed within the rules of the budget legislation, and there is limited scope for carryover of unspent funds, which limits the protection of budgetary allocations for investments over the lifetime of individual projects and impacts execution. While at 10 percent the average under-execution of the capital budget of recent years is well below the EME average of 26 percent, the under-execution in 2014 alone was just under 23 percent.

- The procurement law provides for competitive and transparent procedures, but these are not always systematically implemented.

- Ex post audits of major projects are rarely undertaken (due to many cases of ongoing litigation), and ex post reviews of projects by MoF and BOs are also generally not conducted.

- The law requires project implementation to be monitored and explanations for delays or cost overruns to be given, but in practice monitoring is limited and explanations are rarely provided even when delays or overruns are substantial.

- The government's accounting system includes a comprehensive asset statement, including depreciation, which is published in the annual financial report of Government. However, the Auditor General has routinely questioned the quality of this data.

This report makes eight recommendations aimed at enhancing and enforcing the current institutions, and closing the identified gaps. These include the need to:

- Implement and publish the National Development Strategy, and consolidate sector strategies, including costing for capital and current costs over the medium term.

- Increase transparency of budget documentation by including an annex for PPP and POE investments, and a statement of contingent liabilities.

- Include a schedule of multi-annual commitments/contracts and information on total project costs and project duration in the budget.

- Include the planning of subsequent operation and maintenance costs in capital project proposals and sector strategies, and carry out systematic studies of maintenance needs in key sectors.

- Strengthen the role of the Budget Department and the MoF in general in project appraisal and selection through legislation, and streamline institutional arrangements for taking decisions on the pipeline of eligible projects.

- Establish quality control checks by MoF for data entered by BOs in the PIP system, and review the functionalities and use of the system.

- Pilot ex post reviews, by MoF and BOs, of selected, high risk projects.

- Initiate a dialogue on the conditions under which the Auditor General may conduct audits of projects that are under litigation aimed at initiating audits on investment projects as soon as possible using a risk-based approach.

Table 0. Public Investment Management Assessment: Summary Heatmap

Phase / Institution			Institutional Strength	Effectiveness	Rec.
A. Planning	1	**Fiscal rules**	**Strong:** Debt rule since 2009, deficit rule in effect since 2014, with an investment clause and automatic adjustment mechanism.	**Medium:** In 2014, the deficit exceeded the ceiling by 0.4 percent of GDP within the margin, despite under execution of capital spending.	5, 6
	2	**National and sectoral planning**	**Good:** National development under preparation; multiplicity of sectoral strategies with some performance measures.	**Low:** Around 80 sectoral strategies are in place, without clear coordination and incomplete costing.	1, 4
	3	**Central-local coordination**	**Medium:** Debt limits constrain debt for municipalities; information for municipalities timely; no rule-based allocation of capital transfers.	**Medium:** In 2014, optimistic projections of own revenues of 6 million result in corresponding under execution of capital spending for municipalities.	
	4	**Public-private partnerships**	**Good:** PPPs guided by strategy within strong institutional and legal framework, but not included in MTBF or budget documentation.	**High:** Existing PPPs capital stock account for 1.2 percent of GDP, but several projects planned. Fiscal risks currently low.	2
	5	**Regulation of infrastructure companies**	**Good:** Regulatory framework supports competition; prices set by independent regulators; weak financial oversight assessment of fiscal risks of POEs.	**Medium:** Challenges to regulators' independence. Public investment of POEs account for 0.1 percent of GDP, but fiscal risks not assessed.	2
B. Allocation	6	**Multi-year budgeting**	**Good:** Multi-year ceilings of capital spending are published based on not published projections of full cost of capital projects, but not binding.	**Low:** There are large discrepancies between MTBF ceilings and budget allocations (22 percent for n+2).	1, 3
	7	**Budget comprehensiveness**	**Medium:** Budget incorporates loans and co-financed donor funding, but not externally financed grants and PPPs.	**High:** Externally financed projects not in the budget less than 3% of total capital spending; extra-budgetary capital spending is insignificant.	2
	8	**Budget unity**	**Good:** Budgets disclose capital and current appropriations in a single document in line with GFS, but project specific information is not disclosed.	**Low:** Auditor General qualified the 2014 financial statements because of 5 percent misclassifications of current as capital spending.	4
	9	**Project appraisal**	**Medium:** The methodology is comprehensive; but results not published and limited risk analysis.	**Medium:** MoF and BOs lack resources to undertake the required analysis.	5
	10	**Project selection**	**Medium:** Most project selection carried out by BOs, broadly in line with criteria in PIP Manual; but role of MoF weak and no legal basis.	**Low:** Weak and fragmented decision making on project prioritization and selection contributes to the 45 percent efficiency gap.	5, 6
C. Implementation	11	**Protection of investment**	**Low**: Projects appropriated on annual basis only, no restrictions on virements, and restricted carryovers.	**Medium:** Average under execution of the annual budget was 10 percent, in line with regional average.	3
	12	**Availability of funding**	**Good**: Cash flows planed quarterly and generally released in time, but some grants outside TSA.	**Medium:** 1.1 percent of capital spending is in arrears, but total arrears are 2 percent of GDP in 2014.	
	13	**Transparency of execution**	**Medium:** Procurement law in line with internet standards; quarterly monitoring; limited ex post audit of projects.	**Low:** Court proceedings limit ex post audits of projects to donor-funded projects.	8
	14	**Project management**	**Medium:** Major projects have project managers; adjustment rules generally in place; no ex post reviews.	**Medium:** In 2012 and 2013, around one fourth of the projects had delays.	7
	15	**Assets accounting**	**Good:** Nonfinancial assets regularly surveyed, depreciated and reported annually.	**Medium:** Poor data quality, e.g. mismatch of between capital spending and stocks of 33 percent.	

I. TRENDS IN PUBLIC INVESTMENT[1]

A. Trends in Total Public Investment and Capital Stock

1. **Capital spending has been a key element of fiscal policy since independence.** Since 2008, the authorities have adopted a counter-cyclical fiscal policy that prioritized public investment in infrastructure to support economic growth. The general government deficit—covering central and local governments—peaked at 3.0 percent of GDP in 2013. Despite the deterioration of the deficit by almost 3 percentage points of GDP since 2008, general government gross debt remained within sustainable levels, at 17.5 percent of GDP on average (Figure 1.A). From 2008 to 2012, public investment increased from 8 percent of GDP to 11 (Figure 1.B). This increase is mainly accounted for by the implementation of a single large transport project, Route 7.[2] The latter accounted for 40 percent of total capital spending in 2012 and 2013 (Figure 1.C). The capital stock averaged 50 percent of GDP over the same period, with small improvements after 2012 due to high investment since 2009 (Figure 1.B).[3]

Figure 1.A. Kosovo: General Government Debt and Deficit (percent of GDP)

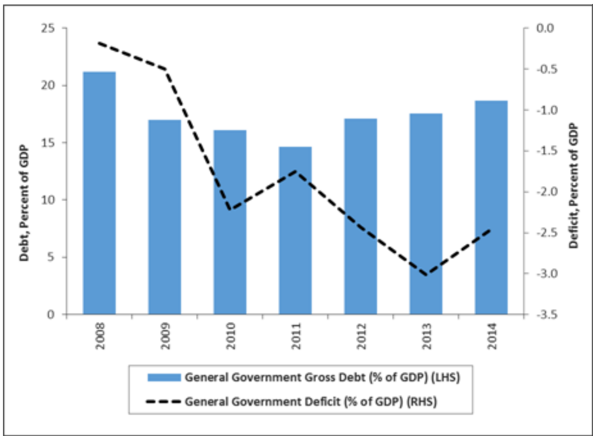
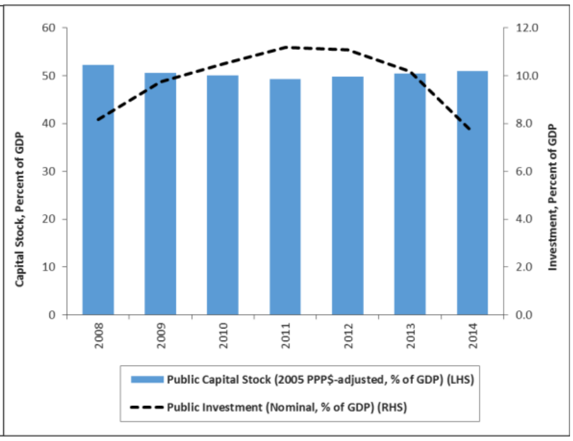


Figure 1.B. Kosovo: Public Investment and Capital Stock (percent of GDP)



Sources: WEO and staff estimates based on official data.

2. **Post-conflict, approximately one-third of public spending was allocated to finance the development of basic infrastructure.** Public investment accounted for 10 percent of GDP in 2013, and for 36 percent of primary spending (Figure 1.D). The rate of

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[1] Public investment is measured as general government gross fixed capital formation and comprises the total net value of general government acquisitions of fixed assets during the accounting period, plus variations in the valuation of non-produced assets (e.g., subsoil assets).

[2] Route 7 Highway, connecting Pristina and Albania, is a publicly financed investment project procured by the Ministry of Infrastructure. The cost of constructing the highway to the Albanian border between 2012–14 amounted to about 20 percent of GDP.

[3] The methodology for estimating public capital stock is detailed in the IMF Board Paper "Making Public Investment More Efficient", June 2015.

implementation of capital spending (budget appropriation relative to actual execution) also improved during this period, from 80 percent in 2008 to an average of 90 percent between 2009–13, though this partly reflected the influence of one major road project (Route 7).

Figure 1.C. Kosovo: Public Investment Composition Main Projects
(In percent of GDP)

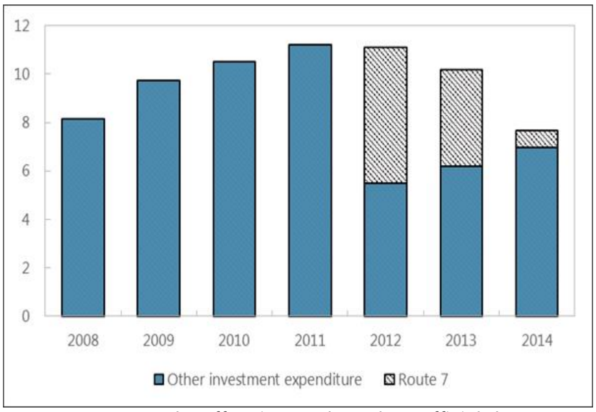
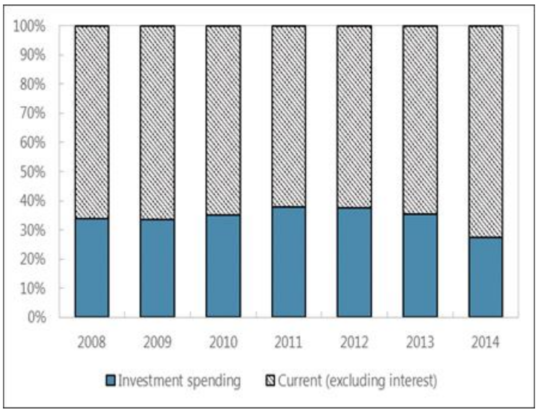


Figure 1.D. Kosovo: Share of Public Investment in Primary Spending
(In percent)



Sources: WEO and staff estimates based on official data.

3. **In 2014, capital spending reverted to the levels observed in 2008, as a result of fiscal measures taken to preserve fiscal sustainability.** The fiscal rule approved in 2013, limits deficits and public debt to ensure fiscal sustainability. In 2014—the first year of implementation—the authorities cut investment spending below the originally budgeted level to keep the deficit within the limits of the rule, in the face of a sharp increase in current spending. As a result, investment spending decreased by 2.5 percentage points of GDP, falling to 7.3 percent of GDP in 2014, similar to the level observed in 2008. However, part of this decline relates to the finalization of Route 7. Excluding the latter, investment spending increased by 0.8 percentage points of GDP relative to 2013, albeit below the amount originally allocated in the budget.

4. **Public investment is mostly financed through domestic sources.** External funding for investment fell sharply from the levels observed in the early 2000s.[4] By 2013, donors financed less than 7 percent of public investment. However, around 40 percent of this external funding takes place off-budget (i.e., it is administered directly by donors and is not included in the budget).[5]

5. **Compared to other countries in the region, Kosovo's public investment has been relatively high, reflecting the authorities' priority to promote growth-enhancing spending.** Since 2008, Kosovo spent more in public investment than the average of

[4] The World Bank's report *"Kosovo, Policy Note on Public Investment Management,"* published in 2007, estimated that donor-funded investment spending represented 17 percent of total public investment.

[5] As a result, total investment spending by the government is equal to domestically financed investment spending plus donor-financed disbursements on capital projects.

Emerging and Developing Europe (EDE) countries (Figure 1.E), reflecting the authorities' priority to support growth-enhancing spending. Despite higher investment spending over the last decade, Kosovo's capital stock remains slightly below the average for neighboring countries (Figures 1.F and 1.G).

