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Russia

Towards Improving the Efficiency of Public Investment Expenditures

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CURRENCY AND EQUIVALENT UNITS

Currency Unit = Ruble
US\$1 = 29 rubles

ACRONYMS AND ABBREVIATIONS

CPI	Consumer Price Index
FCPF	Federal Center for Project Financing
FTIP	Federal Targeted Investment Program
FTP	Federal Targeted Programs
GDP	Gross Domestic Product
GFS	Government Finance Statistics
IFI	International Financial Institution
IMF	International Monetary Fund
MAP	Ministry for Antimonopoly Policy
MoEDT	Ministry of Economic Development and Trade
MoF	Ministry of Finance
MoIS	Ministry of Industry and Science
MoT	Ministry of Transport
OECD	Organization for Economic Cooperation and Development
PIR	Public Investment Review
RDF	Regional Development Fund
VSM	High-Speed Railway Project

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PREFACE

This report was produced by a Bank team composed of Asad Alam (Team Leader, ECSPE), Alexander Morozov, Stepan Titov, Victor Gabor (ECSPE) and Gunnar Eskeland (DECRG). Valuable comments and suggestions were provided by Michael Carter, Michael Fuchs, Ellen Hamilton, Joel Hellman, Allister Moon, Arigapudi Premchand, Christof Ruehl, Graham Smith, and Deborah Wetzel. Vinaya Swaroop (DECRG) and Jonathan Anderson (IMF) provided close guidance throughout the process as Peer Reviewers. The report was prepared under the sponsorship of Julian Schweitzer (Country Director, ECC10), Robert J. Anderson and Helga Muller (Sector Managers, ECSPE) who provided substantive inputs into the design and analysis contained in the report. Lorie Henson, Sandra Craig, and Usha Rani Khanna (ECSPE) provided capable team support with report editing and formatting. Tatyana Alexandrova, Yelena Dobrolyubova, and Olga Stchesnovich (ECC10) helped with the organization of all mission work and translations.

The report was prepared with participation from the Government at key stages from concept through final draft. An early draft of the report was shared with the Government and presented at a Workshop. Comments received from the Government at various stages are reflected in this report. Later technical work on detailing the recommendations of the Action Plan was done in close collaboration with staff of the Ministry of Finance and the Gaidar Institute. The Task Team is thankful to Mr. A.V. Ulyukaev, First Deputy Minister of Finance, Mr. A. Dvorkovich, Deputy Minister, Ministry of Economic Development and Trade, staff from their departments, other government officials, and staff from the Center for Fiscal Policy, the Bureau for Economic Analysis and the Gaidar Institute who assisted with this work.

Schedule of Key Steps	
Concept Paper Review Meeting	: February 12, 2001
Main Mission	: February 19-28, 2001
Draft Report to Government	: May 2, 2001
Mission to Discuss Draft Report	: May 17-25, 2001
Workshop with Government	: May 23, 2001
Written Comments from Ministry of Finance	: June 5, 2001
Decision Draft Issuance	: June 14, 2001
Decision Draft Review Meeting	: June 25, 2001
Mission for Follow Up	
Technical Work with Government	: June 26 – July 6, 2001
PER Workshop	: July 5, 2001
Final Report to Government	: July 25, 2001

EXECUTIVE SUMMARY

This report documents the current levels and patterns of public investment in Russia, analyzes the institutional arrangements in place for investment budgeting, and develops short- and medium-term recommendations where policy or institutional strengthening is required for improving the efficiency of investment expenditures. The analysis of public investment is based primarily over the federal government though some issues of subnational investment budgeting are also touched upon. In any case, many of the issues and recommendations at the federal level are likely to have relevance for subnational investment budgeting also. While the Government is embarked upon overall budgetary reforms, the special characteristics of multi-year investment programs require special attention.

In the face of evidence of inefficiencies in the use of public funds for investment purposes, improvements in their efficiency—both in terms of their allocation across sectors and activities, and in terms of their cost-effectiveness—are clearly important. It is also clear that many gains would come from the strengthening of the institutional arrangements for investment budgeting—in the areas of budget preparation, implementation, and *ex post* evaluation and accountability.

Data Constraints

Data inadequacies hamper an accurate estimation of public investment expenditures. In the absence of actual budget execution data from the Ministry of Finance (MoF), enterprise survey data from Goskomstat was used to develop a profile of public investment. These surveys require all medium and large-sized enterprises—the final executors of investment programs—to report on their sources of investment financing by level of Government (federal, subnational, local, extrabudgetary funds, and other sources) on a quarterly basis. However, these data do not include expenditures on capital repairs. Consequently, adjustments were made by adding MoF budgetary data on capital repairs to come up with an adjusted consolidated figure for public investments in the Russian Federation. However, other key data deficiencies remain with the Goskomstat data, especially with respect to the discrepancy between cash expenditures and accruals (though this problem has been diminishing), the

consistency of data coverage over time, and the accuracy of data reporting.

Given these data deficiencies, what these numbers provide, at best, are broad orders of magnitude for public investments and should be treated as such. It is not the objective of this report to develop precise estimates for public investments, but to provide an overall descriptive context within which the analysis of institutional arrangements can be conducted. However, the lack of good quality data on actual expenditures is indeed a serious impediment to the conduct of expenditure analysis. More importantly, it is an even more serious constraint for policymakers who need good quality and timely data in order to make informed economic choices, and for the public and its representatives who also need to have access to such data in order to exercise oversight and accountability on the functions of the state, necessary for a healthy democratic policy.

Ongoing initiatives in the Government to improve and extend the operation of the Treasury and to introduce standard functional and economic classification for reporting—consistent with international standards and the analytical needs of the policymakers—will help, over time, to resolve these data deficiencies. This is an issue which affects all fiscal accounts and is reinforced by the identification of the deficiencies in the data on public investments. This further highlights the need to rapidly ensure, as a significant step in that direction, that the IMF's Government Finance Statistics (GFS) economic and functional classification is adopted. Both budget presentation and reporting should be fully compatible with this classification.

A Profile of Public Investments

Public investments in Russia are estimated at about 4 percent of GDP of which federal government investments are about 1 percent of GDP. Russia, like many other OECD countries, does not have a separate investment budget. Federal investment projects are conducted in the context of several investment programs comprising of roads, the Federal Targeted Investment Program (FTIP), the Regional Development Fund, and various sector-specific investments, for instance, in coal and agriculture.

Judgements about whether the level of public investment is appropriate for Russia at its current stage of economic development is an assessment that has to be based on a careful analysis of country specific features, including its medium-term sustainable fiscal envelope, the current stock of capital, extent of private sector investments, and development strategy. This is beyond the scope of this report. However, comparisons with OECD countries—which are again heterogeneous in terms of physical size, population spread, income, size of government, and size of the private sector—suggests that Russia is not an outlier country. Most OECD countries have public investment expenditures between 3-5 percent of GDP.

A breakdown of public investments over 1997-2000 reveals several interesting points:

- (i) There has been a relative shift in public investment expenditures away from the federal government to subnational governments. The share of federal government (including federal roads fund) fell sharply from 35 percent to 22 percent, while that of subnational governments increased from 50 percent to 60 percent. While some of this shift may be related to devolving assignments of expenditure responsibilities, incentives for budgeting for investment expenditures may also be different at lower levels of government;
- (ii) The investment budget is developing a strong bias towards road sector investments. Financing from the road funds—both federal and territorial—have increased from 13 percent of total investments in 1997 to 37 percent of planned investments in 2000. While such a shift may well be fully justifiable, it is not clear that there is an underlying economic justification for this based on inter- or intra-sectoral priorities and financing needs;
- (iii) Capital repairs have halved as a share of total public investments, declining from 17 percent of the total in 1997 to about 8 percent in 2000. This, of course, has been the gain of new investments and purchases of machinery and equipment which now take the lion's share of federal and subnational investments. Given Russia's initial stock of capital in public hands, and the relative neglect of

maintenance over the years, it is not obvious that such a high proportion of investments on new projects instead of capital repairs is justifiable on economic grounds; and

- (iv) The regional distribution of public investments suggests that regions with higher incomes get proportionately more public investments than poorer regions. In 2000, the top decile of regions got 60 percent of total public investment while the bottom decile received less than 1 percent. While horizontal equity is not a primary purpose of federal expenditures on investment, it is worth assessing whether such a distribution is consistent with the broader objectives of regional development.

These findings further reinforce the view that the challenge for the Government on the investment budget is not so much over the *quantity* of public investment but over its *quality*. The quality aspect relevant here is the allocative efficiency of investment expenditures—across sectors, projects, and regions. This points to the need for investment budgeting to be based in the context of a national economic policy which reflects the inter- and intra-sectoral, and inter-regional priorities for investments. This would ensure that the observed biases in investment expenditures—for instance, towards road sector investments or richer regions—arises from a deliberate consideration of the policy priorities and is not the unintended result of Government action.

Government's Role in Investments

Central to the analysis of public investments is the public-private choice which needs to underpin the selection of investment projects. This is particularly important and relevant for transition economies such as Russia, which are going through major structural changes in the economy. The decapitalization of the economy—not least because of the decline in economic activity, asset stripping and capital flight, and the needs of restructuring—in the face of a changing role of the state and expenditure retrenchment—puts to the fore the critical issue of the appropriate public role in investments.

Global economic and social forces have changed prevailing notions of the state in several ways. First, the role of Government in a market economy is to address market failures and redistribution. Intervention on these grounds is based on traditional

welfare economic analyses. Recent contributions also recognize that interventions should be measured so as to match government's role to its capabilities. Second, if there is a role for Government intervention, then there are clear economic criteria which can guide what the nature of the public intervention should be. In particular, the choice between the Government financing the creation of new assets as against owning it should be a deliberate one. There is also a growing recognition that the state need not be the sole provider of basic infrastructure, social services and other public goods. Technological, organizational and regulatory innovations have created new opportunities for competitive private providers in many of these areas. Many of the most successful examples of development entail the state working in partnership with markets to correct their failures, not replacing them. Third, cost-benefit analysis can serve as an objective guide to screen worthwhile interventions not only for the traditional infrastructure sectors but also for social sectors. Such objective criteria provide a necessary discipline to the process of project selection and, if done well, maximize the efficiency in the use of public funds. And finally, in a federal structure, where the role of the federal Government through direct budgetary support is less dominant, it is perhaps more important for the federal Government to create an enabling environment for investments by the private sector and subnational governments.

The transition process under-way in Russia has already fundamentally reduced the domain for public intervention. The state is moving in a direction consistent with the above principles. The Government's economic program for 2001-2003 envisages a strategy towards public investments that highlights five objectives for public investments which are also broadly consistent with the above:¹

- (i) enhancing the social focus of investment activities, so as to promote the development of social infrastructure, public health, education, fundamental and applied sciences;
- (ii) promoting the openness and predictability of the state investment policy; so as to encourage private-sector capital flows for

¹ Government of Russia, 2001, Draft Basic Trends In Social And Economic Policy Of The Government Of The Russian Federation Over The Long Term.

priority objectives of national social and economic development;

- (iii) focusing as a priority, on state support of infrastructure facilities of strategic national significance, which promote economic stability, innovation, technological breakthroughs, and environmental security;
- (iv) enhancing the efficiency of investment activities in the state sector of the economy; while ensuring the transparency of investment flows and programs; and
- (v) ensuring the fulfillment of the investment obligations undertaken by the state as part of the approved budget.

However, a review of public investments in accordance with the objective criteria reveals at least four shortcomings in practice:

- (i) *The rationale for Government intervention needs to be clarified.* While for some type of interventions—such as federal roads and some federal targeted programs—this is clear, it is not apparent for many investments, particularly those of a commercial nature which comprise about 13 percent of the federal targeted programs. Budgetary savings can be generated in the short-run by the Government withdrawing from the financing of such investments, and higher returns to public funds can be obtained by making these investments in other sectors;
- (ii) *Where the rationale for Government intervention is clear, an investment decision which leads to the Government owning that asset needs to be determined in relation to other alternatives.* Again, in the federal targeted programs, there are many small investments to power companies and it is questionable—given the nature of the beneficiary enterprises—whether direct financing is the most efficient form of government intervention. The Government needs to review each of these programs to develop a strategy for intervention;
- (iii) *Objective cost-benefit analysis is not used for project selection and should be introduced.* While many projects in the investment program may have high economic rates of

return and may be fully justifiable on economic criteria, their selection is not based upon objective cost-benefit analysis. While final project selection may well be determined by political choices and tradeoffs, the establishment of a rules-based system will introduce some degree of discipline to the process, ensure that the costs or tradeoffs are clearly laid out, and promote the financing of those projects which satisfy some basic requirements. A start should be made by training staff in key line ministries and central agencies in the techniques of cost-benefit analysis, and then progressively requiring all investment decisions to be based on these criteria; and

- (iv) *The role of federal investments in the total public investment program needs to be clarified and streamlined.* This needs to be done in the context of overall assignments of expenditure responsibilities. To some extent, the current profile of investments already demonstrates this, as health and education—primary responsibilities for subnational governments—do not attract significant federal investments. Even in areas of overlap—such as roads—principles need to be established on what types of roads are to be financed from which budgets. In addition, the Government may wish to consider what types of investment expenditures—new fixed investments, reconstruction and repairs, and purchase of machinery and equipment—are to be financed by different levels of Government.

Even with the best normative framework, implementing pure objective criteria in project selection will be difficult. Political factors will necessarily impinge upon economic decisions, but the value of establishing objective criteria is in imposing some discipline over the political process. This would help contain the costs from wrong choices by making explicit the consequences including the foregone opportunities.