Figure 1.E. Kosovo: Public Investment, Comparison with Peers
(2005 PPP$-adjusted, percent of GDP)

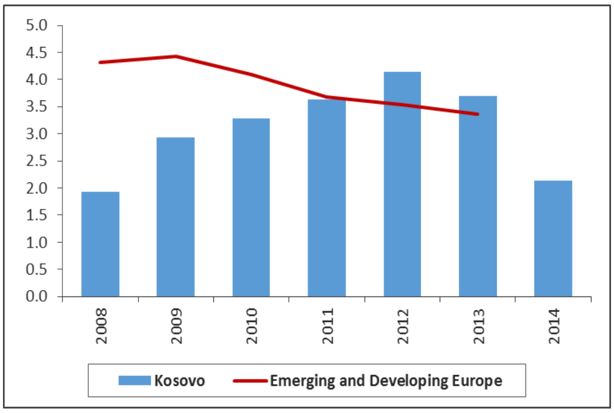
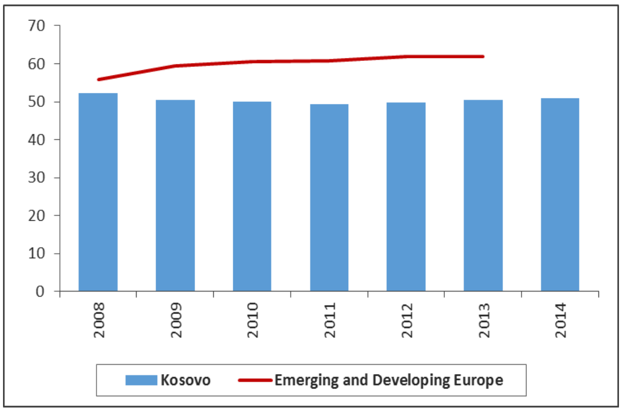
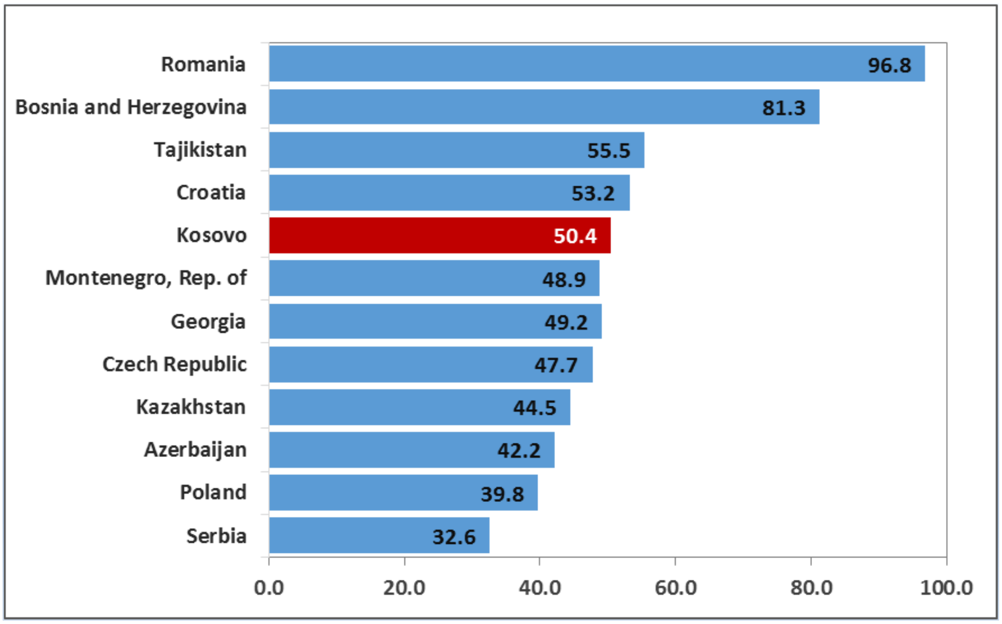


Figure 1.F. Kosovo: Public Capital Stock, Comparison with Peers
(2005 PPP$-adjusted, percent of GDP)



Sources: WEO and staff estimates based on official data.

Figure 1.G. Public Capital Stock, Comparison with Peers
(2005 PPP$-adjusted, percent of GDP)



Source: WEO and staff estimates based on official data.

B. Composition of Public Investment

6. **Investment in the transport sector has been a priority.** Over the last five years, Kosovo capital investment in economic infrastructure accounted for almost 60 percent of total public investment, of which 50 percent relates to the rehabilitation of the transport network (Figure 1.H). Compared to EDE countries, Kosovo's capital spending in economic infrastructure, including transport, comprises a slightly larger share of total public capital spending. However, capital spending in the social sectors, such as health, education, and housing, is only about half the level in EDE countries.

Figure 1.H. Kosovo: Public Investment by Function

(Average 2009–13, percent of total public investment)

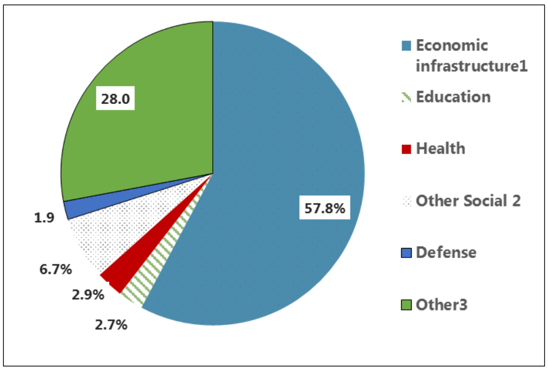
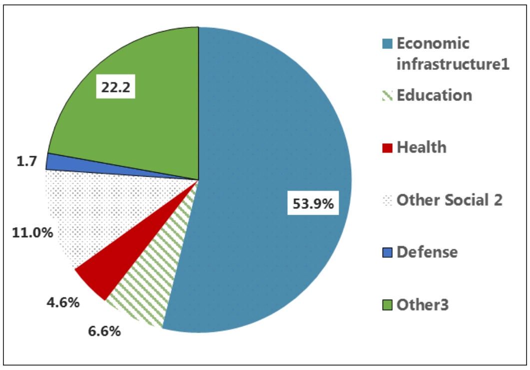


Figure 1.I. Kosovo: EDE Public Investment by Function

(Average 2009–13, percent of total public investment)

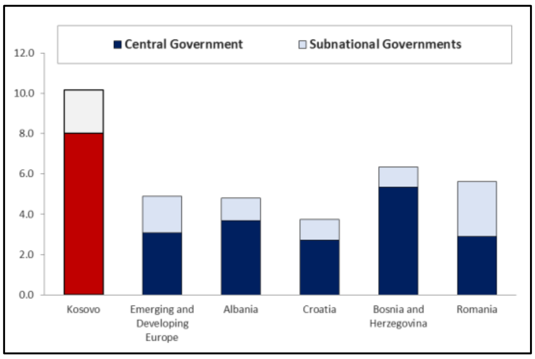


Sources: WEO and staff estimates based on official data based on COFOG classification.
1/ "Economic infrastructure" is proxied by economic affairs and includes public investment for transportation infrastructure, among other components.
2/ "Other social" comprises public investment in housing, social protection, and recreation and culture.
3/ "Other" includes public investment for general public services, safety and public order, and environment.

7. **Subnational governments are strong contributors to public investment in Kosovo.** Municipal spending accounts for close to one-fifth of total investment by general government, close to the average of EDE countries (Figure 1.J). While the central government in Kosovo still accounts for the bulk of public investment, subnational governments are increasingly undertaking responsibilities in the provision of social infrastructure, in line with the government's decentralization policy. The municipalities' share of capital expenditure is expected to increase to 26 percent in 2018 (from 22 percent in 2009). The contribution of publicly owned enterprises (POEs) to total public sector investment is marginal, representing about 0.1 percent of GDP in 2013.

Figure 1.J. Kosovo: Public Investment by Level of Government, 2013

(Nominal, percent of GDP)



Source: WEO and staff estimates based on official data.

8. **Kosovo has not yet made extensive use of Public-Private Partnerships (PPPs), but many projects are in the pipeline.** The estimated capital stock of these PPP projects accounted for 1.2 percent of GDP as of 2013,[6] less than one-third of the average for EDE, and much lower than neighboring countries (Figures 1.K and 1.L). However, about a dozen new PPP projects are currently at various stages of the development process, and have an estimated cost of 1.5 percent of GDP.

Figure 1.K. Kosovo: Public-Private Partnerships Capital Stock
(2005 PPP$-adjusted, percent of GDP)

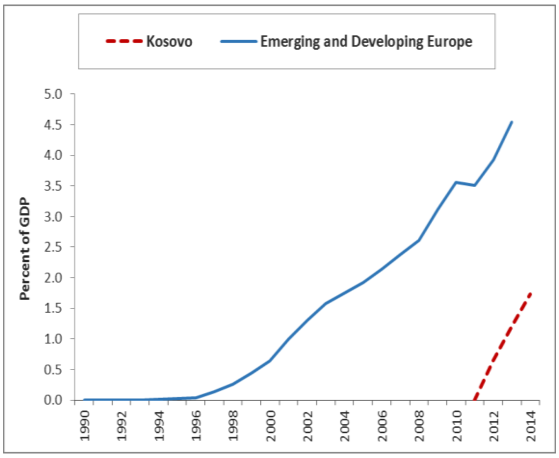
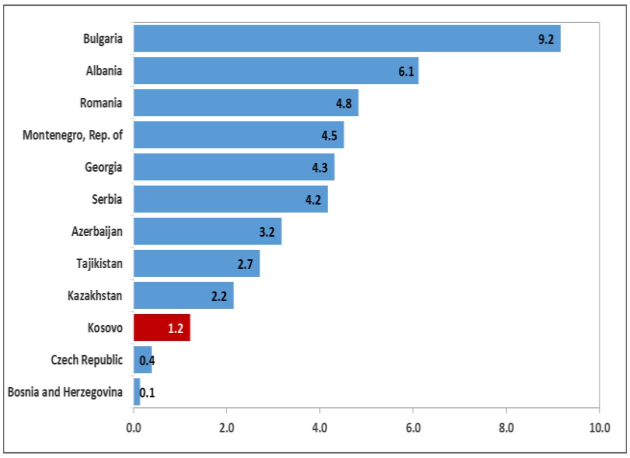


Figure 1.L. Public-Private Partnerships Capital Stock, 2013
(2005 PPP$-adjusted, percent of GDP)



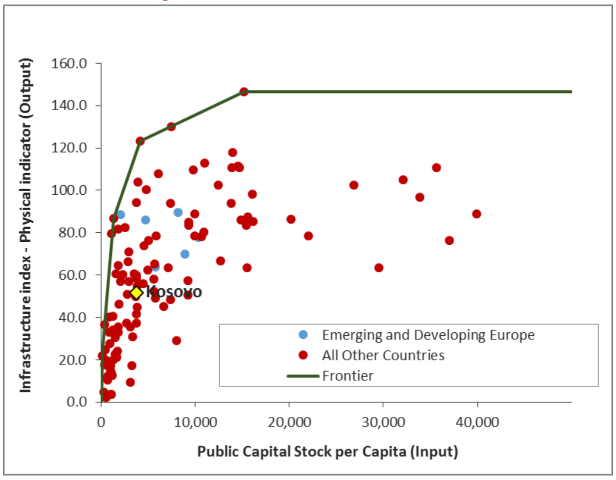
Sources: WEO and staff estimates based on official data.

[6] Estimated using the total construction costs of the assets as a proxy.

II. EFFICIENCY AND IMPACT OF PUBLIC INVESTMENT

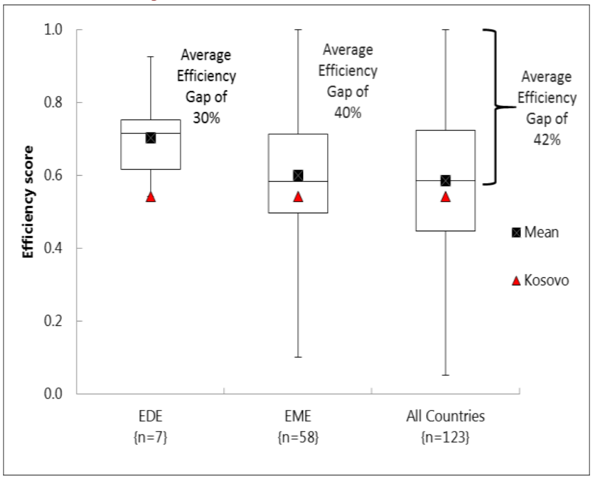
9. **Kosovo's overall public investment efficiency[7] is relatively low.** The efficiency of public investment in Kosovo is well below comparator countries with an efficiency gap of 45 percent compared with an average to neighboring countries (Albania, Montenegro, and the Former Yugoslav Republic of Macedonia) of 30 percent and EME average of 40 percent (Figures 2.A and 2.B). Infrastructure access in Kosovo is substantially lower for education, public health, and roads, and broadly in line for electricity and water (Figure 2.C).

Figure 2.A. Kosovo: Efficiency Frontier, Physical Indicators (2008–14)



Source: Staff estimates.

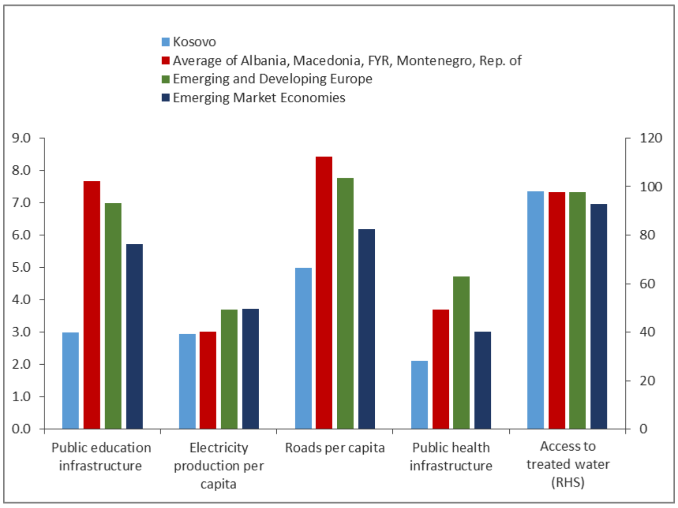
Figure 2.B. Kosovo: Efficiency Gap, Physical Indicators (2008–14)



Source: Staff estimates.

[7] The "efficiency" of public investment is defined as the relationship between the value of the public sector capital stock and the measured coverage and quality of infrastructure assets. In Figure 2.A, the level of efficiency is represented by the distance of a country from the efficiency frontier defined by the countries with the highest coverage and quality of infrastructure (output) for a given level of public capital stock (input). See IMF, *Making Public Investment More Efficient,* June 2015.

Figure 2.C. Measures of Infrastructure Access (2014)*



Source: World Bank, Kosovo Agency of Statistics, staff estimates.*Units vary to fit scale. Left hand axis: Public education infrastructure is measured as secondary teachers per 1,000 persons; Electricity production per capita as thousands of kWh per person; Roads per capita as km per 1,000 persons; and Public health infrastructure as hospital beds per 1,000 persons. Right hand axis: Access to treated water is measured as percent of population.

10. **A range of structural factors discussed in later sections of this report, contribute to the relatively low efficiency of public investment.** In particular:

- Political pressures to spend in non-urgent areas are strong, and these pressures arise from powerful lobby groups, such as pensioners, veterans, former political prisoners, and civil servants, together with some foreign partners. These expenditures risk squeezing out investments in health, education, and other capital projects, which could boost economic growth and reduce poverty.[8]

- There is a tendency in Kosovo to over-invest in new capital stock and under-invest in the maintenance of roads and other infrastructure, partly because maintenance spending gets crowded out by other political priorities. Maintenance expenditure has been falling in recent years both in monetary value and as a ratio of the capital stock (see Figure 3.D).

- The decision making process for capital investment is weak. In the education sector, decision-making is fragmented between central government and municipalities,[9] and accountability is blurred.

11. **A range of new initiatives should help address some of these challenges.** First, the government is establishing a new integrated planning framework, as discussed in Annex 1. Second, a recent EU initiative to prepare a pipeline of projects has the objective of

[8] See: World Bank, *Republic of Kosovo: Kosovo Public Finance Review,* June 2014.

[9] For example, the Ministry of Education is responsible for the construction of some of the schools, but not their maintenance, which is the responsibility of the municipalities.

improving the efficiency of investment in transportation (roads and rail), and energy, as well drinking water, wastewater treatment, and flood protection.[10]

12. **There are specific sectoral issues that need to be addressed.[11]** These include:

- **Transport.** There has been a heavy emphasis on building new roads, which are less environmentally friendly and may crowd out investment in low-emission forms of transport, notably rail. The road maintenance budget is less than half of neighboring Serbia or Bosnia Herzegovina on a per capital basis. The IMF and World Bank have suggested increasing road user charges and vehicle registration fees to ensure sufficient funds are available for road maintenance in the medium- to long-term.

- **Energy.** Ninety-eight percent of the country's electricity generation comes from two outdated, inefficient, and highly polluting lignite power plants. Power outages still occur in some areas when demand is high. About 50 percent of companies in Kosovo have identified access to electricity as a major obstacle, compared to 6 percent in Montenegro, 8 percent in Serbia, and 10 percent in Bosnia Herzegovina. The Kosovo Electricity Corporation (KEK) is considering a 500 MW power plant project, financed by the private sector, which would reduce the supply shortfall and substantially improve energy efficiency. There is also scope for improving efficiency through renewable energy sources, and improving the use of energy in public buildings.

- **Education.** Kosovo has the youngest population in Europe (half of the population is under 25 years). Unemployment is very high, and 60 percent of unemployed people are unskilled. Government investment in education infrastructure over the last few years could broadly replace the three-shift-system in schools, but many schools are still run in two shifts. In addition, capacity for secondary education is not sufficient, while there is room for better use of resources especially in rural areas with small classrooms.

- **Health.** Investments have been made in new medical equipment and buildings while there are deficiencies in basic sewage and water supply systems to health institutions. Efficiency of service delivery could be increased for example by refocusing spending on primary health care and improving maintenance of existing facilities. The World Bank has also recommended a contributory health insurance scheme that would come into effect in 2017. The scheme would raise additional resources for the under-financed health sector and expand the tax base.

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[10] Republic of Kosovo, National Investment Committee, December 2015, *Single Project Pipeline of Infrastructural Investments*.

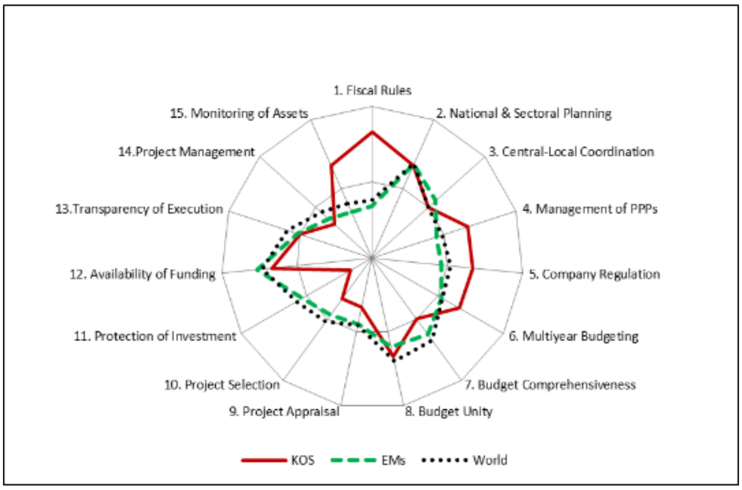
[11] This paragraph draws heavily on two recent reports: World Bank, 2014, *Republic of Kosovo, Kosovo Public Finance Review: Fiscal Policies for a Young Nation*; European Commission, 2014, *Instrument for Pre-Accession Assistance (IP II), Indicative Strategy Paper for Kosovo, 2014–20*.

III. PUBLIC INVESTMENT MANAGEMENT INSTITUTIONS

A. Overall Assessment

13. **Kosovo's institutions for managing public investment are generally well designed, and moderately effective in their implementation.** Figure 3.A compares Kosovo's institutional strength ratings with other countries; the effectiveness was assessed qualitatively, specifically for Kosovo. On average, planning institutions score quite high, but challenges remain in costing and fragmentation of sector strategies. Allocation mechanisms for public investment also score good or medium, but there are weaknesses in the implementation of project appraisal and selection. The scoring of implementation institutions is mixed. Investment is not well protected during the execution of the budget, and project management scores poorly. On the other hand, asset accounting is comprehensive, though the quality of data needs to be improved.

Figure 3.A. Kosovo: Institutional Strength of PIM Institutions



Source: Staff estimates.
Planning institutions: 1–5, allocating institutions: 6-10, implementing institutions 11-15.

B. Investment Planning

1. Fiscal rules (Strength—Strong; Effectiveness—Medium)

14. **Kosovo has rules in place aimed at safeguarding fiscal sustainability and, to some extent, stimulating public investment levels.** The debt rule, enacted in 2009, limits general government gross debt to 40 percent of GDP (including guarantees), and requires the government to present a strategy to the Assembly to correct any potential deviations from this limit, and was adhered to since its implementation.[12] In 2013, the government adopted a new fiscal, rule, in effect since 2014, that sets a ceiling for the general government deficit of 2 percent of GDP. Though the deficit rule is not a "golden rule," it allows capital

[12] Law Nr.03/L- 175, December 29, 2009.

projects financed from privatization receipts to be exempted from the ceiling and includes an automatic correction mechanism.[13] The fiscal rule also specifies the circumstances when the rule may be temporarily suspended such as an economic recession,[14] natural disasters, a crisis in the banking system, and the call of state guarantees.[15]

15. **In December 2015, parliament adopted an amendment to the investment clause that creates additional space for capital projects, albeit with strong safeguards.** As part of the Stand-By Agreement (SBA) approved in July 2015, the authorities have amended the investment clause to allow for new donor-financed capital projects—in addition to privatization-financed projects—to be exempted from the deficit ceiling. The amendment contains strong safeguards, however, and is applicable only if:

- the targeted deficit is below 2 percent of GDP;
- the government's bank balances are above 4.5 percent of GDP; and
- public debt does not exceed 30 percent of GDP (in which case, only projects financed by privatization receipts would be exempted).

In addition, it includes a sunset clause of 10 years, after which the exemption of donor-funded capital expenditures will expire. Furthermore, the MoF will submit to parliament semi-annual reports on all new donor-funded projects that quality under the investment clause, detailing the rationale, expected costs, and financing items (this is also a structural benchmark for the second review under the SBA).

16. **While in 2014 capital expenditures had to be cut to keep the deficit within the rule's limits, the proposed amendment should encourage public investment.** In its first year of implementation (2014), challenges related to the implementation of the deficit rule became evident. The overall fiscal deficit exceeded the ceiling of 2 percent of GDP by 0.4 percentage points, though remained within the ex post margin allowed by the rule. Containing the deficit required deep cuts to capital spending to compensate for a sharp increase in current spending (mostly salaries and social benefits).[16] The recent amendment, however, supports the program's objective of restricting ill-targeted current spending in favor of much-needed investment. It protects capital-spending allocations included under

[13] The investment clause can only be invoked if: (i) the government's bank balance amounts at least 4½ percent of GDP; and (ii) budget commitments are consistent with a deficit of 2 percent of GDP or less. Any excessive deficit should be corrected within the next three fiscal years, so that the average deficit over the four-year period equals 2 percent.

[14] An economic recession is recognized when nominal tax revenues are equal to or lower than the tax revenues collected during the same period of prior fiscal year, excluding the impact of policies and one-off tax revenues.

[15] Specifically, the exception clause refers to a state guarantee that should be paid by the government and that has an impact on overall expenditures over 1.5 percent of GDP.

[16] In 2014, current spending increased by 11 percent in real terms, while investment spending (excluding Route 7), increased by 17 percent in real terms, although less than originally budgeted.

the investment clause from being diverted to cover non-priority spending, or to fund shortfalls on the current spending budget.

2. National and sectoral planning (Strength—Good; Effectiveness—Low)

17. **A National Development Strategy (NDS) is under preparation, while multiple sectoral strategies are in place and have been published since 2012.** The Office for Strategic Planning (OSP), established in 2010 within the Prime Minister's Office, has the mandate of coordinating the preparation of both, the NDS and the related sectoral strategies. The NDS is currently under preparation, and the authorities expect to approve it early in 2016. Since 2012, the OSP has also developed the administrative procedures and methodologies for the preparation and approval of sectoral strategic documents that serve as the basis of the MTEF, the annual budget, and possible funding for donors. In June 2015, the government adopted a new strategy for improving policy planning and coordination, the Integrated Planning System[17] (IPS). This new strategy provides a set of operating principles and supporting structures to harmonize, integrate, and improve the efficiency of the government's policy planning and monitoring systems, including investment planning as a core component (as detailed in Annex I).

18. **The strategic planning process is fragmented, partly due to the absence of the NDS.** There are about 80 sectoral strategies covering major economic sectors. Most of them identify priorities, objectives, milestones, activities, and measurable output targets. Outcome indicators are broadly defined and difficult to monitor. The development of the new NDS is an opportunity for consolidating sectoral strategies and improve the link between policy priorities and the budget. Fragmentation is also present in the decision-making process related to new investment projects (see Annex I).

19. **Weaknesses in the multi-year costing of investment projects results in unrealistic plans, partly inconsistent with macroeconomic projections.** In general, sectoral plans include costing over the medium term, but some are incomplete. Despite requirements for BOs to provide the full costs of projects over their whole life cycle, multi-year costing of major projects is often incomplete due to the exclusion of costing for maintenance of the assets.

3. Central-local coordination (Strength—Medium; Effectiveness—Medium)

20. **The Public Debt Law constrains municipalities' overall debt, but this provision does not specifically identify investment as a possible reason for borrowing.** It sets the limits for municipalities' total gross debt, including guarantees, at 40 percent of their own revenues and general grants. The law[18] prescribes additional limits for short and long-term municipal debt, but no borrowing limits or rules specifically related to investment are set. In

[17] Office of the Prime Minister, *Strategy for Improving Policy Planning and Coordination in Kosovo (Integrated Planning System)*, July 2015.

[18] Article 32 of the Public Debt Law No.03/L – 175, 29 December 2009.

addition, the Law on Local Government Finances (LLGF) specifies that municipalities be required to seek approval of the MoF to borrow.

21. **Central and municipal investment plans are consolidated and discussed formally during the budget negotiation process.**[19] The Grant Commission, an intergovernmental body, assisted by a secretariat headed by the Director of the Municipal Budget Department in the MoF, oversees compliance with the legal framework established by the Law on Public Financial Management and Accountability (LPFMA) and the LLGF. The latter sets the legal framework for municipalities, including the definition of transfers from central government, appropriation procedures, and standards underpinning the distribution of transfers.