Federal Investment Budget Preparation

Good budgets are an essential basis for good budgetary outcomes. These depend in large part on the institutional arrangements for budgeting which are still evolving in Russia. The biggest deficiencies arise from the fragmentation of the investment

budget, the weak links with policy, lack of integration between investment and current expenditures, short one-year budgeting horizons even for multi-year projects, use of non-objective criteria for financing project needs, and inadequate systems for managing multi-year risks. But there are some positive features, too, particularly in the policy basis for the federal targeted programs. Measures to strengthen investment budget preparation have to center upon the following five areas:

- (i) *The federal investment program is fragmented.* The fragmentation is at many different levels. Different agencies and departments are responsible for the development, monitoring and implementation of each of the investment programs and projects. The financing of these programs goes through different financing ‘windows’ of the federal budget. Individual programs are sometimes financed from multiple ‘windows’. There is little evidence of coordination among the various departments, which seriously increases the transaction costs and risks of ‘double-dipping’ undermining the cost-effective preparation and implementation of investment programs and projects. Clearly efficiency gains can be derived through consolidation of some programs and financing ‘windows’, as well as of departmental responsibilities in MoF and MoEDT, and certainly through better coordination;
- (ii) *While the process of investment budgeting follows the annual budget, the integration of the investment components of the budget remains incomplete.* This is at two levels. First, little work is done in terms of an in-depth analysis of the linkages between the economy, specific programs for economic development, and the proposed investment budget so as to bring out the development impact of proposed investment budget measures. Second, neither the current cost implications of ongoing investment programs, nor the future current cost implications of new investment programs and projects are adequately reflected. This needs to be remedied through:
- *the introduction of an integrated Medium-Term Expenditure Program.* This could be done on a rolling basis and

cover both the current and the investment plans. In principle, this should be couched within the context of a medium-term sustainable resource envelope, but a start can be made by looking at expenditures in an integrated manner. This would thus facilitate an informed debate on expenditure priorities and for the role of public investments within them.

- *the initiation of multi-year budgeting for investment projects.* This would help provide certainty of budgetary financing for future years, facilitate timely financing and completion of works, and improve the economic returns from investment projects. This planning should also take into account the flow of work, including seasonality issues, project financing needs, and of course, budgetary affordability.
- *the strengthening of the statistical base of the MoF and MoEDT.* This would aim at the development of a database on expenditure profiles of major programs, unit costs of different types of investments, performance indicators and benchmarks for different investment programs, so as to enable the centralized agencies to have a more precise understanding of the impact of investment programs on the budget and on the economy;

- (iii) *Criteria for budgetary inclusion of projects is not clear.* The scarcity of budgetary resources available for financing the large demands for public funds for approved investment projects necessarily suggests that objective criteria should be used for prioritizing these expenditures. At one level, this needs careful scrutiny in the *selection* of projects as discussed above. This would, for instance, preclude projects of a commercial nature from entering into the investment pipeline. At another level, once projects are approved as being eligible for federal budgetary financing, prioritization—for instance for capital repairs rather than new investments, or for projects closer to completion than others or those performing better than others—would help direct

resources to selected projects to ensure that the life of the state's assets is extended and that new asset-creation is completed in a timely manner;

- (iv) *Project risks—from both macroeconomic and project-specific factors—need to be reduced.* These have arisen primarily from drastic changes in macroeconomic assumptions underlying project costs, such as the rate of inflation, exchange rate, and interest rate. To minimize these risks, the Government needs to consolidate its recent gains towards macroeconomic stabilization, prepare budgets with conservative macroeconomic assumptions, and enforce payments discipline so that payment contracts are honored on time. However, project-specific risks have also been significant and can be *ex ante* reduced by improving the technical quality of project appraisal and instituting periodic reviews of investment programs and projects; and
- (v) *Much of the process of preparing budgets is manual with extensive reliance on paper work.* Although Excel spread sheets are used for recording and calculating individual items, a computer-based budget preparation system is not used for the consolidation of investment program requests or for tracking their financing progress. Consistent with the spread in the use of information technology within Government, an effort should be made to move towards electronic submissions of the budget submissions by spending units (including those for the investment programs).

Project Implementation and Ex Post Evaluation

Even with the best of budgets, the challenge of implementing it efficiently—that is, at least cost and with maximum economic benefits—remains. An assessment of current institutional arrangements suggests that systems for the monitoring of implementation and ex post evaluation and accountability need to be strengthened.

Noticeable improvements have taken place in investment budget execution—to a large extent due to the extension of the Federal Treasury—but there are still significant weaknesses which undermine the overall efficiency of the investment budget.

Recommendations for addressing these weaknesses include the following:

- (i) *Systems for commitment control need to be introduced.* While a generic problem for all budget expenditures, this issue takes special importance for investment expenditures which are often lumpy, multi-year in nature, and support projects which are often scalable. The latter risks more work being done—and thereby expenditure obligations being accrued—even when financing is limited. For Russia, the challenge of commitment control is accentuated by the lack of clarity over budgetary entities, multiple windows of financing for the same investment project, and an unknown stock of contingent liabilities. While full commitment control over federal investments will only be established after the federal Treasury is fully operational, a transitional measure that can be undertaken would be to introduce *de jure* Treasury registration—currently *de facto* in vogue for contracts with utilities and communal services—to investment projects above a certain threshold. This would, however, require amending the Budget and/or Civil Codes;
- (ii) *Competitive procurement for public contracts needs to be strengthened.* While Russia has made steady progress in extending competitive procurement practices—in 1999, 70 percent of federal public expenditures on the purchase of goods, works and services were done by ‘open tendering’, which is the most competitive procurement method available under current legislation—weaknesses remain. Among them are excessive restrictions which apply to many public tenders (including limitations on participation by foreign bidders and, at subnational levels, by bidders from outside the purchaser’s own region) which undermine competitiveness, weaknesses in legislation, particularly in the sub-legislative texts, shifting organizational responsibilities for the conduct of public procurement, and lack of human resources to conduct competitive procurement. This calls for amendments to the current laws to remedy the restrictive stipulations, establishment of an autonomous federal procurement monitoring agency with the role of

developing, monitoring and overseeing Russia’s public procurement system, development of detailed sub-legislative texts which can explain how procurement laws are to be implemented, and strengthening of institutional and human capacity in line ministries, where most procurement takes place;

- (iii) *Internal systems for quality control need to be reinforced.* Inefficiencies in implementation and the inadequacies of systems for quality control are evident from delays in the completion of projects and overruns in project costs. Existing systems show fragmentation wherein line ministries, central ministries, as well as technical agencies of the Government are all involved in various aspects of work verification. However, what is absent is a strong link between budget management and the quality of work being accomplished. As a result, budgetary flows are often released based on the utilization of funds and not on whether the work is being done according to its technical specifications. In addition, procedures for work cost verification are not adequate and need improvement. Measures are needed to require quality reviews by line ministries, as well as establish an investment monitoring unit in MoF or MoEDT with the responsibility for conducting real time performance audits on ongoing tasks;
- (iv) *Timely reporting of expenditures and payments for contracts needs to be ensured.* The development of the federal Treasury has been a big step forward in introducing better reporting and payment discipline. However, problems remain. Inadequate budgetary classifications, weak incentives for reporting, and inadequate systems undermine timely reporting. Payment discipline is reportedly still problematic. This is primarily because budgetary releases are based on equal time-slices of expenditures which do not take into account the flow of work (including seasonality) and are often also sequestered in the face of unexpected budgetary tightness. The challenge in resolving these lie in improving budgetary classifications, introducing standards for reporting, better budgeting and planning of expenditure releases (including cofinancing procedures),

and extending the coverage of the Treasury;
and

- (v) *Ex post evaluation and audit remain under-developed.* Systems of both internal and external audit remain weak. By focussing on financial uses only, they do not provide any 'value-for-money' evaluation which is essential for any assessment of the effectiveness of investment programs. Program evaluation remains systematically weak within Government, with the exception of the federal targeted programs where an annual summary report on their performance is sent to the Government and the Duma. With respect to external audit, the Chamber of Accounts is empowered to conduct these, but also focuses on financial audits only. If the efficiency of investment expenditures is to be improved, then an area for priority action has to be the strengthening of internal and external audit. Measures should include strengthening the capacity within the Chamber of Accounts for external audit and within Government for internal audit, strengthening legislative oversight over external audit, and developing guidelines and manuals for project performance analysis.

A Ten-Point Plan of Action

The agenda for the needed budgetary reforms to ensure effective implementation of the investment budget is large. Necessarily, the Government needs to prioritize among the various recommendations made in this report. One way to proceed would be to focus on a set of ten concrete measures that could be implemented relatively easily, in a logical sequence, and could provide significant gains over a short period of time. This would help launch the process and develop momentum for these reforms. A recommended plan for action would include the following:

- (i) *Develop an inventory of all investment programs (including FTPs, non-program investments, sectoral investments, and foreign-tied investment loans) entitled to federal support under existing normative acts.* This would be the first step towards developing an integrated approach to federal investments and would help implementation of subsequent measures;

- (ii) *Publish on a timely and comprehensive basis the economic and functional classification of actual budget execution data on investment programs; present Budget Law data in the same format. It should be done for federal, subnational and consolidated budgets.* This would require changes in the existing functional and economic classification, expansion of their coverage to cover all investment expenditures (including on FTPs and foreign tied investment loans), and their proper enforcement. Ongoing work on improving the classifications for the budget and the Chart of Accounts, with technical assistance from the IMF and the World Bank, is in the right direction and needs to be accelerated;

- (iii) *Develop a policy statement on the objective criteria to be used for investment programs and projects; define clearly through a Government resolution, areas where the Federal Government would undertake new investments.* Current developed procedures for FTPs and investment loans from IFIs could, with some modification, be adapted for other investment programs also;²

- (iv) *Implement uniform procedures for investment programs and consolidate some departments in MoEDT and MoF into a unified Investment Policy and Program Department in each of these ministries.* Within the MoEDT such a department would prepare standards for project appraisal, provide technical assistance to investment units within spending agencies, ensure the application of common rules and procedures, and screen projects above a certain threshold. Within the MoF the investment department would consolidate funding of investment from the federal budget and--jointly with the Treasury and the MoEDT--develop and apply procedures for resource allocation and disbursement. This would facilitate the integration and internal consistency of investment programs, and the application of common rules and procedures developed above;

² This would require amendments to Government Resolutions No. 594 of June 26, 1995 and 1470 of November 22, 1997.

- (v) *Introduce Treasury pre-registration of ALL federal investment contracts above a certain threshold through amendments to the Budget and/or Civil Codes.* Implementation of this would have to take into account the existing capacity within the Treasury. A start could be made by pre-registering investment contracts from specific sectors, regions, or those above a high threshold, and gradually extended;

For the 2002 Budget

- (vi) *Include only those investment programs and projects which can be adequately financed—that is, for which the financing is consistent with efficient work flow.* This would require from “state customers” (line ministries) realistic estimates of work and related financial flows (at least on the larger projects);
- (vii) *Ensure that recurrent cost implications of all investment projects are included in their proposals and provided for in the Budget for approved projects.* “State customers” should be required to estimate these costs over the medium-term, which should then be verified by MoEDT and be a factor in decisions to finance the project. A phased approach could again be adopted here with a start being made with selected multi-year investment programs;
- (viii) *Eliminate those programs which specifically (a) have commercial orientation and do not meet the criteria for federal public investment, or (b) have been going on for too long without much success of completion, or (c) are non-programmed investments in the FTIP.* If necessary, normative acts which may have sanctioned such investments from the federal budget will need to be amended or rescinded;
- (ix) *Prioritize for investment spending (a) completion of existing programs and projects, particularly those close to completion, rather than new projects, and (b) capital repairs and purchases of new equipment for which greater allocations need to be made.* For this to take place, the MoF will need to ensure that line ministries make

such reallocations within agreed verifiable returnable expenditure limits; and

- (x) *Develop Treasury disbursement procedures for co-financed investment projects wherein disbursement of federal funds would be conditional on timely disbursements from other sources of financing (e.g. with subnational governments or private investors).* This would require the inclusion of a special article in the federal Budget Law for 2002 and amendments to the Budget Code.³

Specific guidance on *how to* implement these specific measures have been developed in further consultation with the Government and are presented in Annex 6.1 of the report.

³ Over time, a better separation of financing of projects from federal and regional sources needs to be developed which would ensure that the investor is also the owner and obviate cofinancing problems.

CHAPTER 1

INTRODUCTION

1.1 This report documents the recent levels and pattern of public investments, analyzes the institutional arrangements in place for deciding upon these allocations and implementing them, and develops selected case studies to illustrate issues in the technical efficiency of these expenditures. The report develops short- and medium-term recommendations where policy change or institutional strengthening is required and identifies some possible expenditure savings. The analysis of public investment is based primarily over the federal government, though some issues of subnational investment budgeting are also touched upon. It is expected that some of these recommendations would feed into the discussions on the 2002 Budget, the preparation cycle for which starts in May 2001.

1.2 The primary audience for this report are policymakers in the Ministry of Finance (MoF), Ministry of Economic Development and Trade (MoEDT) and other relevant government agencies. The report would also be of use to technical staff in Government involved with investment budget preparation and execution, as well as to staff of the Bank and other donor organizations.

1.3 Given data issues (see Chapter 2), this report does NOT (a) present the investment program in the context of an overall medium-term sustainable fiscal envelope, and make judgements on the adequacy (or lack thereof) of the *level* of public investment and its sustainability; (b) provide guidance of the *inter-sectoral* allocation of the investment budget; (c) explore in detail quasi-public investments and implicit contingent liabilities, e.g. in the banking and transport sectors; or (d) explore in detail the use of the public investment budget as a tool of the country's industrial policy. These are all issues directly relevant for budgetary outcomes, but beyond the scope of this report, due to data, timing, and resource constraints.

1.4 Before embarking upon an examination of federal public investments, it is relevant to establish the fiscal context within which this work is being done.

The Fiscal Context

1.5 The Russian fiscal position has substantially improved after the 1998 financial meltdown (see Table 1.1). This has been possible due to a sharp increase in federal government revenues (due in large part to higher tax revenues from the energy sector) which rose to 16.2 percent of GDP in 2000 compared with just 13.4 percent in 1999. Furthermore, practically all revenues collected at the federal level since 1999 have been in cash. In 2000, with federal expenditures kept in check at under 15 percent of GDP, the federal budget had an overall surplus of 1.7 percent of GDP for the first time. The subnational budgets also showed a surplus of 0.7 percent of GDP with total revenues equivalent to 15.8 percent of GDP and expenditures equivalent to 15.1 percent of GDP. The improved fiscal position also reflects a renewed Government emphasis on establishing control over Russia's public finances, and a recognition that strong fiscal discipline is essential for economic recovery.