22. **Transfers to municipalities for investment purposes are not rule-based, but transparent.** There are three main type of government transfers: general grants, specific health care grants, and specific education grants, but no specific capital transfers are made from the central government to the municipalities. The LLGF defines criteria for the allocation of these transfers to municipalities, based on parameters (such as population, territorial size, number of services provided). Municipalities receive these grants to cover both current and investment spending, together with their own revenue sources. They can use specific purpose grants to finance or co-finance investment projects in health care or education that are managed by line ministries, but these specific transfers do not follow a predetermined or rule-based mechanism.

23. **The budget preparation process provides for timely sharing of information between central government and municipalities.** Transfers are discussed and approved by the Grants Commission following the timeframe set in the LPFMA. By April 30 each year, the MoF provides aggregate information on transfers to be appropriated from the central budget to municipalities for the coming year and for the next two years. The first budget circular, issued in May, includes initial estimates of transfers by source of funding to municipalities for the coming year. The second budget circular, issued in July, provides final budget expenditure ceilings by economic category and instructions to finalize the budget. Municipalities present a draft budget proposal to their Municipal Assemblies for their review by August 31 to be approved by September 30.

24. **Central and local coordination for investment planning is complicated due to inadequate and/or incomplete information.** Although formal discussions take place in the context of the budget preparation process, the data used to inform these discussions is incomplete. Municipalities have not developed the costing techniques required to prepare complete information on the medium-term fiscal implications of their investment plans, particularly current spending linked to investment projects (i.e., maintenance spending). Similarly, the municipalities noted that investment allocations are based on increasingly optimistic projections of municipalities' own revenues. When the revenues collected are less than expected, as in 2014, under-execution of capital spending results (Figure 3.B).

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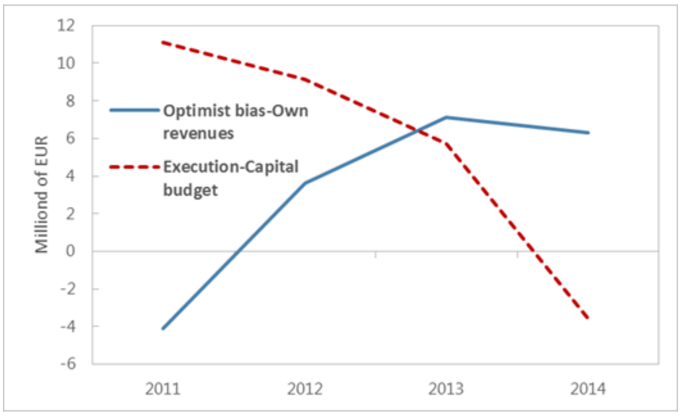
[19] Kosovo's subnational government sector comprises 38 municipalities.

Figure 3.B. Kosovo Municipalities' Own Revenues and Capital Spending
(Comparison between actual and budget data, Million EUR)



Sources: MoF, Consolidated Central Government Financial Statements and Budget documents.

25. **One-fifth of Kosovo's public investment is managed by municipalities.** In line with the government's decentralization policy, municipalities are taking greater responsibility in the procurement of infrastructure assets, including those related to the provision of social services (i.e., hospitals and schools). The municipalities' share of capital expenditure is expected to increase to 26 percent in 2018 (from 22 percent in 2009).

4. Public-private partnerships (Strength—Good; Effectiveness—High)

26. **A legal framework and three-year strategy[20] guide the government's policy and engagement of PPPs, but they are not fully embedded in the MTEF and the annual budget cycle.**[21] In particular, PPPs are evaluated, selected, and approved separately from other public investment projects (see Annex I), hampering the integrity of the evaluation, and selection process of capital projects.

27. **The PPP Law gives the MoF a strong role in managing the potential fiscal costs and risks arising from investment projects procured as PPPs.** The Minister of Finance chairs the Public-Private Partnership Committee (PPPC)[22]—an inter-ministerial body responsible for overseeing, coordinating policies, and approving PPP projects—with veto power of the MoF to terminate projects that are deemed too risky or unaffordable. A dedicated PPP unit in the MoF provides advisory services to contracting agencies, checks the value-for-money and budget affordability of projects, and provides an opinion to the Minister.

[20] PPP Law No. 04/L-045, 25 November 2011; and PPP Development Strategy for 2014–16.

[21] Article 22 of the PPP Law specifies that any funding provided by the government to the private partner needs to be appropriated in accordance with the LPFMA and the annual budget law.

[22] The PPPC has five permanent members: the Minister of Finance and four other members having the rank of Deputy Prime Minister or Minister.

28. **The fiscal costs and fiscal risks associated with PPPs are neither systematically assessed nor reported.** All PPPs have to submit annual reports to the PPPC, but these reports include only limited information on fiscal risks. The PPP unit does not assess and estimate the fiscal risks of existing projects (e.g., related to termination clauses) as well as for projects in the pipeline (e.g., risks related to availability of land), and does not proactively identify potential mitigation measures in the event of the realization of such risks. This is particularly important in the case of Kosovo, given the increasing number of PPP projects in the pipeline and the absence of legal ceilings to the overall government exposure to the risks that may arise. In addition, the legal framework does not include provisions for the accounting of PPP related assets and liabilities according to international standards, nor provisions to report any data on PPPs in the budget and the annual financial statements.[23]

29. **Kosovo has not yet made extensive use of PPPs so far, but several projects are planned.** Only two user-funded PPP projects were executed so far—the Pristina International Airport modernization project and the Urban Bus Transport project in Peja municipality—with a combined capital stock of 1.7 percent of GDP at the end of 2014. However, several projects at the general government level are in development, either at the feasibility or contract procurement stage, with an estimated construction cost of about 1.5 percent of GDP. The great majority of these projects are expected to be fully funded by users, with no guarantees from the government.

5. Regulation of infrastructure companies (Strength—Good; Effectiveness—Medium)

30. **The legal and regulatory framework supports competition in markets for economic infrastructure.** It supports a transparent and nondiscriminatory market based on free market principles, and promotes competition in contestable markets for economic infrastructure. The Procurement Law is broadly in line with EU standards. In 2013, 12,551 public procurement contracts were awarded with a value of €444 million. Contracts awarded through open competition represented 88 percent of the total value of awarded contracts, whereas the use of negotiated procedures, particularly those with no publication of contract notification, amounted to 6 percent.[24]

31. **Four formally independent regulators fix and approve tariff methodologies for the main economic infrastructure services, their independence, however, is challenged in practice.** By law, regulators have full organizational, financial independence, and managerial autonomy (Table 3.A). For the Energy Regulatory Office (ERO) according to the EC Progress report, the operability and independence has been undermined by political interference, low administrative capacity, a lack of human resources, and a 17 percent budget cut. Its board currently has only two out of five members. This report recommends

[23] International Accounting Standards, IPSAS, No. 32 "*Service Concession Agreements,*" sets out the principles of accounting for PPP transactions on an accrual basis. The fact that Kosovo has not yet implemented accrual accounting does not prevent the government to report data on PPPs following "accrual principles" as complementary information to the budget, and in the annual financial statements.

[24] PEFA Assessment in Kosovo, July 2015.

safeguarding ERO's independence, appointing its full board, ensuring its financial stability, and setting up transparent mechanisms to adjust energy prices.

Table 3.A. Kosovo: List of Independent Regulators for Infrastructure
Water and Waste Regulatory Office
Railways Regulatory Office
Telecommunication Regulatory Authority
Energy Regulatory Office

Sources: Official data.

32. **Financial oversight of the 18 POEs is weak, as the Ministry of Economic Development's (MED) consolidated reports focus primarily on operational performance with limited information on financial performance and no formal fiscal risk assessment.** Investment allocations of POEs are financed through own resources, capital grants, and on-lending from the central government. In 2014, investment spending by POEs totaled €5.6 million, accounting for 0.1 percent of GDP. The MED is in charge of monitoring POEs according to the Law on Public Enterprises.[25] POEs are required to have their annual financial statements audited and to submit quarterly and annual reports to the MED's Unit for Policies and Monitoring of POEs, which prepares a summary annual report to the inter-ministerial Commission, chaired by the Minister of Economic Development, and the Commission for Monitoring Public Finances in the Assembly. The government does not prepare a consolidated report on investment plans.

33. **There is limited coordination between the MED and MoF in assessing overall fiscal risks arising from POEs.** The MED publishes annual reports on their official website, but there are no formal procedures for inter-ministerial coordination to discuss the monitoring and financial oversight of POEs.[26] As a result, the MTEF or annual budget documents do not address fiscal risks posed by POEs.

C. Investment Allocation

6. Multi-year budgeting (Strength—Good; Effectiveness—Low)

34. **The government prepares a rolling medium-term expenditure framework (MTEF) that is presented to the Assembly at the end of each April and is published on the MoF's website.** This framework includes projections of capital spending by ministry, budget organization (BO), and program (e.g., the construction of schools, hospitals and roads, and related spending on maintenance), as well as municipalities, over a three-year period. The MTEF indicates the sources of funding for capital projects, but the data are only

[25] Law on Public Enterprises, 2008.

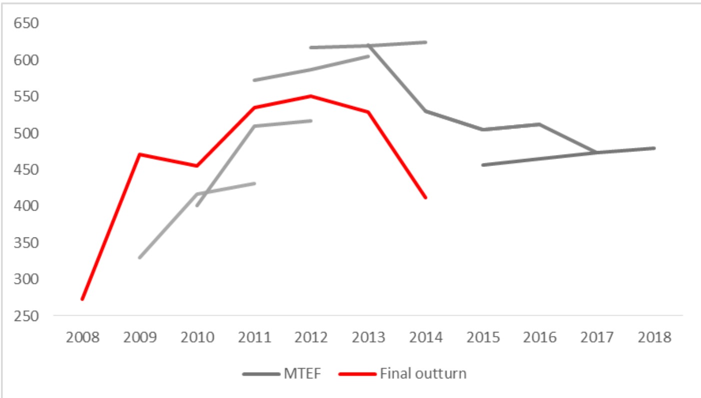
[26] The Auditor General's annual reports have highlighted weaknesses in the financial management and monitoring of POEs.

disaggregated by ministry and program, not by project. Ceilings on capital spending are incorporated in the MTEF, but do not systematically include information on multi-annual commitments (e.g., legally binding contracts with suppliers) entered into by BOs.[27] Budget proposals submitted to the MoF by BOs are accompanied by projections of the full cost of capital projects, but these data are not published, nor is there a system for monitoring actual expenditure against these projections.

35. **The ceilings included in the MTEF are not binding, and are frequently revised before the annual budget is presented to the parliament for approval in December.** Such revisions have been quite substantial in recent years, as have been the in-year revisions to capital appropriations made during budget execution. The revisions have led to substantial average forecasting errors (absolute value of difference between actual and budget) of 23 percent looking two years ahead and 10 percent looking one year ahead. Figure 3.C demonstrates that the ceilings were consistently below outturns until 2010, with the reverse bias since 2011. No explanation is currently provided by the MoF in the budget documents or the MTEF of changes that have been made to the ceilings.

Figure 3.C. Kosovo: Forecasting Performance of Capital Expenditure for General Government in the MTEF

(€ million)



Sources: Budget documentation, financial statements, staff estimates.

7. Budget comprehensiveness (Strength—Medium; Effectiveness—High)

36. **The budget provides a relatively comprehensive picture of capital spending.** The various sources of financing are treated as follows:

- A high proportion (93 percent in 2015) of capital spending is financed by domestic resources through the budget.

[27] The KFMIS system has the functionality to record multi-annual commitments, but data entered are incomplete.

- Co-financing of externally financed projects is integrated in the budget.

- Capital projects financed by external grants are not explicitly recorded in the PIP or the budget, but account for less than 3 percent of total capital spending.[28]

- There are no extra-budgetary entities and funds that undertake a significant amount of capital expenditure, with the exception of a small fund that distributes foreign aid to a predefined group of municipalities, whose capital spending is less than one percent of the total for municipalities.

- Information on PPPs is currently not shown in the budget. Although the current size of the PPP program is modest with 1.7 percent of GDP in 2014, it is expected to expand over time.

- All projects financed by external loans are recorded in the budget and documented in the central documentation system, the Public Investment Plan (PIP).

37. **Current arrangements for the accounting and reporting of PPPs do not conform to good practice.** The annual financial statements include no information on government-controlled PPPs as assets and liabilities, in line with international standards,[29] and guarantees and other contingent liabilities associated with PPPs are not recorded as a memorandum items in the accounts.

8. Budget unity (Strength—Good; Effectiveness—Low)

38. **The budget presents information on capital expenditures together with the associated current (operations and maintenance) spending, but in practice significant misclassifications occurred.** The budget groups capital and current expenditure by ministry and program for the central government, together with a summary of expenditures by economic classification for each municipality. It presents investment projects as part of the appropriations for capital and current spending by program, but does not provide a breakdown of this information by project. The chart of accounts makes a clear distinction between capital and current costs,[30] and the definitions of capital and current spending are broadly in line with the *GFSM 2001*.[31] Appropriations of project costs also include some

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[28] Though the government publishes an annual report on donor activities, the mission were not provided with any data on the absorption rates of donor finance. The data in the report on donor activities are not aligned with the annex on external funding in the budget.

[29] IPSAS 32 in particular, or GFSM 2014.

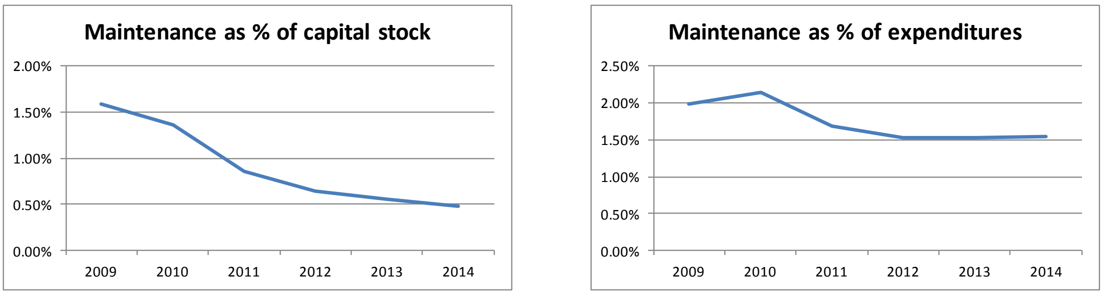
[30] The PIP Manual (Overview, page 8) requires BOs to submit with their project proposals "forecasts of recurring operational costs that will be required to make use of the investment, e.g., wages and salaries of personnel, costs of supplies, consumables, regular maintenance, or replacement of equipment."

[31] Republic of Kosovo, October 2013, *Public Expenditure and Financial Accountability, Public Financial Management Assessment*.

current costs directly associated with the projects,[32] a practice recommended in the government's PIP Manual. In practice, however, serious misclassification of current to capital expenditures—amounting to around 5 percent of total capital expenditure in 2014—have occurred, partly under the direction of the MoF, leading the Auditor General to qualify the government's financial statements in 2014.[33]

39. **Line ministries and municipalities claim that the budget has provided insufficient funding of maintenance expenditure in recent years.** In addition, some delays have occurred in bringing new assets (such as schools and health facilities) into full operational use because of shortages of funds for current expenditure. Though BOs already are obliged to prepare projections of the operations and maintenance costs associated with new capital projects, systematic information about their maintenance needs is not available. Figure 3.D shows spending on current maintenance as a percent of both, the capital stock and the budget, as reported in successive annual financial reports. Spending on maintenance has stagnated in budgetary terms while assets have continued to increase. The current maintenance budget is currently at an historic low of less than 0.5 percent of the capital stock.

Figure 3.D. Kosovo: Evolution of Current Maintenance Budgets, 2009–14



Source: Annual Financial Reports 2007-2014, MoF, staff estimates.

9. Project appraisal (Strength—Medium; Effectiveness—Medium)

40. **Comprehensive guidance on the appraisal of capital projects is provided in the PIP Manual, and the PIP framework is in line with good international practice.** This guidance covers the whole project cycle from the planning and design phase to the point at which the facility or asset is fully operational. In addition, BOs and the MoF are required to

[32] For example, the costs of hiring consultants to prepare pre-feasibility and feasibility studies, and the operations of the project implementation unit (PIU).

[33] Office of the Auditor General, August 2015, *Annual Audit Report for 2014*. The report states that: "In our opinion the Annual Financial Statements of the Kosovo Budget present a true and fair view in all material aspects, except for the following issue: €24,470,260 of goods and services and subsidies and transfers expenditure was misclassified as capital investments. This arose partially because of a direction from the Ministry of Finance which resulted in incorrect budgeting and partially because of inappropriate action by individual budget organizations in the classification of expenditures" (Page 12).

demonstrate that investment proposals are in line with the government's Economic Development Plan and the MTEF, as well as sector strategies. Broadly, similar procedures are recommended for projects proposed by municipalities. The required procedures are more elaborate for major projects (in excess of €400,000) than smaller ones. The PIP Manual requires PPPs to undergo a similar set of appraisal and review procedures, together with an additional value-for-money test, but not all of the twelve PPP projects that are currently planned are recorded in the PIP.

41. **In practice, not all BOs systematically carry-out cost-benefit analysis and other appraisal procedures required by the PIP Manual, but the analyses are rarely published.** For major projects, cost-benefit analyses are not always undertaken and published, for example.[34] Important data on projects (e.g., projections of current costs) are not always entered into the PIP database by project managers in BOs. Ministries noted that their technical capacity needs to be enhanced following staff rotations that have occurred since the initial training on the PIP Manual was carried out. BOs do receive, if requested, support from the MoF's Budget Department in carrying out technical work on project appraisal, but the MoF does not carry out systematic checks that the analyses have been done in accordance with the required procedures.

42. **The appraisal process has some important gaps related to transparency, and the management of risks and cost overruns.** Information on the appraisals carried out by BOs is not made public, and the PIP Manual has also not been published. Despite frequent and often substantial cost overruns the manual does not require BOs to estimate financial and operational risks (e.g., of cost overruns) that good international practice would dictate should be taken into account when appraising projects. In practice, they are normally absorbed by transferring funds from one budget line to another during the fiscal year, rather than by making use of the budget's contingency fund.

10. Project selection[35] (Strength—Medium; Effectiveness—Low)

43. **Project selection currently rests largely in the hands of BOs, based on procedures and criteria laid down in the PIP Manual.** Ministries may hire external experts to undertake work on the appraisal, ranking, and selection of projects, but this facility is not used systematically. Projects pass through four stages of approval starting with the project manager in the BO, followed by the relevant departmental manager, then the chief financial officer, and finally the secretary general of the ministry concerned. According to the selection criteria laid down in the PIP Manual,[36] all major projects should be reviewed by the MoF, but

[34] For example a big road project with total project costs of up to 20 percent of GDP was decided prior to elections without any such analysis having been carried out.

[35] Annex I provides a detailed discussion of these issues.

[36] The Manual stipulates that the MoF must validate that each large project is a priority for the government and the relevant sector, is the best option for achieving the BO's desired objectives, satisfies the analysis of costs and benefits, and is affordable both in terms of capital costs and operational and maintenance costs.

there is no legal basis to propose and reject investment projects. BOs also occasionally take decisions to implement projects without the MoF's formal approval.

44. **The PIP—which is huge, comprising more than 15,000 projects that have been approved or are being proposed for budget financing—has limitations when used as a pipeline for prioritizing and selecting major new projects.** In particular (i) the PIP and the associated manual have no explicit legal basis, and the MoF has experienced difficulties in enforcing the required procedures for entering data and analyzing projects; (ii) the criteria for project appraisal and selection are not systematically applied by BOs; and (iii) the standard reports generated by the PIP are of variable quality and usefulness for senior officials and policymakers.

45. **Two pipelines of investment projects have been established—the PIP and the recently approved Single Project Pipeline of Infrastructural Projects[37]—but at present provide limited guidance for the inclusion of projects in the budget and MTEF.** The coverage of the PIP database[38] is not comprehensive, and there are shortcomings in the methodology for ranking and selecting major projects. The methodology used in assessing projects to include in the Single Project Pipeline was also questioned by the donor community, and the estimates of economic impact were not clearly defined. The final ranking of projects was quite different from the initial ranking, for reasons that were not explained. In addition, the projects identified are linked to an EU program (the "Berlin process") to strengthen "infrastructural interconnectivity" in the western Balkans, would benefit primarily from EU financing, and are currently limited to three sectors (transport, environment, and energy).

46. **In addition, the MoF currently lacks the institutional strength to play a leading role in the prioritization and selection of major infrastructure projects.** The absence of a strong central mechanism for coordinating decisions on project selection leads to a sub-optimal allocation of budgetary resources, and contributes to the 45 percent efficiency gap discussed in Section II. It may also weaken the government's hand in negotiating loans and grants with International Financial Institutions and donors.

47. **The government's recently announced IPS[39] will include public investment as a core pillar.** However, this framework contains shortcomings in regard to planning major capital projects: (i) two pipelines of investment projects—one for donor financing, the other for budget financing—have been established, which is economically inefficient, and conflicts with the concept of an integrated strategy; (ii) the MoF control of the selection of domestically-financed capital investment projects would be increased, but projects financed by donors would be screened initially by the Ministry of European Integration; and (iii) the

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[37] Republic of Kosovo, National Investment Committee, December 2015, *Single Project Pipeline of Infrastructural Investments: Transport, Environment and Energy*.

[38] The budget shows the projects in table 3.2 for central level and table 4.2 for municipal level.

[39] Office of the Prime Minister, May 2015, *Strategy for Implementing Policy Planning and Coordination in Kosovo (Integrated Planning System)*. The Strategy was adopted by the Government in June 2015.

management of PPPs has not been integrated within the new framework. Annex 1 outlines a revised governance framework for the IPS, which would be based on a single pipeline of projects that have satisfied the tests of economic viability and consistency with national strategic plans. The proposed revisions would also enhance the role of the MoF in screening major projects, and bring PPPs inside the framework.

D. Investment Implementation

11. Protection of investment (Strength—Low; Effectiveness—Medium)

48. **Outlays for capital investment are appropriated on an annual basis.** Table 3.2 of the annual budget documentation presents the following information for each project: budget year allocation; the total of any carryovers from previous years plus planned spending for the budget year; estimates for two outer years; and the sum of these three amounts. The documentation does not disclose the amount already spent on the project up to the budget year, nor does it show the total cost of the project over its lifetime. Municipal projects require the explicit approval of their Municipal Assembly prior to implementation. This practice is not applied at the central level, although the LPFMA requires the Assembly to give high priority to securing funding and making appropriations under current and future budgets for approved capital projects. The oversight of capital projects could be significantly strengthened if information on project lifetime costs and duration were provided in budget documentation. The current format for the capital budget can be redesigned to accommodate this information, drawn from the PIP database, which would allow the identification of cost overruns and extensions of project duration by comparing the documentation of the budget year under consideration with that of previous years.

49. **In-year transfers ("virements") from capital to current spending are not restricted and do not protect capital spending.** Article 30 of the LPFMA establishes authorization levels.[40] Virements up to 5 percent can be made by the BO, up to 15 percent with the approval of the MoF, and up to 25 percent with the approval of the government.[41]

50. **A restricted form of carryover for capital projects is allowed under the current legal framework.** While Article 27 of the LPFMA prohibits carryovers except in the case of own source revenues of municipalities, Article 7 of the Annual Budget Laws has broadened the exceptions to include own source revenues of central government, donor grants, and capital projects. The Government approves amendments to Tables 3.2 and 4.2 to cover obligations from last year and informs the Parliament of these changes by January 30. Article 7 of the Annual Budget Law is a general principle of the PFM system and should

[40] Article 13 of the Annual Budget Laws of 2015 and 2016 raise the level of this approval to the Assembly.

[41] For the moment capital spending is protected through ring fencing under the IMF supported Stand-By Agreement. However, this preferential treatment for capital spending has created incentives to budget and account purchases of school supplies and maintenance of roads, as well as other types of current spending, under the capital budget, which have been identified by the Auditor General as misclassifications (see Section III.C.8).

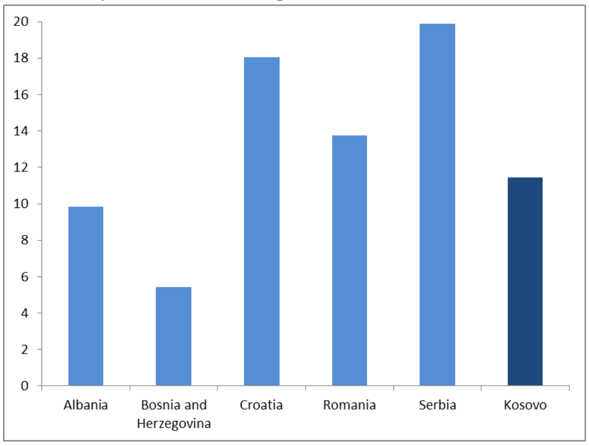
systematically be part of the LPFMA. During the last five fiscal years, carryovers amounted to 8 percent of total investment on average.

51. **Under-execution of the capital budget is significant but in line with comparator countries.** Between 2010 and 2013, public investment was underspent by 10 percent on average. However, under-spending increased to 23 percent in 2014. The experience in Kosovo is comparable to other countries in the region but less than in EMEs (26 percent)—see Figure 3.E. Furthermore, both under-execution and under-budgeting can be quite significant when viewed at the project level—for example in 2015 a large capital project was under budgeted by €25 million or 5 percent of total investment. However, recent experience in Kosovo suggests that over-optimistic plans and implementation constraints have also contributed to under-execution of capital.

Figure 3.E. Budget Implementation, 2010–13

Average deviation between annual budget and actual

In percent of budget (absolute values)



Source: WEO and staff estimates.

12. Availability of funding (Strength—Good; Effectiveness—Medium)

52. **Cash flow plans are prepared annually by BOs, which the Treasury uses as a basis for issuing quarterly spending allocations.**[42] Commitments made by BOs are recorded against these allocations in the Treasury system. In practice, BOs update their cash flow plans quarterly. The LPFMA requires BOs to notify contracts, including multi-annual contracts, to the Treasury, which should keep a complete record, although this provision has yet to be fully enforced. The Treasury is planning to upgrade the Kosovo Financial Management Information System (KFMIS) to provide for an e-documents module that may help to resolve this shortcoming. Annual procurement plans are prepared, but not always aligned with cash flow plans.