1.6 However, despite these positive developments, the sustainability of Russia's current fiscal position remains suspect for several reasons. First, prospects for sustainable growth and revenue buoyancy therefrom remain questionable in the wake of the slow pace of structural reforms. Second, given the huge agenda of reforms and the fiscal costs thereof, the budget needs to plan for a well sequenced, integrated, and affordable program of structural reforms; else fiscal

stability may be at risk. For instance, the pursuit of piecemeal reforms, such as enterprise restructuring, without commensurate improvements in the targeting of social assistance programs could lead to additional claims on the budget that could undermine fiscal stability. Third, budget revenues remain highly sensitive to changes in the international price of oil. While Russia should be able to weather a short-run fall in the price of oil without much difficulty because of the reserve cushion built up in 2000, any sustained reduction in price to under \$20 per barrel (which is the conservative assumption in the 2001 Budget) could lead to serious fiscal strains. Fourth, the dynamics of Russia's external outflows are onerous with peaks in debt repayments in 2003, 2005 and 2008. In the absence of an integrated fiscal strategy, the debt dynamics pose a serious risk to budgetary outcomes and macroeconomic management.

	1997	1998	1999	2000 (estimate)	2001 Budget Plan
FEDERAL					
Revenues	12.3	11.0	13.4	16.2	15.2
Expenditures	19.4	16.9	18.1	14.5	15.2
Balance	-7.1	-5.9	-4.7	1.7	0.0
SUBNATIONAL					
Revenues	18.5	16.2	15.8	15.8	14.3
Expenditures	19.4	17.4	15.9	15.1	14.3
Balance	-0.9	-1.2	-0.1	0.7	0.0
CONSOLIDATED					
Revenues	28.6	25.3	27.6	30.7	26.8
Expenditures	36.6	32.4	32.4	28.3	26.8
Balance	-8.0	-7.1	-4.8	2.4	0.0

Source: Ministry of Finance, IMF.

1.7 **Recent Fiscal Initiatives.** In order to address the above risks and lay the policy and institutional basis for strengthened fiscal management, the Government embarked in recent years upon systemic fiscal reforms along several dimensions.

1.8 First, in the area of tax policy and administration, the Government is engaged in a comprehensive program of reform. The program identifies the main objectives of tax reform as: (i) improving the investment climate and creating conditions for achieving a balanced budget; (ii) lowering the tax burden and sharing it more equitably; (iii) simplifying the tax system; and (iv) improving tax administration. In 2001, the statutory tax burden has been reduced. A unified flat personal income tax rate of 13 percent was introduced from that year. The road users tax rate was reduced with a decision to eliminate this tax fully from 2003. A unified social tax replaced former charges to four social extra-budgetary funds with overall reduction in tax rate. The Government has also embarked upon a comprehensive program to address the main remaining issues in tax administration, including putting in place a uniform functional organization structure, transition to self-assessment of tax declarations, consolidating information processing with the adoption of modern information systems, improving inter-agency coordination, increasing adequacy of tax policy and compliance analysis, creating an integrated taxpayer registration system, and developing institutional arrangements to reduce the incidence of arrears.

1.9 Second, in the area of treasury management and expenditure control, all budget and off-budget accounts of federal budget organizations are successfully being moved to the Federal Treasury, including the lower tiers of the Ministry of Defense. This process is expected to be completed by the end of 2001. In the interim, transition arrangements have been introduced for

strengthening commitment control. The Budget Classification system and the Chart of Accounts are also being improved to provide for better separation between functional and economic categories, simplification of coding system, and mutual consistency between them. Moreover, in an effort to identify legitimate budgetary organizations, recipients of budgetary funds from the federal budget are being delineated into budgetary organizations financed on a line item basis and commercial organizations and enterprises financed on a net transfer basis. Budget consolidation work has proceeded with the incorporation into the 2001 Budget of the Federal Road Fund—one of the largest earmarked budgetary funds. The bulk of other earmarked funds in the budget have also been eliminated.

1.10 Third, in the area of inter-governmental fiscal relations and fiscal federalism, a follow up concept on the reform in this area is being finalized within the Government. It includes progressive implementation of treasury execution of subnational budgets, further clarification of expenditure assignments among budgetary levels, transparent rule-based procedures for disbursement of all interbudgetary transfers from the federal budget, gradual change in tax assignments in accordance with principle 'one tax – one budget' and increased responsibility of local and regional governments for their budgets.

1.11 Fourth, in the area of public administration, the Government has established a high level Working Group which is trying to develop proposals for the rationalization of the size and structure of Government, improving the efficiency of Government, and improving the financial incentives for civil service performance. Other areas of public administration in which reform proposals are developing are with respect to the judiciary and the federal structure. Preparatory work in these areas is being supported by the World Bank and other donors.

1.12 And finally, fiscal reform issues are highlighted in the Government's Program of Priority Measures for 2000-2001 (Directive No. 1072-p dated July 26, 2000) which seeks to accelerate a program of macroeconomic, social, and structural reforms in an integrated manner. In order to enable the implementation of the overall program, the MoF has launched a medium-term program of fiscal work with the objective of addressing: (i) the fiscal implications and affordability of the reform program; and (ii) identifying the expenditure savings that can be generated through improvements in budget management. This is elaborated in the MoF's draft Expenditure Efficiency Program Concept Paper. Within this context, various donors have committed themselves to financing analytical work on budget management systems, sectoral public expenditure reviews, and public administration reforms.

1.13 **World Bank Role.** The World Bank is providing broad ranging support to the Government in support of its fiscal reform efforts. This includes a recently completed Tax Administration and Modernization Project, and several projects under preparation for FY02, including a sequel Tax Administration Modernization Project II, a Treasury Modernization Project, and a Fiscal Federalism and Regional Fiscal Reform Loan. In addition, the Bank is providing extensive analytical and advisory services to support the preparation of the Government's public administration reforms and other elements of its expenditure efficiency program. To that end, the MoF has requested the Bank to (i) play a coordinating role vis-a-vis the full set of analytical work being done on public expenditures, and (ii) conduct selective analysis of expenditure management issues as well as an analysis of public investment expenditures. This report is meant to address this latter request. As a follow-up to this report, the Bank is working with the Government to develop an integrative assessment of the various sectoral public expenditure reports. To that end, the Bank sponsored a technical workshop in Moscow on July 5, 2001, where the various sectoral reports were presented and the synthesis work started.

1.14 The analysis of investment expenditures contained herein not only meets the specific Government demand for such analysis but also addresses a significant knowledge gap in the understanding of the institutional arrangements for public investment at the federal level. This is particularly relevant for Russia (and most other transition economies) as the role of the state in investment is being redefined and rationalized. The World Bank's previous formal analytical work on public investment has been limited to a 1995 Investment Policy Report, a 1996 Budget Management Report, and a 1999 report on Benchmarking Public Expenditures. The initial report had some dedicated discussion on investment budgeting practices which were largely inherited from the Soviet Union. Though some issues raised in that report remain valid today, a more comprehensive, pragmatic, and current assessment is now provided so as to develop relevant recommendations which could provide a firm basis for continuing reforms in budget and expenditure management. The latter two reports cover general issues of public expenditures and budget management in Russia, and had limited discussion of issues relating to public investment.

Structure of the Report

1.15 The report is divided into six chapters. Following this introductory chapter is Chapter 2, which provides a current profile of public investments. Chapter 3 looks at the role of the Government in investments and the criteria for project selection. Chapter 4 examines issues in investment budgeting, while Chapter 5 looks at the implementation and ex post evaluation of investment expenditures. Chapter 6 brings together and summarizes the key issues and recommendations, and develops an Action Plan for the Government.

CHAPTER 2

PROFILE OF PUBLIC INVESTMENTS IN RUSSIA

2.1 Public investments are here defined narrowly to comprise public expenditures on the purchase of equipment and durable goods, capital construction (including housing, roads, and production facilities), and capital reconstruction and repairs.⁴ Unfortunately, neither the Annual Budget of the Russian Federation nor reports on budget execution provide a detailed breakdown of federal expenditures by its economic classification. Therefore, for the purpose of developing a profile of public investments, survey data from Goskomstat were utilized and adjustments were made to it in order to provide for proper coverage. The focus here is on the narrower definition of *investment* expenditures—those expenditures which lead to the creation or extension of life of the capital stock.

Structure and Classification of the Investment Budget

2.2 The federal public investment program is broadly composed of the following:

- (i) **Federal Targeted Investment Program (FTIP).** This is the largest formal program of public investment and is comprised of the following:
 - investment under earmarked federal funds in support of various programs, including regional development programs (about 140 programs in 2000; most of the investments are construction activities across economic structures).
 - discrete investment projects made according to the decisions and resolutions of the President and Government (mostly construction and reconstruction in different sectors of the economy);
- (ii) **Regional Development Fund (RDF).** This co-finances, with the FTP, investment expenditures in regional development programs as well as some discrete actions of the President and the Government regarding specific Russian regions (includes construction and reconstruction of schools, hospitals, and other social infrastructure);
- (iii) **Sector Investments in Coal Mining and Agriculture** (excluding federal earmarked programs). In coal mining, these investment are primarily in mine closure programs, while in agriculture, these are investment support to farmers;

⁴ The coverage here excludes other forms of capital expenditures. International practice with respect to the classification of capital expenditures varies. For instance, the IMF's 2000 Revised Government Finance Statistics (GFS) define capital expenditures to include payments for the acquisition of fixed capital assets, purchases of strategic or emergency stocks, land, and intangible assets, and capital transfers. However, the US Government in its definition of capital budgeting includes expenses towards research and development (both defense and non-defense) as well as education and training. In Russia, the categories of capital expenditures excluded from the narrower focus on investments are large and include: capital transfers, such as the capitalization of the new financial agencies (e.g. Russian Development Bank, the Russian Agricultural Bank, and the Agency on Restructuring of Credit Organizations (ARCO)), subventions for capital investments to Territorial Road Funds for construction and reconstruction of roads at the regional level, capital transfers to the population in terms of housing certificates, and replenishment of Agricultural Leasing Fund.

- (iv) **Investments in Roads.** These investments used to take place through the Federal Road Fund which was abolished and integrated into the 2001 Annual Budget. The investments from the federal Budget include:
- Rehabilitation of the federal roads (reconstruction of the federal roads directly from the federal budget).
 - Purchase of road equipment and machinery;
- (v) **Investment from Earmarked Budget Funds** (other than for roads). These are primarily the purchase of equipment and construction according to the profile of particular earmarked federal budget funds; and
- (vi) **Others.** These are mostly capital repair by federal agencies of non-production facilities.

Data Sources and Issues

2.3 In the absence of data on the economic classification of expenditures from Ministry of Finance, Goskomstat data were used. Goskomstat reports on budgetary execution data from its enterprise surveys. From 1998, these require ALL medium- and large-sized enterprises—the final executors of investment programs—to report on their sources of investment financing by level of Government (federal, regional, local, extrabudgetary funds, and other sources) and on a quarterly basis. Data on public investment expenditures by level of Government are then compiled and published in monthly bulletins with a lag of about two months.

2.4 However, these data do not include expenditures on capital repairs. Consequently, adjustments are made by adding MoF budgetary data on capital repairs to come up with an adjusted consolidated figure for public investments in the Russian Federation.

2.5 It is important to note that the data suffer from serious deficiencies which compromise the precision of its estimates, as well as the comparability of the numbers over time. **At best, what these numbers provide are broad orders of magnitude and should be treated as such.** Some of the more difficult data problems are:⁵

- (i) *Consistency of data over time is suspect.* With respect to the Goskomstat surveys, changes in coverage in 1998 resulted in a shift from all surveying enterprises to medium- and large-sized enterprises only. This reduction in coverage introduces a discontinuity in the time series data and constrains time series analysis of public investment over this period;
- (ii) *Discrepancy between cash expenditures and accruals.* MoF data reports expenditures on a cash basis, including expenditures on clearance of overdue accounts payable on construction and purchase of equipment. Since these overdue accounts payable reflect actual investments that have been made in previous years, their incorporation over-estimates actual investments in any reported year.⁶ However, with the reduction in the net stock of overdue accounts payable, the discrepancy between cash and accruals is now smaller and therefore less of a problem; and

⁵ This study does not examine and make recommendations on Goskomstat's survey design instrument and its coverage. General support for modernizing the statistical data gathering and analysis is being provided under the Bank's \$400 million project on Strengthening the State Statistical System.

⁶ Clearance of accounts payable for the federal investment fell from 2.5 billion rubles in 1998 to 0.1 billion rubles in 1999 (excluding defense).

- (iii) *Inaccurate reporting.* Data reporting by enterprises to Goskomstat may be inaccurate. For instance, when enterprises manage to obtain off-budget public funds to finance budget investment and then they receive federal budget flows to clear arrears on accounts payable, they may not report to Goskomstat on these funds, thereby biasing downwards the public investment estimates. However, it is not known how big a problem this may potentially be.

Recent Trends in Public Investment

2.6 During transition to a market economy, the required fiscal adjustment led to repeated budget sequestration. Public investment expenditures were among the first to be cut during this process. This in turn put additional pressures on investment plans of different federal ministries. As a response to this pressure, several Government resolutions were approved in the mid 1990s, which provided a framework for claims on the shrinking budgetary resources, and which tried to arbitrage among competing claims for investments, particularly in commercial activities. Table 2.1 below presents the derived estimates for public investments:

	1997	1998	1999	2000
1. Federal Budget Investments	41.5	20.9	37.5	58.6
2. Subnational Budget Investments	43.1	40.2	61.7	145.4
3. Extra Budgetary Funds Investments	18.7	34.3	50.1	48.4
4. TOTAL Enlarged Government Investments (1+2+3)	103.3	95.4	149.3	252.4
As % of GDP	4.17	3.54	3.24	3.63
ADJUSTMENTS:				
5. Total Capital Repairs	20.7	21.9	22.2	23.1
Of which:				
5a Federal Budget Capital Repairs	1.8	6.0	1.1	3.2
5b Subnational Budget Capital Repairs	18.9	15.9	21.0	19.9
7. ADJUSTED Total Enlarged Government Investment (4+5)	124.0	117.3	171.5	275.5
As % of GDP	5.00	4.35	3.72	3.97
Memo:				
Federal Investments/Enlarged Government Investments (%) $((1+5a)/7)$	34.9	22.9	22.5	22.4
Road Investments/Enlarged Govt. Investments (%)	13.4	27.3	38.0	37.4
Capital Repairs/Enlarged Govt. Investments $(5/7)$	16.7	18.7	12.9	8.4
Foreign-financed Investments/Enlarged Govt. Investments (%)	8.7	16.0	17.6	7.0
GDP	2479	2696	4607	6947
Note: 1. Investments under (4) may also include capital grants and investment loans from the respective level of government which are not possible to separate here.				
2. Federal budget capital repairs in 1999-2000 are budget numbers; 1997- trillion 'old' rubles				
Source: MoF, Goskomstat, Bank staff estimates and calculations.				