53. **Payments are generally released in a timely manner, in line with appropriations.** All payments are made through the Treasury Single Account (TSA) using KFMIS. The LPFMA sets a deadline of 30 days for BOs to request payment of their invoices, and provides

[42] Rules set out in Article 34, 35, and 37 of the LPFMA.

recourse for creditors to go directly to the Treasury if payment is not made within 60 days. The LPFMA also provides for enforced payment through court judgments as a last resort. In 2015, there were 318 such cases, totaling €5 million.

54. **While expenditure arrears remained manageable over recent years, the recognition of significant unpaid obligations in the 2014 accounts risks undermining payment discipline with consequent impact on capital spending.** The new provisions for past expropriations add €113.8 million (7.5 percent of total expenditure) to the unpaid obligations reported in the annual financial report for 2014, bringing the total unpaid obligations for general government to €165.4 million, just under 11 percent of total expenditure. By comparison, unpaid obligations averaged 2.5 percent of total expenditure between 2010 and 2013. Around one-third relate to unpaid invoices outstanding for 60 days or more. In 2014, just under half of those related to capital spending representing a total value of €5.6 million (or 1.1 percent of capital spending) of which €3.2 million were at municipal level. Although the arrears related to capital spending are not that significant, future spending pressures related to the settlement of expropriation claims could adversely affect capital expenditures given the low priority they are accorded in the LPFMA.[43]

55. **Where external financing is channeled through the budget, the funds are fully integrated within the TSA, with the exception of direct donor payments to suppliers.** Some external financing—mainly bilateral grant financing—remains outside the budget and the TSA (but within the Central Bank for central government). Where funds are outside the TSA, the BOs are required to register them with the Treasury, which records them in the KFMIS. Efforts by the Ministry of European Integration to track all donor funding through the Aid Management Platform (AMP) software have so far not delivered reliable data to complement the information on grant-funded expenditure already included in the government's accounts. Accurate data on total donor grant funding outside the TSA are not available, but it is estimated at about €10 million per year. On the other hand, external loan funding (well under 1 percent of total spending with the exception of 2013 when it was 6.4 percent) is channeled through the TSA.

13. Transparency of execution (Strength—Medium; Effectiveness—Low)

56. **While the current procurement law contains adequate provisions, its implementation is far from effective, according to the 2014 Auditor General's report.** All procurements above €100,000 require competitive international bidding, and a web-based system for disseminating key procurement information has been established.[44] However, shortcomings identified by the Auditor General include, poor procurement planning; entry into contracts without committed funds; splitting of tenders in order to avoid the open

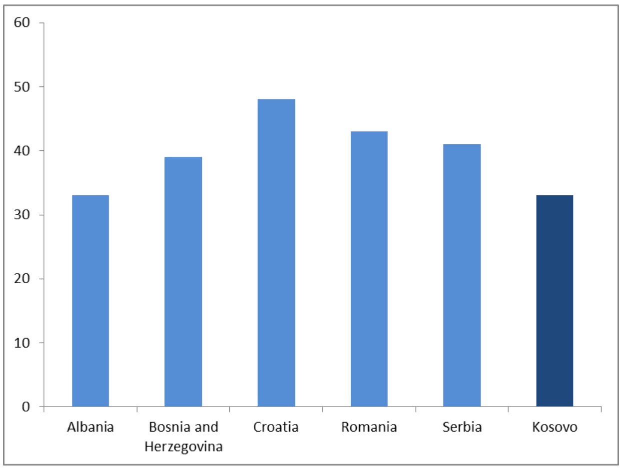
[43] In the event of cash shortfalls, the LPFMA places capital expenditure as a low priority (Articles 38–39).

[44] The April 2015 SIGMA baseline assessment undertaken in the context of EU convergence states that Kosovo's legal framework for procurement is largely aligned with the EU-Acquis, but falls short on implementation.

procurement procedure; customization of the tender criteria thus favoring certain operators; weaknesses in tender evaluations; and entry into contracts with abnormally low prices.

57. **These shortcomings, recognized by the authorities, are expected to be addressed in the new procurement law adopted in December 2015.** The law provides for improved centralized control over procurement through the Central Procurement Agency. It also removes the domestic supplier preference clause added to the old law, gives the government the option to establish an e-procurement system, and introduces enhanced provisions to combat corruption. In the Corruption Perceptions Index,[45] Kosovo has a lower ranking than regional comparator countries (Figure 3.F), with a declining trend. Full implementation of the new law, which will require secondary legislation and sustained training, would bring the procurement practices in Kosovo into line with EU good practice and improve the execution of the capital budget.

Figure 3.F. Comparison of Corruption Perceptions Index, 2014



Source: Transparency International.

58. **The PIP process provides a comprehensive system for establishing annual and quarterly reporting of capital projects.** BOs enter basic information on their projects, including total costs and timeframes, as well as data on financial and physical progress, directly into the PIP database. This work is done as part of the annual budget preparation process and updated on a quarterly basis during the year.[46] MoF budget analysts have access to this data and use it during their appraisal of budget submissions by BOs and for the semi-annual reviews of the budget.

59. **However, while a monitoring framework is in place, the quality and comprehensiveness of the data recorded in the PIP system by BOs are questionable.** For

[45] The Corruption Perceptions Index ranks countries and territories based on the perception as to the level of corruption in the public sector. A country or territory's score indicates the perceived level of public sector corruption on a scale of 0 (highly corrupt) to 100 (very clean).

[46] Tables 3.2 and 4.2 of the annual budget documentation provide data on capital projects, and are produced directly from the PIP database.

the annual budget preparation process, the focus is on the three-year timeframe of the MTEF, and not on total cost of projects (which are not reported in the budget) or delays in implementation. Table 3.B analyzes 57 major projects with spending of more than €1 million in the 2015 budget, of which around 60 percent were delayed and around 15 percent with continuous revisions.

Table 3.B. Analysis of Major Projects in 2015 Budget

57	Total project sample (appropriation > €1 million)
38	Projects where end date changed at least once
8	Projects where end date changed 4 or more times
7	Projects where end date < current year (2015)

Source: PIP database, Ministry of Finance.

60. **Ex post audits of major projects by the Auditor General are rarely undertaken, though audits of some donor-funding projects are now being conducted.** In the case of domestically funded projects, which represent the bulk of public investment, the Auditor General has taken a policy decision not to audit any project, which is under litigation on the basis that the audit could prejudice the court proceedings. According to the Auditor General, more than 90 percent of projects are under litigation.

61. **The absence of ex post audits of projects significantly reduces the opportunity to learn from past project implementation challenges and mistakes.** Ex post audits, especially of big projects such as Route 7, would provide useful information on the oversight and management of capital projects, focused on their financial and physical performance during implementation, and on whether economic, efficient, and effective use of resources was achieved. Such information would be beneficial to help improve project management practices.

14. Management of implementation (Strength—Medium; Effectiveness—Medium)

62. **Most ministries establish formal procedures for managing the implementation of large projects, but this is not required by law.** These practices, however, vary across line ministries depending on the size and complexity of the project and the number of projects being undertaken. In the Ministry of Infrastructure, for example, only the largest projects have a dedicated project implementation unit that is outside the ministry. For most road projects, project management is carried out by the relevant department, with quality control outsourced to an independent company. Clear reporting lines exist within the Ministry of Infrastructure, all the way up to the general secretary and/or minister. The PIP requires implementation plans to be submitted for all projects prior to their approval for inclusion in the budget.

63. **Project management needs further strengthening to reduce cost overruns and delays experienced in implementing many projects.** The Auditor General's report for 2014 confirms that projects are subject to significant delays and that there are problems in the management and oversight of contracts. This directly contributes to the underperformance of the capital budget noted in IMF staff reports as well as reports prepared by the World Bank

and the EU (see Section III.D.11). Improving the absorption rates of donor funded projects will also require enhanced project management capacity. Preliminary analysis of data from the PIP database indicates that in 2012 and 2013 around one-fourth of the projects reported delays, but discussions with the BOs and local governments during the mission suggested that the incidence of delays and cost overruns is more prevalent.

64. **The PIP process establishes rules for adjustments to projects during the course of implementation.** These adjustments require approval at various levels within the BOs as well as the MoF. Article 14 of the Annual Budget Laws regulates adjustments between capital projects appropriated within the same sub-program (or program for the municipal level) in the budget.[47] The rules require submission of justifications, but rarely result in a fundamental review of the project even for substantial changes.

65. **Ex post reviews of projects of MoF and BOs are generally not conducted, except for some donor-funded projects.** Such reviews are an important management tool aimed at assessing whether the project outputs and outcomes were successfully and efficiently achieved. Successful outcomes depend in part on how quickly created assets become operational in delivering anticipated facilities or services. Especially big projects, such as Route 6 and 7 would require ex post reviews.

15. Assets accounting (Strength— Good; Effectiveness—Medium)

66. **The management and reporting of nonfinancial assets in Kosovo is generally well regulated.** Regulation 02/2013 prescribes the management of nonfinancial assets by BOs, requiring them to: appoint officers to manage the assets; maintain a register of assets; document all purchases, sales and movements in assets; undertake a stock taking of assets at least once a year; and prepare statements of nonfinancial assets. These arrangements have not yet been fully implemented in a few BOs and municipalities.

67. **The asset reports of BOs are consolidated into the annual financial reports prepared by the Treasury.** Regulation 02/2013 establishes asset-specific linear depreciation rates applied by BOs and municipalities when preparing their annual financial reports. They contain important analytical data essential for the preparation of full balance sheets, should the authorities decide to move to an accrual-basis of financial reporting.

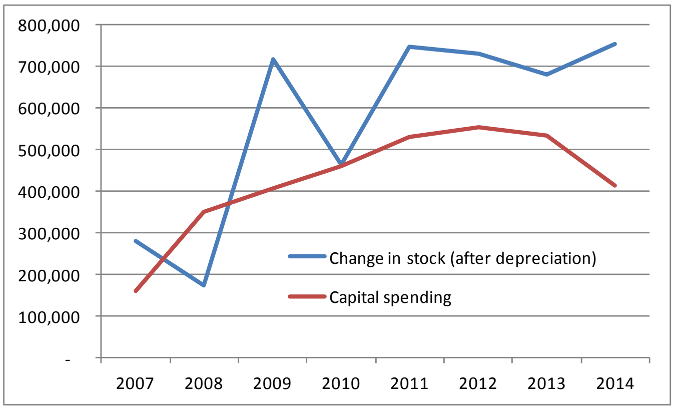
68. **The Auditor General, however, continues to raise concerns about the reliability of the data and the management of assets in his audits of BOs.** His 2014 audit report noted the limited interest paid by top management of BOs to the control and oversight of nonfinancial assets, and cited this issue as a reason for giving a qualified opinion to the accounts of four municipalities. The report also questioned the reliability of nonfinancial asset data reported in the government's Annual Financial Report of 2014, noting that the data contained in the two national systems used for recording assets did not match. Figure 3.G shows an average difference between nonfinancial asset stocks and capital spending of

[47] Up to 15 percent with the approval of the Minister of Finance, and up to 25 percent with the approval of government.

33 percent, which illustrates the questions raised by the Auditor General as to the reliability of the asset data presented the annual financial reports.

Figure 3.G. Kosovo: Comparing Changes in Capital Stock and Capital Spending

(2007–14)



Source: Annual Financial Reports 2007–14, Ministry of Finance.

IV. RECOMMENDATONS

69. **Based on the assessment provided in Section III, the following recommendations are suggested (for further details, see Annex II):**

Issue 1: Sector strategies are not aligned with each other and not yet guided by the National Development Strategy, which is in preparation and some strategies lack comprehensive costing.

Recommendation 1: Implement and publish the National Development Strategy (2016) and consolidate sector strategies as outlined in the government's new Integrated Planning System (2016–19). Prepare and implement costing methodologies for estimating capital and current costs (2016–19).

Issue 2: Some types of public investment, such as PPPs and POE investments, are not reflected in the budget, and monitoring of fiscal risks is not undertaken systematically.

Recommendation 2: Increase the transparency of the budget documentation by including an annex for PPPs and POE investments (2016). Record the assets, liabilities, and fiscal risks relating to PPPs, and the contingent liabilities arising from POE investments in the government's annual financial statements (2017).

Issue 3: Multi-annual contracts/commitment are not planned and managed systematically, and total costs and timeframes of capital projects are not included in the budget documentation limiting the scope of scrutiny of budgeting, cost overruns, and implementation delays, leading to under-budgeting for ongoing projects, and preventing the calculation of the fiscal space available for financing new capital projects.

Recommendation 3: Include a schedule of multi-annual commitments/contracts in the budget (2016) and financial statements (2017); include an analysis showing the fiscal space available for financing new projects (2016); and add total project costs and project duration in Tables 3.2 and 4.2 of the annual draft law on the budget (2016).

Issue 4: Maintenance costs are not adequately reflected in the budget, and limited analysis of maintenance needs is available.

Recommendation 4: Plan capital projects and their subsequent maintenance costs comprehensively (e.g., in sector strategies). Include a specific item for maintenance costs in the budget, and carry out a study of maintenance needs in relevant BOs (2016–17).

Issue 5: A multitude of committees and two sets of project pipelines make the appraisal and selection of projects unnecessarily complex, while the scrutiny role of the Budget Department and MoF in general remains limited.

Recommendation 5: Formalize project appraisal and selection procedures, and the documentation required in the PIP in a regulation or law (2016–17). Streamline institutional arrangements for taking decisions on the pipeline of eligible projects, as described in Annex 1 (2016).

Issue 6: The PIP is a potentially useful database, but lacks systematic input of comprehensive and reliable information from BOs, is not used as a managerial tool, and requires additional features to better differentiate types of projects and analyze project data.

Recommendation 6: As discussed in Annex 1, establish quality control checks by the Budget Department (and other relevant entities of the MoF) for data entered by BOs in the PIP system (2016), review the functionalities and use of the PIP system (2016), expand the range of standard reports for monitoring investment projects (2016–17), and provide the PIP procedures with an explicit legal basis (2017).

Issue 7: Ex post reviews of projects are rarely undertaken by MoF and BOs, limiting the opportunity to learn from project implementation challenges and shortcomings, including delays and cost overruns.

Recommendation 7: Pilot ex post reviews for selected high-risk projects, such as Route 6 and 7 (2016/2017), by MoF together with BOs.

Issue 8: Audits of capital projects are restricted by pending court cases.

Recommendation 8: Examine the changes to legislation required to authorize the Auditor General to conduct audits of projects that are under litigation to permit timely assessment of all investment projects based on a risk-oriented approach. This will require discussions between Ministry of Finance, Auditor General, Procurement Commission, Ministry of Justice, and Prosecutorial and Judicial Councils to agree on the most appropriate approach (2016).

Annex I. Prioritization and Selection of Capital Investment Projects in Kosovo

Background

In its July 2010 Letter of Intent[1] with the IMF, the Government of Kosovo pledged to undertake a set of measures to enhance the planning, selection, and monitoring of capital investment projects. The main features were:

- Establishment of a Public Investment Committee to oversee the planning and prioritization of capital spending.
- Preparation of a list of investment projects, ranked in order of priority.
- Introduction of a mandatory system of cost-benefit analysis to appraise all large-scale investment projects.
- Preparation of quarterly monitoring reports on the execution of capital spending.

In 2013, on the basis of advice from the EC, the government established the Public Investment Planning (PIP) framework. This framework incorporates the elements included in the July 2010 Letter of Intent. The PIP comprises an IT system and database into which project managers in BOs can enter data on all investment projects. In addition, a PIP Manual was prepared that provides guidelines for project managers and other users of the system.

Assessment of institutional arrangements and the PIP database

Institutional arrangements

The Public Investment Committee did not work as intended. The Committee met infrequently and did not provide an effective mechanism for coordinating the prioritization and selection of capital projects, and for monitoring the implementation of ongoing projects, functions that rest mainly with the BOs. In practice, the MoF continues to play only a limited role in this prioritization process. There is also no explicit legal basis for the process of prioritizing and selecting projects. As a result, the MoF has experienced difficulties in enforcing the procedures set out in the PIP Manual and ensuring that the quality of information contained in the PIP database is of sufficiently high quality.

In May 2015, the Office of the Prime Minister (OPM) announced a strengthened architecture of institutional arrangements for national development planning[2]—the

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[1] IMF Staff Report, July 2010. No. 10/245.

[2] Office of the Prime Minister, May 2015, *Strategy for Implementing Policy Planning and Coordination in Kosovo (Integrated Planning System)*. The Strategy was adopted by the Government in June 2015.

Integrated Planning System (IPS). This new framework included the programming of investment as one of its core elements. The OPM's report (page 12) noted that while public investment is simply a component of public expenditure, it is addressed separately as a core component of the IPS "as it requires a distinct identification process that needs significant improvement to be properly linked to decision making in the framework of the MTEF and the annual budget process."

A complex structure of committees and procedures was announced by the OPM in May 2015, but has not yet come fully into effect. The new structure includes the following features relevant to the planning of public investment:

- The government decided to abolish the Public Investment Committee, as well as the Fiscal and Budget Affairs Committee,[3] also chaired by the MoF, and merge their functions into a new, high-level Strategic Planning Committee (SPC), chaired by the Prime Minister.[4]
- The SPC's mandate includes the selection of strategic priorities, approving the National Development Strategy, reviewing new policy initiatives, establishing the government's macro-economic framework, deciding the ceilings to be included in the MTEF, and reviewing strategic issues related to public investment and external assistance.
- The SPC will be supported by a committee of high-level officials and the Strategic Planning Steering Group,[5] together with a Strategic Management Group, established at ministerial level that will monitor the implementation of their ministries' plans under the National Development Strategy.
- A three-stage process has been established for reviewing public investment projects: a first review by the MoF (or by the Ministry of European Integration (MEI) for externally-financed projects), a second review by the Strategic Planning Steering Group, and a final review by the Strategic Planning Committee. Data drawn from the PIP and other sources would be used in undertaking this work.

As a result of a separate decision, the National Investment Committee was created, but this Committee is not mentioned in the OPM's report on the IPS. It should be noted that:

[3] In justification of this decision, the OPM's report argued that these committees had existed for two years but had not become fully operational, and were constrained by the absence of an effective inter-ministerial coordination mechanism.

[4] The other permanent members of the SPC are the Deputy Prime Minister, the Minister of Finance, the Minister of European Integration, and the Minister of Trade and Industry.

[5] Permanent members include representatives of the OPM, the Ministry of European Integration, the MoF, and the Ministry of Public Administration.

- The National Investment Committee is jointly chaired by the Minister of European Integration and the Minister of Finance. In December 2015, the Committee announced the Single Project Pipeline (SPP) of Infrastructural Projects,[6] which will be partly financed by donors. The announcement of the SPP is consistent with the structure of the IPS in which two streams of decision-making are identified: the first relating to budget-financed projects and the second to externally-financed projects, including by implication the SPP.
- The OPM's report does not discuss the management of PPPs within the integrated planning framework, nor the role of the PPP Council, which was established by law in 2011.

To summarize, the implications of the new IPS framework for public investment management are that:

a) two pipelines of investment projects have been established, which are economically inefficient and conflict with the concept of an integrated planning strategy;

b) the MoF retains control of the selection of domestically-financed capital investment projects, but not projects that are financed by donors, which will be screened initially by the MEI;

c) the mandate and role of the National Investment Committee in the context of the IPS's overall governance structure remains unclear; and

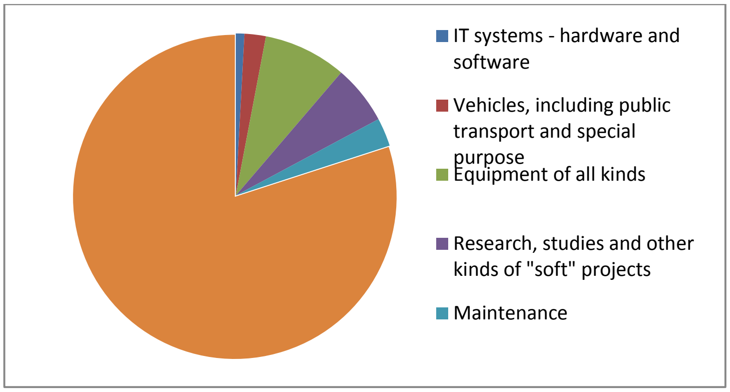
d) the management of PPPs has not been integrated within the new framework.

PIP database

The PIP database contains more than 15,000 projects and capital purchases carried out by the central government and municipalities with a total cost in excess of €1,000. Only 2,803 projects, however, are identified in the 2015 budget—689 at national and 2,114 at municipal level. Of these projects, 362 (286 national and 76 municipal) qualify as major projects with an estimated total cost in excess of €400,000. Around 20 percent of the central government's capital budget relates to non-infrastructure capital spending, and 80 percent to infrastructure projects (Figure A1.1).

[6] Republic of Kosovo, National Investment Committee, December 2015, *Single Project Pipeline of Infrastructural Investments: Transport, Environment and Energy.*

Figure A1.1. Kosovo: Capital Budget 2015



Source: PIP.

The database is a valuable information system that provides important raw material for the preparation of the MTEF and the annual budget. It has the following limitations, however, if it is to be used as a tool for prioritizing and selecting major capital projects:

- The PIP database is designed for capital spending only, while also including many "soft" development projects typically found in the education and health sectors.[7] This limitation encourages BOs to classify some "soft" projects as capital even when the spending is clearly recurrent in nature—items such as the use of consultants, purchase of goods and services, and even salaries.
- The PIP database is also used for administrative capital spending—e.g., vehicles, photocopiers, and computers—which are different in nature from the typical multi-year investment project, and require different systems of planning and implementation.
- The PIP database includes projects at all stages of development. Data on projects at an earlier stage of development, which might nevertheless be important for preparing the pipelines, are not systematically recorded in the database.
- It is not certain that the PIP includes all projects to be implemented by POEs that may require financing through the budget. Similarly, the extent to which donor-financed projects are included in the database needs to be confirmed.[8]

[7] "Soft" projects differ from physical infrastructure, and are linked to the development of the stock of human capital, such as the preparation of school curriculum, or training programs to improve the capability of teachers, doctors, or administrators.

[8] The Annual Report on Donor Activities for 2014 published by the MEI indicates disbursements of €212 million recorded in their Aid Management Platform (AMP) database. This figure contrasts strongly with the Annual Financial Report of the Republic of Kosovo for 2014, which shows only €12.4 million of donor grants and €9.8 million of external borrowing.

- In practice, many BOs do not systematically enter much of the data required by the PIP, including important fields on cost-benefit analysis for major projects[9], and medium-term projections of the operational and maintenance costs[10] associated with capital investments (e.g., for running of schools and clinics, and maintaining roads). These data are essential to a proper analysis of the economic and budgetary impact of new investment projects.
- The MoF's Budget Department does not carry out a rigorous scrutiny of BOs' capital investment proposals, or a quality control of the data entered by BOs. The PIP Manual stipulates that the MoF must validate that each major project is a priority for the government and the relevant sector, is the best option for achieving the BO's desired objectives, satisfies the analysis of costs and benefits, and is affordable both in terms of capital expenditure and the associated operational and maintenance costs. Such analyses, however, are rarely undertaken by the MoF, partly because of the relatively small number of budget officers[11] and the many other demands on their resources.
- In principle, the PIP could be used for assessing PPPs, but in practice the tool has not been tested for this purpose, and its functionalities in this area need to be assessed. The PPP process should require BOs to enter information on PPPs in the PIP database, including information on public sector comparators, as a way to document the comparison of PPPs with the traditional procurement process. In addition, the database should include cases of PPPs where the government makes payments to a private contractor who is responsible for the design, construction, long-term maintenance and financing of a project (so-called "availability payments") in addition to the concession agreements used so far.
- The standard reports delivered by the PIP system do not meet the full requirements for guiding decisions on prioritization, and tracking the performance of large projects.[12] It is difficult to extract from the PIP, for example, reports showing how many major projects have been delayed, the length of these delays, and the size of cost overruns.

The recently published Single Project Pipeline of Infrastructural Projects uses a different and more comprehensive methodology for the prioritization and ranking of projects than the PIP. The projects identified in this pipeline, however, are explicitly linked to the EU-led

[9] Some BOs provide information on cost-benefit analyses in paper form.

[10] Operational and maintenance spending refers to current costs.

[11] The Budget Department comprises 21 staff, including 16 budget officers/analysts. Some of these officers cover four or more BOs.

[12] By comparison, the report on the Single Project Pipeline (July 2015) includes chapters on each of the 39 projects that summarize for policymakers in a few pages a brief description of the project, the criteria used in assessing its strategic relevance, the project's ranking, maturity, overall cost, and year-by-year breakdown of costs.

"Berlin process" to strengthen "infrastructural interconnectivity" in the Western Balkans; would benefit partly from EU financing, through the Western Balkans Investment Framework; and are currently limited in terms of the range of sectors considered (transport, environment, and energy).[13] A comparison of the projects included in the Single Project Pipeline and the PIP has not been made, and it is not clear how financing the projects would fit into the budget envelope for 2016–18.[14]

Recommendations for strengthening project selection and the PIP

1. Strengthen central decision-making on public investment

Currently, the IPS envisages that two separate pipelines of investment projects would be created, thus bifurcating and complicating the process. One pipeline would be financed by the budget and approved by the Strategic Planning Committee, the other financed by external loans and grants and initially screened by the MEI (see Figure A1.2).

An economically more efficient arrangement would be to prepare a single pipeline at the beginning of the process, including all new investment projects, regardless of the options for financing them, as illustrated in Figure A1.3. This alternative approach would work broadly as follows:

- The MoF would carry out the first screening of new investment projects. All new projects proposed by BOs would be subject to the same appraisal procedures and those projects, which pass the tests of economic viability, and conform to the government's national and sectoral priorities, would be placed in a list, ranked according to standard criteria, and submitted to the Strategic Planning Steering Group. This committee would identify potential funding options: budget, donor funding, PPPs, or POEs. Discussions to obtain expressions of interest from donors to finance some of the projects would inform this process, and would be chaired jointly by the MoF and the MEI.
- The pipeline would then be divided into four lists of new projects: (i) those that are expected to be financed through the budget; (iii) those expected to receive financing from the EU or other donors; (iii) those expected to be procured as PPPs; and (iv) those expected to be financed from the budgets of POEs.
- The preparation of these pipelines would inform the selection of new projects by the MoF that would be subject to the investment clause of the fiscal rule.
- In the next step, the four pipelines would be submitted and discussed at a ministerial level, possibly by the NIC (see below). A second round of consultation with donors could

[13] It is intended, however, that the coverage of the SPP be extended to the social sectors. See Press Release by the Ministry of European Integration, July 30, 2015.