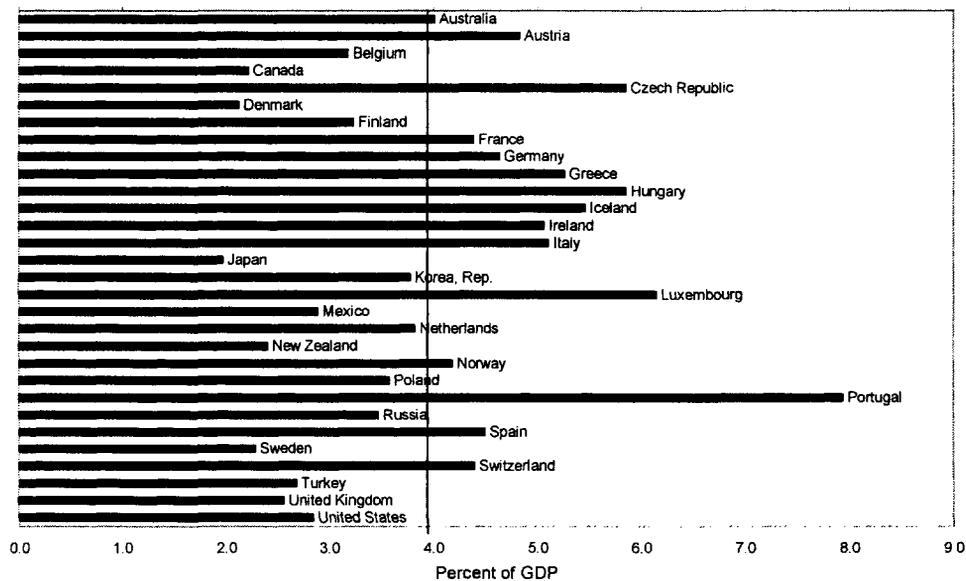
2.7 Several interesting results emerge. First, the numbers, while only approximate, suggest total public investments in Russia of about 4 percent of GDP, down from 5 percent of GDP in 1997. While it is difficult to assess whether such a level of capital expenditures is appropriate for Russia given its current economic situation, comparison with other OECD countries (see Box 2.1) suggests that Russia is not an outlier. Most OECD countries have public investments in the range of 3-5 percent of GDP. While some higher income countries have even lower levels of public investments, these may reflect their more liberal investment regimes and stronger regulatory environments which provide for higher levels of private investment in infrastructure. With respect to the ratio of public investments to non-interest public expenditures, Russia's share of

Box 2.1: International Comparisons of Public Investments

Assessment of the adequacy of the levels of public investment in any given country has to take into account the country specific features, in particular, its current stock of capital, development strategy, extent of private sector activity, and availability of financing. Nonetheless, it is interesting to compare Russia with other industrialized or industrializing countries to see where Russia stands relative to these countries. Such a comparison was made with 29 OECD member states. Data coverage varies— 9 countries had data for 1999, twelve for 1998 and eight countries for 1997.

The ratio of public capital expenditures to GDP for each of these countries is shown in Chart 1. The countries investing the most as a share of GDP were Portugal, Luxembourg, the Czech Republic and Hungary. The lowest expenditure ratios were in Japan, Denmark, Canada and Sweden. Russia stands close to the median level of capital expenditure (shown as a vertical line) which were about 4 percent of GDP.

Chart 1: Russia and the OECD countries: Public Capital Expenditures (% of GDP)
Sources: IMF Government Finance Statistics Yearbook, 2000 and World Development Indicators, 2000



But why do many of the richer countries spend so little? Is there any relationship between *level* of development in terms of per capita GDP and the level of public investment? This is not so clear from the statistical analysis and no significant relationship is observed. The answer may lie in a variety of factors—higher levels of private investments in utility and transport infrastructure because of state and regulatory reforms, different sizes of government, different initial conditions (especially in terms of the quantity and quality of capital stock), as well as differences in physical size and population spread.

Source: Bank staff calculations.

about 10 percent is also close to the median share of about 8 percent for the OECD countries. This suggests that the challenge for the Government is to improve the efficiency of investment expenditures rather than increase the current levels of public investments.

2.8 Second, during these four years, there has been a relative shift in public investment expenditures from the federal to the subnational governments. During 1997-2000, while the share of the federal government (including federal roads fund) fell sharply from 35 percent to 22 percent, that of subnational governments increased from 50 percent to 60 percent. This primarily reflects the shifts in expenditure obligations to the regions.

2.9 Third, the investment budget is developing a strong bias towards road sector investments. Financing from the Road Funds has increased from 13 percent of total investments in 1997 to 37 percent of planned investments in 2000. Road expenditures now comprise almost 1.5 percent of GDP. International comparisons put this at about the same share of GDP as that in the U.S. but almost double that in the U.K., France, and Germany. World Bank data from nearly a hundred countries for the early 1990s show that road expenditures typically account for 0.5-1.5 percent of GDP in most countries. The EU recommends road expenditures of about 1.0 percent of GDP to its central European candidate members. However, countries that are large and sparsely populated, like Russia, and which have a large and deteriorating stock of roads, would tend to spend more on roads relative to GDP. While the increase in road expenditures in Russia may therefore be fully justifiable, it is not clear whether such a shift is underpinned by the necessary economic analysis in terms of the inter-sectoral priorities of the Government, and the sector's budgetary financing needs. If indeed it is the case that road sector investments may be crowding out other higher value investments, then this is a matter of concern for the national authorities and needs to be remedied.

2.10 Fourth, capital repairs have halved as a share of total public investments, declining from 16.7 percent of the total in 1997 to 8.4 percent in 2000. This, of course, has been the gain of new investments and purchases of machinery and equipment which now take the lion's share of federal and subnational investments. Given Russia's initial stock of capital in public hands, and the relative neglect of maintenance over the years, it is not obvious that such a high proportion of investments on new projects instead of capital repairs is justifiable on economic grounds.

2.11 **Key Investment Programs.** The largest part of the *federal* investment program is expenditures of the former Federal Road Fund (see Table 2.3). The second biggest item is FTIP. But this program is not presented in a satisfactory economic classification. The earmarked investment part of this program amounts to about 60 percent while discrete investment decisions of the President and the Government comprise the rest.

	1999	2000	2001 (Budget)
FEDERAL ROADS	16.9	22.7	12.2
Of which:			
Rehabilitation	16.4	22.4	11.7
Purchase of Road Equipment	0.5	0.3	0.5
FTIP	7.1	21.1	28.1
REGIONAL DEVELOPMENT FUND	1.5	2.1	3.3
INVESTMENT TO COAL	n.a.	1.6	8.2
INVESTMENT TO AGRICULTURE	n.a.	n.a.	3.3

2.12 The FTIP is composed of several types of programs and non-programs including:

- *social and cultural programs*. Examples of such programs are the Presidential programs of Children of Russia, Social Support to Disabled People, Diabetes, Anti TB, Development of Education, Preservation and Development of Culture and Arts, and Development of Federal Resorts. Most investments are small. For instance, in 1999, the federal budget financed total expenditures of the Program of Disabled Children in the amount of 177.8 million rubles, of which only one-third (55.3 million rubles) was spent on investment. These investments were primarily the reconstruction of centers for the care of disabled children such as the orphanage in Krasnoyarsk, the rehabilitation center in Tambovskaya oblast, and the special orphanage in Orlovskaya oblast. Some expenditures were also made for the purchase of special rehabilitation and technological equipment. Another example is the Presidential program on “Preservation and Development of Culture and Arts in the Russian Federation in 1997-1999”. The 1999 federal Budget funded 3167.23 million rubles to this, of which about 12 percent was spent on investment on reconstruction of museums, construction and reconstruction of federal and regional art galleries, including the Bolshoi Theater.
- *social and economic development of regions*. Recently funded programs have covered regions such as the Republic of Mordovia, Republic of Buryatia, Republic of Chuvashia, Republic of Sakha (Yakutia), Krasnodarskiy kray, Rostov oblast, Astrakhanskaya oblast, and Bryanskaya oblast. There are also intraregional programs for development (such as those of the Kuril islands or the development of the Balkar people), as well as regional programs for development (for example, the programs for the Development of Small and Medium Size Cities in the Far East or the Development of Northern minorities). Amounts provided for these individual programs vary in size but are typically small. For example, in 1999, federal funds allocated to the Program for Economic and Social Development of the Republic of Mordovia amounted to 98.63 mln rubles, of which only 7.5 mln rubles were investments aimed at construction of the water pipe system (7 million rubles) and a hospital (0.5 million rubles).
- *development of specific industries or sectors of the economy*. Examples of these include the Program for Fuel and Energy (1996-2000) which received 335.91 million rubles, of which 296.6 million rubles were state investments to cover construction and reconstruction of special equipment pipelines, reservoirs, and gas compressor stations. Also financed are investments in the Russian trade fleet, reconstruction and modernization of metallurgy, biotechnology, production of buses, trolley-buses and trams, development of agro-industry, and the federal space program.

2.13 Other investment programs include the Regional Development Fund (targeted at social infrastructure projects in the regions), investment into agriculture (aimed at investment support to the farmers), and investments in the coal sector (targeted at environmental facilities).

Functional Classification

2.14 A detailed functional classification of consolidated government investment expenditures is available for 1997-1999, also from Goskomstat published data (see Table 2.3). However, with about 40 percent spent on a catch-all category of “other services”—which presumably includes investments in health, education, culture, and state administration—caution needs to be exercised in interpreting both the relative shares and the changes in functional expenditures. In particular, the data does not shed light on the levels and adequacy of budgetary investments in health and education, which is a serious issue in Russia given growing empirical evidence pointing to a

decline of human capital investments and a growing problem of maintaining social assets.⁷ Moreover, the data presented here only covers expenditures from domestic budgetary sources and excludes foreign-financed investments. A functional breakdown for the latter is not available from other sources either.

	1997			1998			1999		
	Consolidated	Federal	Sub-National	Consolidated	Federal	Sub-National	Consolidated	Federal	Sub-National
Total Public Investment a/	100	100	100	100	100	100	100	100	100
Agriculture & Forestry	3.1	4.1	2.2	3.0	4.7	2.0	3.4	5.1	2.3
Industry	11.8	16.8	6.9	10.9	16.2	7.9	14.9	12.8	16.4
<i>Of which:</i>									
Power	1.7	1.8	1.5	0.9	0.8	1.0	1.3	0.9	1.5
Fuel	5.1	7.5	2.9	4.0	5.5	3.2	5.9	2.6	8.1
Chemicals & Petrochemicals	0.4	0.5	0.2	0.3	0.3	0.3	0.2	0.2	0.3
Machine building	1.1	2.0	0.2	0.6	1.3	0.1	1.1	2.4	0.3
Pulp & Forest industry	0.1	0.1	0.0	0.1	0.3	0.1	0.2	0.1	0.2
Construction materials	0.2	0.3	0.1	0.2	0.3	0.2	0.3	0.2	0.4
Light	0.1	0.2	0.0	0.2	0.2	0.2	0.1	0.1	0.1
Food	1.1	1.4	0.9	1.9	4.3	0.6	1.9	3.3	0.9
Construction	1.1	1.7	0.4	2.3	2.8	2.0	3.7	2.6	4.5
Services	85.1	79.0	90.6	86.0	78.9	90.0	81.5	82.2	81.1
<i>Of which:</i>									
Transport	22.1	25.7	18.6	22.2	43.1	10.6	31.2	53.3	16.4
Communications	0.3	0.1	0.5	0.4	0.3	0.4	0.1	0.1	0.2
Trade & public catering	0.4	0.2	0.5	0.3	0.0	0.5	0.3	0.1	0.4
Housing	16.1	13.7	18.3	15.5	13.2	16.8	11.8	9.7	13.3
Other services	46.2	39.3	52.7	47.6	22.3	61.7	38.1	19.0	50.8

Memo:

a/ Numbers may not add up to group averages because of rounding and non-reporting here of some shares by other functional groups.

b/ From 1998, information is available for large & medium size enterprises only.

Source: Goskomstat Construction in Russia 2000, pp. 30-31 (Stroitel'stvo v Rossii 2000).

⁷

These issues are expected to be dealt with in detail in complementary sectoral federal expenditure reviews of health, education, and social protection which are being sponsored by other donors, as well as some regional expenditure reviews of health and education expenditures being carried out by the Government.

2.15 With that caveat in mind, the reported functional breakdowns during these three years shows a growing concentration of expenditures (relative to the total consolidated budget investment expenditures) in transport (22 to 31 percent) and industry (9 to 11 percent), while share of investment in housing fell down (from 16 to 12 percent). The share of transport has increased primarily through the rising share of road investments. However, a large unknown element here is investments in railways, which could be one-third to one-half of road sector investments. The data also reveal that industry continues to receive direct budgetary investments, primarily in fuel, energy, food, and machine building sectors. The share of housing has decreased as the state has moved away from direct construction of new housing to providing certificates for housing to those deemed eligible. However, the costs of those certificates, many of which can only be used to purchase new units, are not included in the investment data presented above.

2.16 **Federal Government Investments.** There is a clear hierarchy of federal investment expenditures. Over 1997-1999, most expenditures were concentrated in the transport sector where its share doubled from 26 percent in 1997 to 53 percent in 1999. Unfortunately, the next most important item is lumped together as "Other market and non-market services". The third most important sector of investment is industry, which has declined from 17 percent of federal investments in 1997 to 13 percent in 1999. Within industry, the investment priorities were in fuel, food industry, machine-building, and energy.

2.17 In nominal terms, almost all federal investment suffered a huge drop in 1998 (besides food industry), but then strongly recovered in 1999. It is not clear what the reason for this drop is. This may be driven partly by the drastic budget cuts in the wake of the 1998 financial crisis and partly by changes in the methodology of the Goskomstat enterprise surveys.

2.18 **Subnational Investments.** Most subnational investment expenditures were on transport (although apparently only a part of the investment expenditures of the Territorial Road Funds are reflected in the survey in the category subnational budget investment), housing, industry (especially fuel), and agriculture. However, it is not clear from the breakdown what the investments in the health and education infrastructure were. These are the primary responsibility of subnational governments.

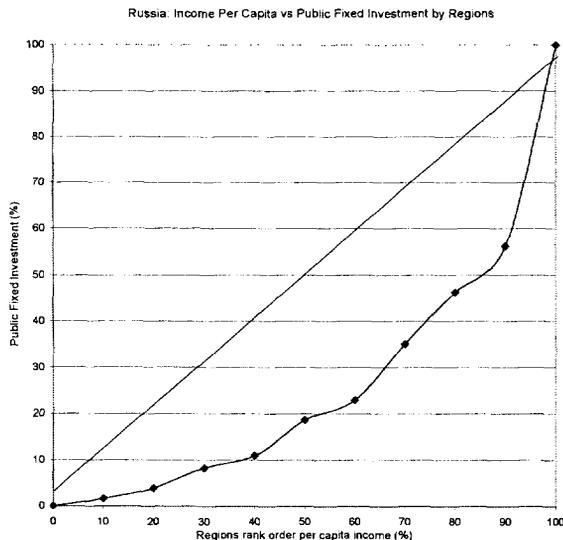
Regional Distribution

2.19 The regional distribution of public investment expenditures is unequal (see Box 2.2). While income equalization is not an expressed objective of public investments—and other instruments of the Government such as equalization transfers are meant to address these issues—it is worthwhile for the Government to examine the extent to which this observed pattern of regional investment expenditures—albeit for one year—is consistent with the Government’s policy of achieving some measure of horizontal equity. Some of the investment programs also have a strong emphasis on regional socioeconomic development. There may therefore be an issue here of the consistency among investment programs as well as between investment expenditures and overall budget expenditures.

Box 2.2: Regional Distribution of Public Investments

An analysis of the regional distribution of public investments in 2000 suggests that richer regions (those with higher income per capita) get proportionately more public investments than poorer regions. Given that these investments still account for about 4 percent of GDP, this outcome runs contrary to the equalizing transfers from the budget, equivalent to 9.8 percent of GDP. While horizontal equity is not a primary objective of investment funds, many investment programs are used in some measure for this purpose. This, therefore, calls for an integrated approach to regional allocation of public funds.

In 2000, for the consolidated government, the top decile of regions in terms of income got almost 60 percent of total public investment, while the bottom decile received less than 1 percent. The picture is a little better, but still highly skewed for *federal* investments. The top income decile of regions received 24 percent of total federal public investment, while the bottom decile received less than 2 percent. For subnational budgets, the skewness is even more, but not surprising, since richer regions can afford higher levels of public investment. The top income decile of regions accounted for a larger 72 percent of total subnational public investment while the bottom decile received less than 1 percent. (Of this, Moscow City received 45 percent of total subnational investment.)



Source: Goskomstat data; Bank staff calculations.

Quasi Public Investments

2.20 Loans and guarantees have been an important instrument in the financing of investment projects at both the federal and subnational levels, but much less so now (see Box 2.3). While these are not classified as “investment” expenditures and come under the category of “net lending”, it is important to recognize the role played by these in the past and the Government policy of diminishing this role further in the future. Over the last two years, federal investment loans (domestic) amounted to 1170.6 million rubles in 1999 (of which 475 million rubles were spent on agriculture (leasing fund) and 695.6 mln rubles on investment in coal mining) and 1232 million rubles in 2000 (of which 500 mln rubles were spent on agriculture (leasing fund) and 732 million rubles on investment in coal mining). In 1999, only one guarantee on Sberbank investment loan to agriculture was provided by the Russian government in the amount of 550 million rubles. From 2000, the issuance of guarantees by the federal budget has stopped and the Government has adopted a stronger policy stance by discontinuing foreign borrowings from

Box 2.3: Case Studies in Investment Loans and Guarantees

Investment loans and guarantees have declined in importance at both the federal and subnational levels. However, there remain significant fiscal risks from them as these two case studies demonstrate. The City of St. Petersburg demonstrates a case where a subnational government has improved the process for managing public guarantees even though risks remain. The First High-Speed Railway Project is an example of a large publicly guaranteed investment where the guarantees were called at high cost to the taxpayers.

City of St. Petersburg. Most of the city guarantees are issued for foreign investment loans. All guarantees are reflected in the annual Budget laws (from the year 2000), they are capped in the annual budgets, incorporated into the city's debt management system, and information on them are available to the public. The declared principles of selection of borrowers are: (i) sustainable finance of the firm-borrower; (ii) no budget and extrabudgetary funds tax arrears; and (iii) provision of 100 percent liquid collateral. In practice, however, guarantees are also provided to commercially non-viable entities, e.g. hospital, research institute or district heating company. By January 1, 2001, all city guarantees amounted to 1425 million rubles, declining during 2000 by about 700 million rubles and from 21 to 11 percent of total debt. In 2000 the biggest guarantees were issued to the unitary enterprise “Russian Institute of Radio Navigation and Time” (120 million rubles), construction of a sports arena (478.5 million rubles), housing certificates (105.3 million rubles). Among outstanding guarantees, the biggest are issued to Vodokanal (DM24.4 million on EBRD loan in 1997 and DM20.1 million on Northern Investment Bank loan in 1998). Possible guarantee payments, if called, on foreign investment loans are almost equally distributed in 2000-2010. Contingent guarantee payments on domestic loans are concentrated in 2001 (367.7 million rubles) and 2003 (120 million rubles).

High-Speed Railway Project (VSM) between Moscow and St. Petersburg. The VSM High-Speed Railway Project was founded in 1991 to manage the construction of a new rail link that would halve the travel time between Moscow and St. Petersburg to just 2 ½ hours. VSM was set up as a JSC with charter capital of R250 bln and with the Federal Property Commission owning 85 percent of the stock. Other shareholders include the governments of Leningrad oblast, the cities of St. Petersburg and Moscow. The cost of the 654-kilometer railway was estimated at \$7.4 billion. Work on the project started only in 1996. The project was financed primarily through periodic auctions of corporate bonds at high interest rates despite a joint federal and St. Petersburg Government guarantee. Contracts were signed with foreign and domestic companies in 1997 for the design and construction of rail network and the terminal stations. However, the project started to encounter financial difficulties in the wake of the 1998 financial crisis and the company repeatedly defaulted on its ruble-denominated bond coupon payments over 1998-1999. Long negotiations ensued among representatives of the company, the bondholders and the MoF with the creditors demanding that MoF, as guarantor of the VSM bond issue, live up to its obligations. The MoF subsequently developed and agreed to a restructuring plan that would involve a phased repayment to creditors totaling 230 billion rubles. On March 1, 2001, the Prime Minister officially ordered MoF to start repayments and ordered VSM's property transferred to the Federal Property Commission.

Sources: St. Petersburg- Results of Debt Management in 2000, Finance Committee of St. Petersburg. Various economic reports.

specialized investment agencies of foreign governments.⁸ Even at the regional level, the situation has improved, though investment loans and guarantees continue to be provided.

Conclusions

2.21 The above analyses raise broad issues for the consideration of the Government. It is clear that movement has to be made quickly towards developing good quality data on public investments which can inform policymakers on the stance and developments of fiscal issues. This is an issue which affects all fiscal accounts and is reinforced by the identification of the deficiencies in the data on public investments. This further highlights the need to rapidly ensure that the GFS economic and functional classification is fully adopted and reported by the MoF for both budget and actual data. Both budget presentation and reporting should be fully compatible with this economic classification. Such data should be made publicly available so that the public can understand the uses to which taxpayer receipts are being put, and that the development of the budget takes place in an informed public space. With the growth of the Treasury system, it would be possible to narrow the discrepancies between cash and commitment budgets. This problem is diminishing given the reduction in the stock of accounts receivable, but it is not possible to establish how much of a problem this is on the investment budget.

2.22 The discussion in this chapter is suggestive of the thesis that the challenge for the Government on the investment budget is not so much over the *quantity* of public investments but over its *quality*. With respect to the level of investment budgeting—notwithstanding the possible errors in estimation—it is not obvious in comparison with other countries that the level of public investments in Russia is either too high or too low. This would argue that the emphasis of policy has to be on improving: (i) the allocative efficiency of investment budget—across sectors, projects, and regions; and (ii) the technical efficiency of these expenditures so that more is achieved with the same expenditures. The former issue points to the need for investment budgeting to be based in the context of a national economic policy which reflects the inter- and intra-sectoral priorities as well as the regional priorities for investments from a socio-economic perspective. This would ensure, for instance, that the bias towards road sector investments arises from the deliberate consideration of the policy priorities and is not the unintended result of Government action. The second issue points to the need for improving the cost-effectiveness of expenditures by introducing and extending budgetary practices which would provide for these improvements. These would include the selection of high economic return projects, strengthening of competitive procurement, regular monitoring, systems of internal and external audit, performance measurement, and greater transparency in the management and use of public funds for investment purposes. These are the subject matter of the following Chapters 3-5.

⁸ Investment lending is to be shifted from the federal budget to the Russian Development Bank and the Russian Agricultural Bank.

CHAPTER 3

PUBLIC ROLE IN INVESTMENTS

3.1 Central to the analysis of public investments is the public-private choice which underpins the selection of investment projects. This is particularly important and relevant for transition economies such as Russia which are going through major structural changes in the economy. The decapitalization of the economy—related to the decline in economic activity, asset stripping and capital flight, and the needs of restructuring—in the face of a changing role of the state and expenditure retrenchment puts to the fore the critical issues of: (i) the appropriate role for the government in each sector; (ii) whether public investment and ownership is the intervention called for, if at all; (iii) the criteria for project selection; and (iv) the appropriate roles of federal and lower levels of government.

3.2 The lack of clarity of the rationale for public intervention in a market economy continues to undermine public investment planning in Russia. Public investment still involves the Government directly undertaking commercial projects and/or risk. Undoubtedly, a continued role for public investment remains in key infrastructure and social sectors even as an enlarged role for the private sector and alternative forms of government intervention (e.g. regulatory and price) are warranted in other sectors. This chapter lays out a normative framework for defining the role of the Government in public investments. It then evaluates the current investment program—to the extent possible—to test whether the investment program meets this normative test. It further assesses the extent to which cost-benefit analysis is used in project selection, and lays out a suggested criteria for project selection as a practical guide for Government staff involved in these processes.

Towards a Normative Framework for Public Investment

3.3 The role of the state in investments has to be seen in the context of the desired role of the state in the economy (see Box 3.1). This emphasizes that the state should limit its role to providing the basic public goods—such as law and order, environmental conservation, public administration, market infrastructure, public health, and basic education—which are essential to promote social and economic development, and to improve equity which is necessary to ensure that the poor also gain from economic growth.

3.4 The transition process under-way in Russia has already fundamentally reduced the domain for public action. The state is moving in a direction consistent with the above. The Government's economic program for 2001-2003 envisages a strategy towards public investments that highlights five objectives for public investments which are broadly consistent with the above:⁹

- (i) enhancing the social focus of investment activities, so as to promote the development of social infrastructure, public health, education, fundamental and applied sciences;
- (ii) promoting the openness and predictability of the state investment policy; so as to encourage the private-sector capital flows for priority objectives of national, social and economic development;

⁹ Government of Russia, 2001, Draft Basic Trends in Social and Economic Policy of the Government of the Russian Federation Over the Long Term.

- (iii) focusing as a priority, on state support of infrastructure facilities of strategic national significance, which promote economic stability, innovation, technological breakthroughs, and environmental security;
- (iv) enhancing the efficiency of investment activities in the state sector of the economy; while ensuring the transparency of investment flows and programs; and
- (v) ensuring the fulfillment of the investment obligations undertaken by the state as part of the approved budget.

3.5 Drawing on the principles from Box 3.1, and the Government's objectives for public investment, one immediately obtains guidance on how to evaluate the broad composition of investment expenditures (see Table 2.3). The investment programs are largely meant for socio-economic development. The biggest expenditure category is investment in roads which comprises 40-50 percent of the federal investment budget.

3.6 **Are Public Investments Providing Public Goods?** Even with public investments being appropriate, the challenge is in terms of other levels of decision: (i) what type of investments to make—for instance, for roads, whether to build new roads (if so, which ones, where, to what standards) or invest in capital repairs and maintenance of existing stock of roads; and (ii) what level of Government should finance these investments. For the first aspect, the decision should rest on cost-benefit analysis (see below for more discussion on this), while for the second, normative guidelines can be developed for investment expenditure assignments by levels of government (see below for further discussion on this).

3.7 Investments in roads is a good example of government intervention for the provision of a public good. The role of government grows directly out of the observation that a road creates benefits for users that are not (necessarily) captured by the provider in the form of revenues - so both investment and operation need to be shaped by factors other than just market forces and the profit motive.

3.8 For some of the other investment programs—such as housing and some federal targeted programs—it is not clear what the nature of the public good is that warrants state intervention. Even if one accepts the proposition that given the lack of markets in various sectors and the evolutionary stage of Russia's economic transition, there remain unusual market failures requiring state intervention, the question still remains as to what the *nature* of the state intervention should be, especially, what assets the state should *own*. Modern microeconomic theory and transaction cost analysis suggests that ownership is often immaterial. The federal Government has rightly refrained from obtaining new ownership of housing, financing most of new investments through housing certificates. This protects the Government from potential inefficiencies related to government ownership of housing.¹⁰ The housing certificates—which are primarily for military personnel being demobilized—combines two good economic features: it approximates a cash grant and provides beneficiaries the freedom of choice while also distancing the Government from the business of procuring and operating housing, a business in which governments elsewhere have shown to be typically weak.

¹⁰ Inefficiencies arise because—for political economy and other reasons—a commitment to charge users and pay the owner (government) often is not credible; so a publicly owned housing stock will suffer from insufficient funding. At the same time, government decisions of the nature of the housing stock may also suffer from poor match with the population's needs and preferences. The latter problem increases when housing is linked to the employment relationship within an overall process of economic restructuring, such as Russia is currently undergoing.