[14] The projects in the SPP have an estimated total cost of €2.35 billion spread over ten years.

also inform this process. In parallel, decisions on PPPs would continue to be approved by the PPP Council as stated by the PPP Law, with veto power from the MoF.

- Finally, the NIC would send a final list of new projects for confirmation by the Strategic Planning Committee and final approval by the Cabinet.

Figure A1.2. Kosovo: Existing Structure

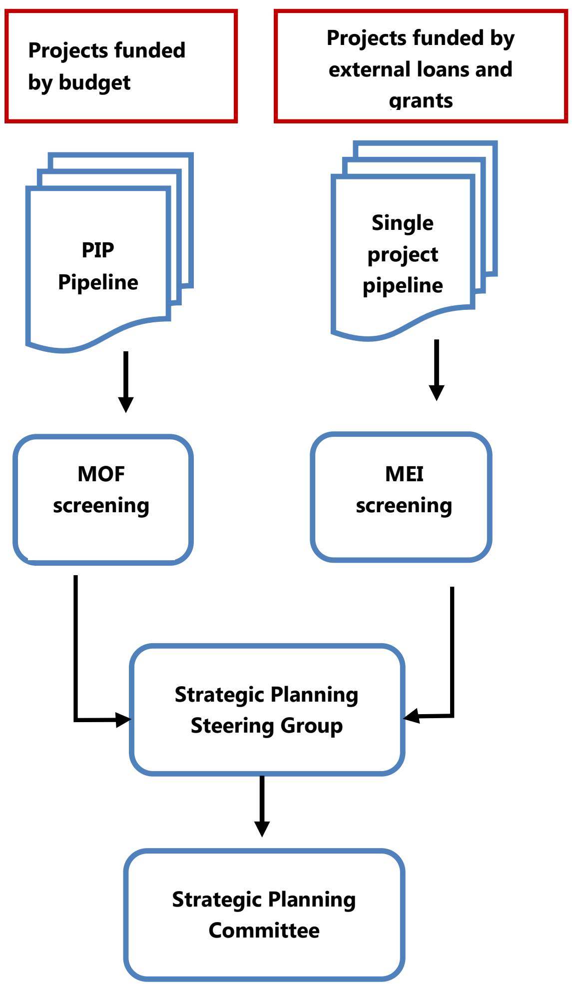
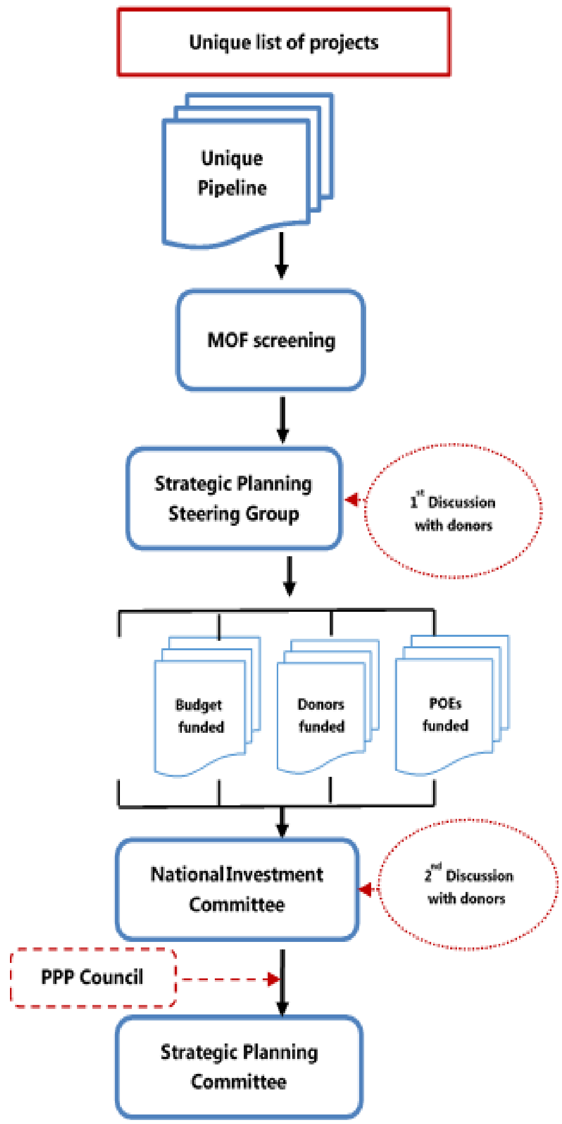


Figure A1.3. Kosovo: Proposed Structure



Source: Staff.

In order to streamline the committee structure, the role and mandate of the National Investment Committee could be amended so that it acts, together with the PPP Council, as a sub-committee of the Strategic Planning Committee (as illustrated in Chart B). The National Investment Committee would continue to be chaired jointly by the Ministers of European Integration and Finance and would have the following mandate:

- To review and approve all major new capital projects before they are included in the MTEF and the draft budget proposal, and to ensure that alternative options for providing the necessary facilities or services more efficiently and effectively have been fully considered.
- To ensure that all approved projects are consistent with the priorities set out in the government's National Development Strategy and the related sectoral strategies.
- To consider alternative sources of funding the projects concerned, including external loans or grant finance.
- To monitor the implementation of major projects, including cost overruns and delays in bringing the assets and facilities into use.

2. Review and make modifications to the PIP

A comprehensive review of the PIP should be carried out by the MoF. The review should assess how well the system is delivering the objectives set out in the PIP Manual; the extent to which its various functionalities are being applied; the perceived strengths and weaknesses of the system from the viewpoint of different users, and the challenges they have faced; the adequacy of reports generated by the system; and the skills and resources required to operate the system effectively. The review should make recommendations for modifying or improving the PIP.

Key issues for the review should include:

a. Separation of the two core functions of the PIP database noted above. This separation could be achieved either by distinguishing the two different types of projects in the PIP database—the first dealing with all existing projects and the second with proposed new major projects—or by generating special reports on new major projects which would then be screened by the MoF and the NIC on the lines discussed above.
b. Limiting the requirement for BOs to rank projects in order of priority to new major projects only, thus facilitating the task of the NIC in selecting projects for financing through the budget or other means.[15]
c. Development of specific procedures and criteria for conducting cost-benefit analyses, the ranking of projects, and project selection that should be based on international good

[15] Municipal PIP budgets may require separate treatment, because the size of their projects is typically smaller.

practice[16] and incorporation into the proposed legal framework for project selection. These procedures should take into account the methodology used to construct the Single Project Pipeline, as well as the guidelines already set out in the PIP Manual.

d. Preparation of analytical reports to highlight important missing fields that have not been completed by BOs (e.g., cost-benefit analyses and projections of the medium-term costs of operational and maintenance expenditure related to major projects) so that budget officers can follow up. Such a change would strengthen the hand of the MoF in the process of planning and selecting projects.

e. The production of other standard reports, tables, and charts form the PIP that provide essential information for ministers and senior officials in monitoring the implementation of major projects, and taking decisions to approve new projects.

f. Closing fields and functionalities of the PIP—in light of the results and recommendations of the proposed review—that are not systematically used and do not contribute significant value to the process of appraising, selecting, implementing, and monitoring projects.

g. The suitability of the PIP's functionalities for assessing the economic value and fiscal risks of proposed PPPs and generating reports on PPP projects that can be used by the PPP Council for approving or rejecting the proposals concerned, as well as monitoring their progress.

In addition to changes in the PIP database, a revised version of the manual could be prepared after the proposed review has been completed. The results of the review should first be discussed and agreed with counterparts in the BOs and with other stakeholders.

3. Strengthening the Legal basis for Public Investment Management

Formal rules for the appraisal and selection of major investment projects should be approved by the Cabinet and the Assembly. There is currently no formal legal basis for procedures and rules relating to the appraisal, prioritization, and selection of investment projects. This lacuna should be corrected, and a new law or regulations be approved by the Cabinet so as to provide a clear framework for policymakers and users of the PIP and to reinforce the authority of the Budget Department and the MoF in general to exercise its oversight and quality assurance role.

[16] See, for example, European Union, 2008, *Guide to Cost Benefit Analysis of Investment Projects*. This guide focuses on EU Structural Funds, Coherence Funds and Instruments for Pre-Accession, but has wider applicability. In Korea, a state-of-the art system of public investment management has been implemented, including procedures for projection prioritization and selection. See World Bank, 2012, *The Power of Public Investment Management: Transferring Resources into Assets for Growth*, Case Study on Korea by Jay Hyung-Kim.

4. Capacity Building

There would be a need for a realignment of resources in the MoF to support the Integrated Planning System process and its implications for public investment and the budget process. Additional resources would enable the Budget Department to exercise a stronger quality assurance role on the PIP and improve its effectiveness in the oversight and quality assurance of the technical work carried out by the BOs, who would also need to review their skills base and human resource requirements.

Implementation

The following sequenced steps are recommended:

- Changes to the institutional arrangements for taking decisions on the pipeline of eligible projects (2016);
- Review of the PIP (2016);
- Preparation of new legislation on public investment management (2016); and
- Changes to the PIP database and the PIP Manual (2017)

Annex II. Public Investment Management Assessment Methodology

For the purpose of the assessment of public investment management in Chapter 3, two dimensions were assessed for each institution:

- *Institutional strength:* Institutional strength assesses the design of the processes, laws, systems, and managerial tools implemented from a design point of view. It is based on the questionnaire presented in the IMF Board Paper "Making Public Investment More Efficient." This questionnaire comprises 15 institutions each with three indicators. For each indicator, three possible scores are set (low, medium, and good). The scoring of the three indicators per institution are aggregated using simple averaging. The following color code was used and scores for the institution were assigned according to the following principles:

	Strong	Good	Medium	Low
Strength of the institution	Highest score on average	2 Highest scores and one low, or 2 medium, and one highest score	Medium score on average	Lowest score on average

- *Effectiveness:* The effectiveness assesses how well the institution is implemented in practice and whether it achieved the envisaged results. It was assessed qualitatively, based on evidence (e.g., numerical, reviews and assessment of international organizations, audit reports). The following color code was used:

	High	Medium	Low
Effectiveness of the institution			

Annex III. Sequenced Action Plan

Recommendation	2016	2017	2018	Responsible Agency
1. Implement and publish the national strategy and consolidate and cost sector strategies	- Finalize national strategy - Take stock of all sector strategies - Develop framework for costing of sector strategies	- Consolidate sector strategies and cost them - Extend the pipeline of projects and integrate with national strategy	- Continue consolidate sector strategies and cost them	MoF (Budget Department), MEI, OSP, BOs
2. Increase transparency of budget documentation by including PPPs and POE investments and the fiscal risks related to them	- Include an annex in the 2017 budget for PPPs and related risks - Include an annex in the 2017 budget for public investments in POEs	- Include a statement of contingent liabilities related to PPPs and POEs in the 2016 financial statements - Develop IPSAS-based accounting and reporting standards for PPPs	- Apply IPSAS-based accounting and reporting standards for PPPs in 2017 financial statements	MoF (Budget Department, Treasury), PPP Unit, POE Unit in MED
3. Include on-going project obligations versus fiscal space for new projects, and project total cost and duration in the budget documentation	- Design of revised format for Table 3.2 and 4.2 and include in 2017 budget documentation - Enforce reporting of multi-annual commitments as required in the LPFMA - Disclose multi-annual commitments in 2017 budget - Present an analysis of fiscal space for new projects in 2017 budget	- Disclose multi-annual commitments in an annex of the financial statements 2016 - Monitor multi-annual commitments through KFMIS		MoF (Budget Department, Treasury) BOs

Recommendation	2016	2017	2018	Responsible Agency
4. Include subsequent maintenance costs in the planning of capital projects	- Conduct studies on maintenance needs - Include an “out of which” line for maintenance under Goods and Services in the 2017 budget - Scrutinize 2017 budget submissions to ensure that capital and current spending are classified appropriately	- Strengthen the focus on current costs of capital projects in sector strategies		MoF (Budget Department), BOs
5. Strengthen MoF role for project appraisal and selection	- Align institutional arrangements for taking decisions on the pipeline - Amend the regulatory framework for public investment management			MoF (Budget Department), OSP, MEI
6. Improve the PIP system	- Review functionality and use of the PIP system - Develop changes in PIP system, including targeted monitoring reports - Establish an MoF quality control process for major projects and follow up BOs - Establish tracking for projects under investment clause	- Implement changes to the PIP database - Revise the PIP Manual - Expand the MoF quality control process to cover mid-sized projects	- Extend MoF quality control to other projects	MoF (Budget Department, IT Department), BOs
7. Establish procedures for ex post reviews	- Design an ex post review process undertaken on a selected high-risk basis - Select pilot projects	- Conduct pilot ex post reviews		MoF (Budget Department), BOs
8. Expand ex post audits by the Auditor General	- Review necessary changes in legislation to permit auditor general to carry out ex post audits of projects with pending court cases	- Undertake ex post audits of all major projects	- Undertake ex post audits of all projects	Auditor General, MoF, MoJ, Prosecutorial and Judicial Councils

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