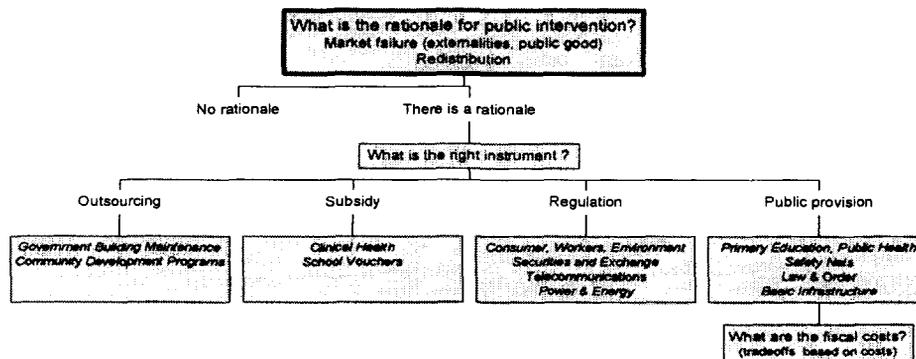
Box 3.1: The Economic Rationale for State Intervention

Global economic and social forces have changed prevailing notions of the state. It is clear that the state retains two distinctive roles:

- *providing the public goods that promote social and economic development.* Public goods are goods that are non-rival (consumption by one user does not reduce the supply available for others) and non-excludable (users cannot be prevented from consuming the good). These characteristics make it infeasible to charge for the consumption of public goods, and therefore, private suppliers will lack the incentives to supply them. Market failures—the set of conditions under which a market economy fails to allocate resources efficiently—continue to provide the primary rationale for state intervention.
- *improving equity.* Competitive markets may distribute income in socially unacceptable ways; government action may be needed to protect the vulnerable. Empirical evidence from around the world, particularly East Asia, has shown that the familiar tradeoff between growth and equity is not inevitable. Appropriately designed policies in health, education and social safety nets can increase equity while promoting growth.

The above criteria lead to a decision-tree (see below) for evaluating where the Government should intervene and what type of intervention it should make. The chart is suggestive of the direction of movement and reflects a growing recognition that the state need *not* be the *sole provider* of basic infrastructure, education and health services, and other public goods. Technological, organizational and regulatory innovations have created new opportunities for competitive private providers in many of these areas, such as in telecommunications and utilities. Many of the most successful examples of development entail the state working in partnership with markets to correct their failures, not replacing them. However, state intervention through various instruments would still be required where markets may under-provide services and/or where equity considerations may be important (e.g. in hospital services and universities).

Decision Tree for Evaluating Public Programs



The challenge for the state is *to match its role to its capabilities* (by undertaking and promoting collective actions—such as law and order, public health, and basic infrastructure—efficiently) and *to raise its capabilities* (by reinvigorating public institutions by designing effective rules and restraints, establishing checks on arbitrary state action, combating crime and corruption, improving incentives for public sector performance, and bringing government closer to the people). Matching the state's role to its capabilities requires choosing what to do, what not to do, and how best to do it. While capabilities may vary from state to state, five fundamental tasks lie at the heart of any state's role: establishing a foundation of law, maintaining a market-friendly environment (including macroeconomic stability), investing in basic social services and infrastructure, protecting the vulnerable, and protecting the environment. The extent to which a state is able to address these fundamentals establishes its credibility *via-a-vis* the market, which is essential for attracting private investment and promoting growth.

3.9 Applying the normative criteria to the federal targeted programs suggests the need for a significant re-thinking of the role of the federal Government and the nature of investments it is making in these programs. First, in the "social complex", housing and communal investments are almost one-third of FTP expenditures (see Table 3.1 and Annex 3.1). Many of the other investments in the social complex are for health, education, and social welfare facilities. These may be fully justifiable on both redistribution and public goods criteria, but more detailed analysis is warranted to determine whether the underlying goals could be better pursued with other forms of federal support rather than investments in physical structures. Second, a growing 13 percent of the investments are of a commercial nature (17 percent if fuel and power are included), in the sense that the federal government makes investments on behalf of enterprises, thereby strengthening enterprises' balance sheet.¹¹ It is not clear what the market failures might be that are being addressed by these investments. Third, an examination of the individual investment programs reveals that many of these individual investments are small. For instance, there are about 40 power sector investments in existing joint stock power companies. The average investments are 2-15 million rubles (see Annex 3.2 for a more detailed industrial breakdown). Investments of a similar nature are made in various other industries. It is probable that these projects would still be completed even without the federal investments. In that case, the question may be asked as to what benefit is gained through a process that is administratively costly, and for which the federal Government foregoes other needed investments.

	In million rubles		In percentage of total	
	2000	2001	2000	2001
TOTAL	21,459	28,773	100	100
Social Complex	12,405	18,145	57.8	63.1
Housing & Communal Services	4,900	8,658	22.8	30.1
Central Org	2,807	3,978	13.1	13.8
Education, Culture & Health	2,816	3,878	13.1	13.5
Of which: Culture	595	1,061	2.8	3.7
Education	405	906	1.9	3.2
Public Health	1,083	1,767	5.0	6.1
Science	333	499	1.6	1.7
Fuel and Power Complex	1,073	1,072	5	3.7
Electric Power Engineering	774	693	3.6	2.4
Gas Industry	222	150	1	0.5
Transport & Communications	1,862	3,548	8.7	12.3
Moscow underground	1,046	1,950	4.9	6.8
Other non-road Transport	782	1,528	3.6	5.3
Communication	34	70	0.2	0.2
Commercial/Semi-Commercial	1,937	3,920	9.0	13.6
Special Works	3,623	4,249	16.9	14.8
Water Management	193	657	0.9	2.3

Notes: Figures do not add up precisely to 100 because of rounding and because of exclusion of some minor categories. Breakdown is not available for 'Special Works'
Source: Federal Budget Law for 2000 and 2001: Bank Staff reclassifications.

¹¹ See Annex 3.1 for details on sub-groups within these commercial-type investments.

3.10 The federal government is attempting to implement a policy of obtaining shares in enterprises in return for its investments in joint stock companies. The principle to have an exchange of assets is appropriate, but there are many reasons to view government as ill-suited to serve in such an ownership function. It would therefore likely be a better approach to obtain loan certificates than to accept shares. Minority share holders—even when government—are often typically not effective in corporate governance. This latter set of problems would be solved if investments on behalf of joint stock companies were reciprocated by a loan agreement (and repayment), rather than shares. This would put the government in a position as a lender for industrial development, possibly an improved situation but still leaving challenges of further disengagement.

3.11 **Do the Public Investments Provide Redistribution?** While, in principle, an examination of the social incidence of public investment expenditures is possible to assess the extent to which they satisfy the redistribution criteria, this task is beyond the scope of this study. The informational requirements for such a study, given existing data weaknesses, are such as to preclude the conduct of such an investigation at this point. Moreover, these have to be seen in the context of all fiscal expenditures since current expenditures often play a dominant part in redistribution.

Cost-Benefit Analysis for Project Selection

3.12 Cost-benefit analysis is not being used for the selection of projects into the federal public investment program. This seriously risks compromising the efficiency of the use of investible funds for economic development. Cost-benefit analysis is a tool which permits project-by-project

Box 3.2: Cost Benefit Analysis –A Primer

Cost-benefit analysis assesses the costs and benefits of a project and reduces them to a common denominator. If benefits exceed costs—both expressed in terms of present value—then the project is acceptable; if not, the project is rejected. Benefits are defined relative to their effect on the fundamental objectives while costs are defined relative to their opportunity cost, which is the benefit foregone by not using these resources in its best alternative use. By doing so, cost-benefit analysis seeks to ensure that no alternative use of the resources consumed by the project would secure a better result from the perspective of a country's objectives. Thus, if X_t defines the benefit from the project in year t , C defines the cost today, r is the discount rate, and n the number of years that the project is expected to deliver benefits, then in very simple terms, a project is selected if: $\sum X_t / (1+r)^t - C > 0$.

Economic analysis is similar in form to financial analysis in that both assess the profit of an investment. The concept of a financial profit, however, is different from that of social profit of economic analysis. The former identifies the money profit accruing to the project-operating entity whereas the latter measures the effect of the project on the fundamental economic and social objectives. These different concepts are reflected in the different items considered to be costs and benefits and in their valuation. Thus, a money payment made for wages is by definition a financial cost, but it will be an economic cost only to the extent that the use of labor in this project implies some sacrifice elsewhere in the economy with respect to output and other objectives. Conversely, if the project has an economic cost which does not involve a financial flow—for example, because of environmental costs—this does not constitute a financial cost. Economic costs and benefits are measured by “shadow prices” which may approximate market prices in well functioning market systems. However, imperfect markets—like those characterizing transition economies—typically reflect a divergence between them.

The key requirements for social cost-benefit analysis are: (i) specification of the costs and benefits; (ii) valuation of costs and benefits; (iii) choice and formulation of constraints; (iv) treatment of risk and uncertainty; (v) choice of the rate of interest for discounting future costs and benefits; and (vi) choice of a decision rule for accepting or rejecting projects.

Source: Lyn Squire and Herman van der Tak, 1975, *Economic Analysis of Projects*, Baltimore and London.

decision-making on the appropriate choices between competing uses of resources with costs and benefits being defined and valued so as to measure their impact on the development objectives of the country (see Box 3.2 and Annex 3.2). Traditional infrastructure sectors—such as water, power, and transport—are probably the ones for which cost benefit analysis is the easiest to apply. But this technique is now readily applicable for health and education sector projects too. The importance of this tool is that it provides an objective and sensible methodology for project selection. In the presence of political and bureaucratic pressures, such an anchoring of investment decisions in objective criteria is valuable.

Rationale for Federal Government Involvement

3.13 In the classical setup for fiscal federalism, the *subordination principle* pushes expenditure responsibilities down to the lowest level at which a problem can be handled, taking into account economies of scale in production and *transjurisdictional externalities* in terms of the domain of benefits from the various public goods (see Box 3.3). In practice, jurisdictional design and expenditure assignments must represent consolidation across several public goods, as when the local government handles both public security and fire services while the federal government invests in projects with transregional effects, such as interregional transportation infrastructure.

3.14 This classical posture notwithstanding, there are of course possible weaknesses in the institutional framework for *effects within regions*. This opens a discussion along the same lines as when missing markets and institutional weaknesses can give a role to public investments in areas otherwise contained to the private sphere. Nevertheless, it also points to the ideal of correcting the weaknesses directly rather than compensating with other strategies that involve other problems. As an example, subnational investments in infrastructure (roads, for instance) may fail to reach optimal levels due to financing constraints that are more severe for subnational government than for the federal government. Again, one should first ask whether this problem is best addressed by the federal government engaging in regional investment programs (or support for these) or by measures more directly alleviating the financing constraints of regional governments.

3.15 With respect to roads, the central government should finance those roads' networks which provide strategic national networks linking regional capitals or other areas. Whether this should be done in cost-sharing with other level governments or not would depend mainly on fiscal considerations (see Box 3.4 for a more detailed look). However, there are advantages of sole responsibility assignments (avoiding costly bargaining and risk of non-cofinancing) which could avoid the disadvantages in potential loss of provincial contributions. In addition, the relative strength of national taxing powers often point towards letting the national government take sole responsibility for such projects. In its turn, the regional governments should finance roads within their regions while other local government should finance local roads. Nevertheless, since parts of the road network draw their value from other parts, federal grants as well as collaborative arrangements can be elements in a well-functioning system for a federation. In Russia, a framework for collaborative projects between the federal government and regions, as well as federal grants to territorial roads with federal connections, has been in place. However, with the incorporation of the roads funds into government budgets, this needs to be closely watched.

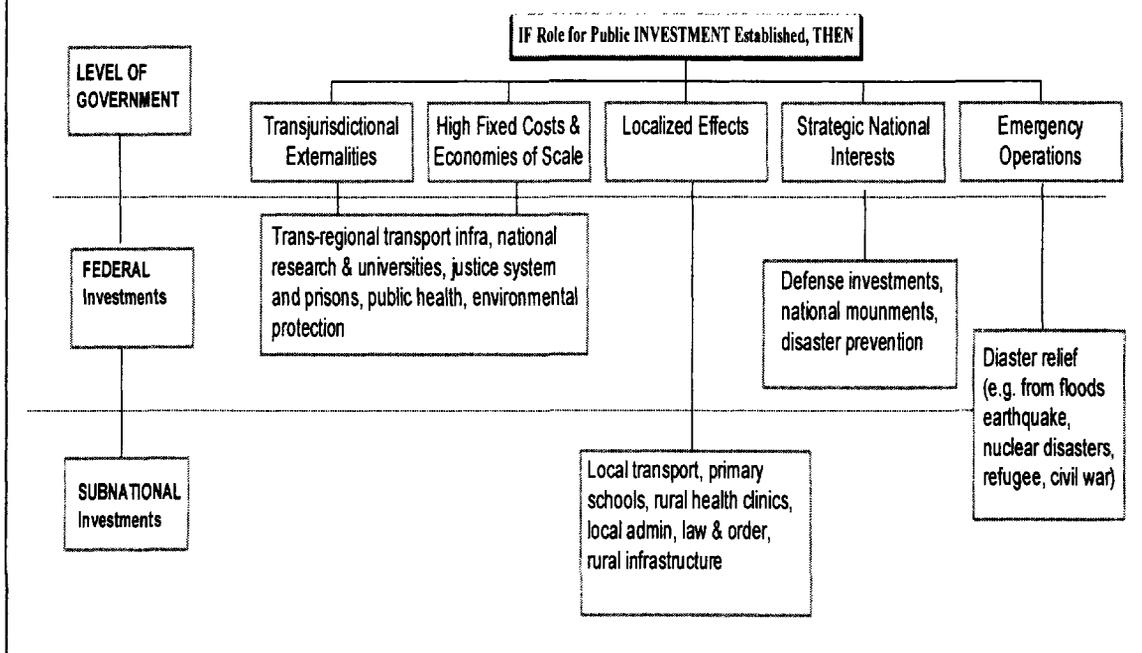
3.16 An interesting way in which intergovernmental issues may work themselves out is on repairs and maintenance of roads where governments typically have a tendency to be more

involved in the creation of new assets than in their subsequent maintenance and operation.¹² In principle, this could work well for roads whose ownership is transferred to the local community. In practice, however, it will be the case that renewed financial support from higher levels of government can be counted on *if* maintenance fails, making such failure likely. This is an important example of a broad problem of soft budget constraints, and attempts at resolving it can take many forms—(i) the central government disengages from the local scene completely; (ii) the central government intervenes in less distorting ways, for instance, providing unconditional block

Box 3.3: What Should Federal and Subnational Governments Be Investing In?

Once the rationale for public investment is established (as per Box 3.1), what should be the investment expenditure assignments between federal and subnational governments? While this has to be determined within the context of overall budget expenditure assignments, there are some criteria that the Government can use in determining what type of investments different levels of Government should be making. Currently, federal and subnational governments in Russia co-finance many programs and projects without clear criteria on the types of investments that they should be making.

Essentially, public investments that pass the test of Box 3.1 can have five types of attributes—externalities which spillover to other regions, high fixed costs and economies of scale, localized effects, of strategic national interest, or an emergency relief operation (see chart below). It would make sense for the federal government to invest in those projects with significant transjurisdictional externalities or large economies of scale since these externalities would not be captured in the objective functions of subnational governments. However, projects with localized effects—for instance, in local transport, rural infrastructure, or rural health clinics—both in terms of decision-making on selection of projects and allocation of resources among them, are better implemented at the subnational level. Projects of strategic national interests, such as defense investments or investments in disaster prevention, are again better served through federal investments while emergency relief operations should be supported by both federal and subnational investments.



¹² See, for instance, Dabla Norris, 2000, "Expenditure Assignment" in *Fiscal Decentralization and Economic Performance: The Case of Russia, Ukraine, Kazakhstan*, IMF, Washington DC; Dabla-Norris, Era Martinez-Vasquez, J. Norregaard, 2001, IMF, (forthcoming).

grants; or (iii) the central government increases the engagement—from being involved only in investments to also allocating for, and monitoring, maintenance and operations.

Box 3.4: Case Study: Decentralization and Governance in Roads

Institutional design in terms of the fiscal responsibilities of different levels of government has implications for efficiency, while posing political challenges for the allocation of investment expenditures. A case in point is roads in Russia. Two characteristics emerge. First, 25 percent of roads expenditures is spent on federal roads which comprise only 5 percent of the total road network (in road-km) but carry at least 25 percent of the traffic (in the U.S., 1 percent of road kilometers are interstate highways, supporting 20 percent of the traffic). This looks reasonable given that most expenditures are for rehabilitation and incremental increases in capacity, which address the rapid growth in road transport in recent years.

Second, fiscal arrangements for financing road expenditures have changed with the 2001 budget. Federal road fund expenditures are now integrated into the budget (the federal road fund is abolished); and steps are envisaged by which regional governments follow suit. These are important decentralization decisions in two ways: (i) the regions will now have greater autonomy over how much to spend on roads and what type of expenditures to make, and this may boost the efficiency of road expenditures; and (ii) progressive integration of territorial road funds into the budget may bring greater interventions by the regional legislatures in the use of resources for road use, making these expenditures more accountable, but also risking further politicization of road budgets. Both of these suggest that local capacity for decision-making, budgeting, and oversight needs to be strengthened.

As in other areas, the roads sector would benefit from clearer effective assignment of responsibilities (See Dabla-Norris, 2000), including addressing the existing disincentives for subnational government to attend to repair and maintenance. As grants and other elements of intergovernmental fiscal relations become more objective and less politicized, a commitment of the federal government to limit its attention to projects of inter-jurisdictional significance would be firmer, and costly games to gain favors from the center would become less prevalent.

The Political Challenge of Implementation

3.17 Even with the best normative framework, implementing it is difficult, since politics rules. In political processes, allocations are shifted as favors are traded, and this process can be internally costly. Thus, road links are regularly built despite negative net benefits, for instance because a politician from the town in question can offer a critical vote in *another* battle – and the road is his *price* for his vote in that unrelated quibble. Such political bargaining processes need not be illegal or corrupt (i.e. there is no exchange of private gains), but it redistributes rent in a way that wastes resources. The role of tools such as cost benefit analysis in this context may be modest, but important. It can impose some discipline over the political process by imposing efficient criteria (though it may not over-rule the political process) and it can perhaps contain the costs by making explicit the consequences, including the foregone opportunities.

Conclusions

3.18 Any analysis of public investments has to have a frame of reference. Economic theory and international experience suggest four key elements in such a frame. First, the role of Government in a market economy should seek to address market failures and redistribution. Intervention on these grounds is based in traditional welfare economic analysis. Recent contributions recognize that interventions should be measured so as to match government's role to its capabilities. Second, if there is a role for Government intervention, there are clear economic reasons which can guide what the nature of the public intervention should be. In particular, the

choice between the Government investing and owning assets should be a deliberate one, chosen from among the alternatives. Third, cost-benefit analysis can serve as an objective guide to screen worthwhile interventions, not only for the traditional infrastructure sectors, but also for social sectors. Such objective criteria provide a necessary discipline to the process of project selection and, if done well, maximize the efficiency in the use of public funds. And finally, in a federal structure, the role of the Government of Russia through its direct budget (and investments) is less dominant, highlighting its role in creating an enabling environment for investments by the private sector and subnational governments.

3.19 Applying this framework to the federal investment program suggests four areas for strengthening which would help instill greater objectivity in project selection:

- *the rationale for Government intervention needs to be clarified.* This is not apparent in many investments, particularly those of a commercial nature. Budgetary savings can be generated quickly by the Government withdrawing from the financing of such investments, and higher returns to public funds can be obtained by making these investments in other sectors.
- *where the rationale for Government intervention is clear, an investment decision which leads to the Government owning that asset needs to be determined in relation to other alternatives.* This is true even in those sectors— such as the social sectors— where there is a clear role for Government intervention, but it is not obvious that direct financing and federal ownership of these assets is the most efficient strategy. The Government needs to review each of these programs to develop a strategy for supporting such initiatives.
- *cost-benefit analysis need to be introduced for project selection.* A start should be made by training staff in key line ministries and central agencies in the techniques of cost-benefit analysis, and then progressively requiring all investment decisions to be based on these criteria.
- *the role of federal investments in the total public investment program needs to be clarified and streamlined.*

CHAPTER 4

INSTITUTIONAL ARRANGEMENTS FOR INVESTMENT BUDGETING

4.1 Efficiency of public investment to a large extent depends on procedures utilized in preparation of investment projects and institutional capacity of government bodies to make rational investment decisions. The fragmentation of the investment budget, insufficient objectivity in investment decisions, the inconsistencies in applying project clearing procedures, the separation of new fixed investment from the rest of federal expenditures and the short financing horizon are among the most serious deficiencies of investment budgeting in Russia.

4.2 While the earlier chapter dealt with the overall rationale for government intervention, the nature of that rationale, and the use of cost-benefit analysis for project selection, this chapter takes the discussion further. It deals with the public investment budgeting cycle – planning, financing, and budget risk management. The focus of analysis lies largely at the federal level, though some issues which bear on budgeting of investment expenditure at the subnational level and for off-budget public entities are also touched upon.

Overview of the Investment Budget

4.3 Investment budgeting in Russia is characterized by several features which undermine its effectiveness. First, investment budgeting is quite fragmented. As we have seen in the preceding chapter, the investment program in Russia is composed of several individual programs, each with their own objectives, planning and financing arrangements, and implementation responsibility. In addition, the budget also includes so-called ‘non-programmed’ investments, which are urgent investment demands arising from ad hoc Government decisions and from a need to deal with accidents and natural disasters for which the emergency funds of the President and the Government are not sufficient. Many agencies are involved in the preparation of the investment program. The Ministry of Economic Development and Trade is the primary ministry responsible for developing the investment program. The MoF is responsible for the preparation of the budgetary financing plan for the investment program and to oversee its implementation. It tries to ensure that the outlays on public investments are determined within the overall resource constraints. Various sectoral agencies at the federal, subnational, and local levels prepare specific investment proposals in the sectors they supervise. Besides, typically there are several independent divisions within each of these Government bodies, which are responsible for selected pieces of the overall investment program, without any strong coordination among them. This introduces a substantial fragmentation of the process with high coordination costs and risks duplication of effort and financing.

4.4 Second, problems with fragmentation are compounded by the lack of complete coverage. While there has been a progressive trend in expanding the coverage of the budget to include key investment expenditures erstwhile financed from extra-budgetary and earmarked budgetary funds (such as Federal Roads Fund), substantial portions of public investments still remain outside the budget. For instance, in 2000, new fixed investment by unitary enterprises under the Ministry of Railways were Rb 80 billion — almost one-third larger than the total amount of new fixed investment from the federal budget. Similarly, in many regions, regional road funds still remain outside the subnational budgets. Even when consolidation of such and similar funds within federal or subnational budget happens, often they are given a status of earmarked funds, which de facto separates them from the rest of the budget in terms of the budget process and control.

4.5 Third, the decision-making process of investment budgeting is characterized by a high degree of politicization and non-transparency which undercut objectivity. Political interference

helps to bypass the regular procedures required for investment program and project approval and financing. For instance, investment projects approved by ad hoc decisions of the President and the Government are not required to have a standard package of project documentation. Amendments done to the investment program by the Duma during annual budget law discussions are ad hoc, too, often without reasonable economic justification. Such subjective practices discourage due diligence and objectivity in project preparation for all investment projects.

4.6 Fourth, the above problems—primarily the fragmentation and the lack of objectivity in the process—makes financing decisions by the MoF difficult to undertake and enforce. Financing needs typically far exceed available resources. For instance, in 2001, financial requests to the federal budget for financing federal targeted programs and construction sites exceeded by a multiple of five the available budgetary resources. The MoF approach in the face of these constraints is to use incremental budgeting techniques whereby all investment demands are cut to affordable levels. The downside of this approach is that this cut is spread more or less proportionally across all investment programs and projects, leaving them without sufficient financing regardless of priority and efficiency considerations. It is clear that even potentially efficient projects under these circumstances would require more time for their completion and may become inefficient at the end.

4.7 Fifth, *new* fixed investments under federal targeted programs represent 50-60 percent of the FTIP. There are over 150 federal targeted programs included in the 2001 budget, reflecting the strategic priorities of the Government. Adequate financing, supervision, and monitoring of all programs is a challenging and largely infeasible task. In recognition of this, the Government has decided to reduce, by 2002, the number of federal targeted programs to 62 (see Annex 4.1 for revised list of federal targeted programs). However, risks of budgetary pressures remain, as many of these programs are a pure compilation of several smaller programs. For instance, the proposed federal program for modernization of the transportation system in Russia incorporates four programs from 2000. Moreover, the Government also continues to approve new federal targeted programs in addition to those included in the revised list.

4.8 **Recommendations.** It is clear from the above that several options are available to the Government to address these deficiencies with a view to developing a rules-based and objective process for investment budget, which can give the best chance for the selection of high-return development projects and their effective implementation. These include:

- *consolidate responsibility for investment program approval.* Given the current fragmentation in decision-making, systems should be established that all investment programs and projects are approved only after the ‘no objection’ received from the MoEDT and MoF and that changes to the investment programs can take place only within the context of a list of already approved programs. This would reduce the scope for program approvals outside of these central economic agencies and ensure that all approved projects meet minimum thresholds in terms of economic rates of return and investment justification.
- *expand budgetary coverage.* Budgetary coverage of investment programs should be expanded consistent with ongoing efforts of the Government.
- *improve budget contingency planning.* In order to cover genuine cases of financing relief and rehabilitation measures in the wake of natural disasters and emergencies, adequate contingencies should be planned in the budget with a view to gradually expand the practice of insurance of state and private property so as to reduce implicit contingent liabilities over the medium term.

The Investment Budget Cycle

4.9 The current annual budget preparation process in Russia starts in March-April with the Government issuing a resolution on preparation of the budget law for the following year (see Figure 4.1).¹³ Upon receiving annual spending limits from the MoF in June, line ministries prepare budget requests in three week's time. However, for investment programs, the timing is a little bit different. Subnational governments issue in May a request for proposals to 'state customers' (line ministries and other government agencies) for federal targeted programs with pre-specified financing limits. The state customers then submit budget requests by each program within the established spending limits to the MoF by June. For development of new federal targeted programs, typically, an initial initiative comes from a line ministry or a beneficiary region, either directly to the Government or indirectly through the Federal Assembly.¹⁴ In most instances, it is the MoEDT which plays a coordinating role in reviewing proposals for investment programs, except for investment projects in the roads sector and those being financed by IFI's. On research and development programs—which may also have investment components—the Ministry of Industry and Science (MoIS) is involved as a central player.

4.10 Depending upon the type of investment program –federal targeted program, sectoral investments, etc.– the relevant department of MoEDT takes charge of the preparation of the program. Coordination of different investment programs across departments of MoEDT is weak or missing. Even within a line ministry or a sector department of the MoEDT, a coherent sector investment policy embracing all investment from the federal budget, as well as from other public sources, is not formalized institutionally; only fragmented information is available, which has to be pieced together to get the complete picture.

4.11 Despite formal requirements (e.g. para.5 of Government Resolution #594 of May 26, 1995), line ministries do not perform proper efficiency analysis of public investment programs, and the MoEDT also does not insist on it. With regard to commercial investment projects, this is the result of inadequate capacity and training of staff of line ministries, as well as the obsolescence and difficulty of use of investment analysis guidelines. With regard to non-commercial projects, cost-benefit analysis guidelines have not been developed at all.

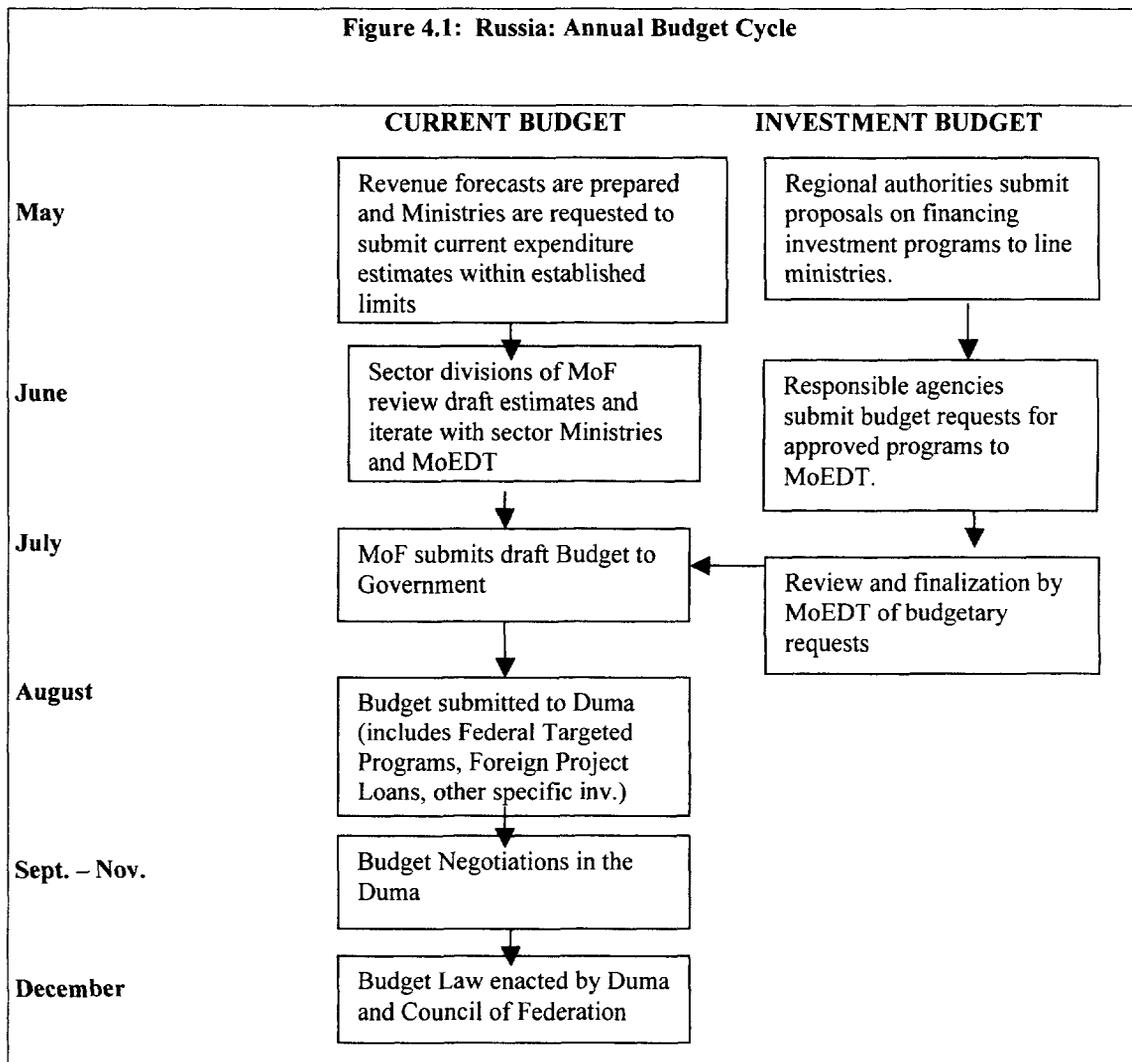
4.12 If the MoEDT supports the concept of an investment program, consultations take place between it, the relevant agency submitting the proposal and the MoF leading to a proposal for review at a Government session. A positive decision of the Government (either in the form of a protocol decision or a resolution) is an invitation for responsible agencies (state customers) to develop a full-fledged investment program, which is also to be approved by the Government after a new round of inter-agency negotiations.¹⁵ The program typically has a breakdown by investment projects only for the first year of its implementation. Investment projects under an approved investment program are then included in the sectoral request for funding during the

¹³ In 2000, the timetable was as follows: Govt. resolution on budget preparation: March 28; Spending limits by MoF: June 1; Requests for proposals for FTPs: May 15; Submission of Budget requests: June 15; Draft Budget to Govt.: July 15; Budget submitted to Duma: August 26; Budget Law approved by the Parliament: December 20; Enacted by the President: December 27.

¹⁴ Individuals and supranational bodies are also empowered with investment program initiation, though it is an exception rather than a rule.

¹⁵ Since a list of state customers is currently approved by a government decision (*rasporyazhenye*) without formal government hearings, for some programs government agencies representing final consumers are not included in the list of state customers. It creates a supply driven bias in program preparation and implementation.

following budget cycle. The timetable for the whole cycle up to this point is not defined and is generally spread over the year.



4.13 Where a framework decision is not made for federally financed investment projects, the Government gives its approval along with other documents prepared as part of the draft federal budget for the following year. The State Duma usually votes to increase the financing of investment projects under the FTIP and other sectoral appropriations (e.g. coal sector, agriculture). When additional investment projects under federal investment programs are not specifically identified by the Duma, a line ministry jointly with the MoEDT, undertakes the task to develop it later on. In some instances, investment decisions are made directly by the President, the Prime Minister, or his first deputies. Sometimes, these decisions take place outside of the budget cycle and the federal budget law, and even without formal approval of the MoEDT and the MoF. Usually, these decisions also instruct the MoF and the MoEDT to find budgetary resources for their execution.

4.14 The monthly financing plan for the investment budget is prepared primarily by the MoF, and on its basis line ministries allocate budgetary resources across individual recipients by each

investment program through payment register. If the monthly financing plan is significantly lower than stipulated in quarterly budget appropriations under the federal budget law, it is not possible at all to take into account some seasonality of expenditures (for instance, in road construction), the lumpiness of contracts. Based on this register, the Federal Treasury makes payments to spending units upon the receipt of their payments requests against work completed. The MoF receives quarterly budget execution reports from the line ministries, which reports upon the status of expenditures on each program.¹⁶ On a monthly basis, the MoF receives only aggregate expenditure information in broad functional classification.

4.15 Several characteristics of Russia's investment budgeting cycle deserve attention. First, most investment policy decisions tend to be made without substantive empirical analyses. While investment policy decisions are taken over time, and not constrained by the tight time squeeze of the budget calendar, little work is done in terms of an in-depth analysis of the linkages between the economy, specific programs for economic development, and the proposed investment budget so as to bring out the impact of proposed investment budget measures. Moreover, neither the current cost implications of ongoing investment programs, nor the future current cost implications of new investment programs and projects are adequately reflected.

4.16 Second, investment programs and projects are budgeted for only one year at a time, notwithstanding the multi-year nature of these projects. Since such projects do not generate economic benefits while under completion—except for gains from employment and purchase of equipment and machinery needed for construction—delays, discontinuation, and disruptions in project financing may result in high sunk costs, reduce the time span for reaping the benefits, and lead to negative economic returns. The absence of multi-year budgeting increases uncertainty for program developers about future financing of the programs and stimulates formulation of inflated requests for program financing during first year of program life irrespective of the real needs. Information is not available on the age profile of investment projects or on the differences in completion times compared with original estimates; however, these are thought to be high reflecting the inadequate financing of investments. For instance, an apartment building in Kaluga region for involuntary migrants to Russia was not completed because of absence of co-financing sources other than federal budget. Multi-year budgeting can help resolve this problem by ensuring that investment projects are budgeting for 3-5 years at a time, with guarantees of financing in the outer years subject to satisfactory performance along specific benchmarks and annual adjustments. Besides, amendments to the legal framework (e.g. Government resolution # 594 of June 26, 1995) which would streamline co-financing procedures for public investment to ensure transparency and competitive selection of construction sites and bidders would also help.

4.17 Third, the formulation of the investment expenditure estimates tends to be oriented to financing specific pre-determined time slices of expenditures rather than looking into the factors contributing to needs, volatility of macroeconomic and project-level factors, pace of work required for efficient completion, etc. Nor does the process permit an identification of the high risk areas including contingent liabilities. As a consequence, the Government is compelled to look into the additional needs and issues during the fiscal year. More significantly, the spending ministries and agencies do not bother to think about the overall macroeconomic pictures, or the resource limitations, or about their own role in that context. The current practice of anchoring expenditure control is hardly adequate for the purpose of the efficient execution of the investment programs and projects.

4.18 And finally, much of the process is manual with extensive reliance on paper work. Although Excel spread sheets are used for recording and or calculating individual items, a

¹⁶ Though not all line ministries accurately do so.

computer-based budget preparation system is not used for the consolidation of investment program requests or for tracking their financing progress.

4.19 **Recommendations.** In addressing the above issues, the following factors need to be kept in view: (i) the basis of investment policy formulation needs to be improved so that the full current cost implications of the investment budget can be identified and analyzed; (ii) the participants in the budgetary process should have a heightened awareness of the resource limitations and the developments in the domestic economy; (iii) there should be a growing emphasis on performance or the results of the investment budget; and (iv) to improve efficiency, a major part of the budgeting process could be conducted on an electronic basis.

4.20 More specific suggestions for improvement are:

- *increase transparency and public debate in the preparation of federal targeted programs.* This can be promoted by several initiatives: (i) state agencies representing final consumers of services should be permitted to actively participate in program preparation; (ii) prior to government approval, the concepts of programs, as well as the draft programs, should be made available to the public for discussion and comment; (iii) co-financing procedures for public investment and competitive selection of construction sites and bidders should be streamlined. (These changes may need amendments to the Government resolution # 594 of June 26, 1995.)
- *strengthen the statistical base of the MoF and MoEDT.* As an integral part of this effort, data on expenditure profiles of major programs, unit costs of different types of investments, performance indicators and benchmarks for different investment programs should be developed so as to enable the MoF to have a more precise understanding of the impact of investment programs on (i) the budget (including their expenditure dynamics); and (ii) on the economy.
- *enhance inter-department/agency coordination.* The fragmentation of decision making (referred to earlier also) introduces high transactions/coordination costs into the system. The current division of responsibility among various departments in MoEDT and MoF appears to be a legacy of the past institutional arrangements and re-organizations. For instance, in the MoF, federal programs of regional development do not fall under the responsibility of the department for interbudgetary relations or department for sector policy. Rather it is the responsibility of the department for macroeconomic policy and banking. Similarly, the department for state investment in the MoEDT is separated from the investment policy department and both of them are in charge of different investment programs. This issue should be resolved by institutional re-organization of these two key ministries in the light of (i) an overall review of their functions and organization, and (ii) with due consideration of the technical capabilities of staff to handle new/revised responsibilities.
- *develop an integrated Medium-Term Expenditure Program.* This could be done on a rolling basis and cover both the current and the investment plans. In principle, this should be couched within the context of a medium-term sustainable resource envelope, but a start can be made by looking at expenditures in an integrated manner. Such an expansion of vision would force a recognition of all important factors affecting the expenditure side, including contingent liabilities. It would show the existing commitments and the margins available for additional expenditure growth. It would thus facilitate an informed debate on expenditure priorities and for the role of public investments within them.
- *such a framework would also permit multi-year budgeting for investment projects.* This would help provide improved certainty of budgetary financing for future years, facilitate timely financing and completion of works, and improve the economic returns from investment projects.

- *undertake electronic submissions for investment programs.* Consistent with the spread in the use of information technology within Government, an effort should be made to move towards electronic submissions of the budget submissions by spending units (including those for the investment programs).

Investment Projects and Links with Economic Policies

4.21 As discussed, investment expenditures are not formulated in the context of medium-term economic or sectoral strategies. Such a separation precludes the pursuit of a coordinated policy towards expenditure on maintenance, capital repairs, new equipment, and new fixed investment. As a result of fiscal constraints, capital repairs are usually budgeted as a residual category, while there might be large new fixed investment programs in the same sector in the budget at the same time. For instance, unfunded needs for capital repairs in the education sector are more than 10 times higher than the approved amount of financing of a federal targeted program “Development of Education”.

Box 4.1: Federal Targeted Programs—A Brief Description

A federal targeted program is intended to address an important sectoral or inter-regional problem. A decision on the development of each targeted program is made by Government resolution, and once the program is prepared, it is again approved by Government resolution. A typical federal targeted program consists of problem description, main program objectives and tasks, program stages, a list of program measures, quality assurance, implementation mechanism, program management and control, efficiency analysis, ecological and other expertise, and financing sources. Besides financing from the federal budget, programs incorporate financing from other sources (subnational governments and/or private investors) so that federal financing accounts for just 10 percent of total costs, on average, while regional contribution is even lower at about 5 percent, on average. Regional development programs are a subset of federal targeted programs, and are region-specific.

4.22 Of the various investment programs, the federal targeted programs are presumably the closest to reflecting the strategic priorities of the Government, and developing an integrated approach to solving important inter-sectoral or inter-regional problems (see Box 4.1). However, a review of these programs reveals lack of policy orientation, inadequate socio-economic justification, and unclear relationship among the various projects in the program. This is apparent with the federal programs of regional development—a subset of federal targeted programs unified in the Regional Development Fund (RDF)—which finances very small investments in many regions. The fact that these programs are often used for distribution of political largesse and the small size of the RDF relative to the Federal Fund of Financial Support to Regions (‘equalization fund’)—the primary mechanism for transfers to the regions—begs the rationale for its existence as an instrument for objective support of economic development.

4.23 **Recommendations.** Investment programs and projects are typically separated from economic and sectoral policies. This not only undercuts the application of objective economic criteria for their selection, it also undermines an integrated approach towards adequate allocation of resources among current and investment budgets and, within the investment budget, among new investments, capital repairs, and purchase of equipment and machinery. Approaches towards strengthening the system should include the following:

- *enforce the existing legal framework regarding budgeting of federal targeted programs.* Develop specific guidelines on all required documents and make sure that all the documents are prepared and of good quality.
- *re-allocate resources within investment budget in favor of capital repairs.* Integrate budgeting of capital repairs with other investment budgeting and make sure that new investment projects are not financed if justified demands for capital repairs are not met.

- *strengthen socio-economic justifications for federal targeted programs.* This is needed to (i) link federal budget resources allocated under the programs with other federal expenditure allocations for the sector; (ii) define measurable objectives for each program and quantitative criteria to evaluate program outputs and outcomes; and (iii) use cost-benefit analysis for efficiency evaluation of non-commercial investment projects.
- *develop objective criteria for distribution of funds for regional development projects.* First, the need for a separate financing window should be reconsidered given the existing equalization transfer and the proposed window for competitive allocation of transfers to eligible high-performing regions. Second, should a need still be felt for maintaining this program, the allocation process should be strengthened through (i) adoption of a transparent formula for resource allocations across regions; (ii) establishment of a requirement for co-financing from regional budgets; and (iii) extension of greater flexibility to recipient regions in choosing construction sites within the closed list of eligible sectors.
- *move towards program-based budgeting.* As a final objective, the overall allocation of federal budget funds should be function and program based (e.g. ‘health sector, program of TB prophylactics and treatment’) rather than being driven by separation of new fixed investment from other types of expenditures.

Criteria for Prioritizing Projects for Financing

4.24 The scarcity of budgetary resources available for financing the large demands for public funds for approved investment projects necessarily suggests that criteria need to be developed for prioritizing the investment projects. At one level, this needs careful scrutiny in the *selection* of projects, an issue which has been discussed at length in the preceding chapter. This would, for instance, preclude projects of a commercial nature from entering into the investment pipeline. At another level--once projects are approved and are being financed--prioritization would help direct sufficient resources to selected projects to ensure their early completion. The over-riding objective here is of course to maximize the economic returns derived from these projects. Given the current problems with the portfolio of investment projects in Russia, five criteria can help weight different projects in the short-run and thereby ease the budgetary financing pressures. These are:

- extent of work done: projects near completion should be prioritized over new or young projects.
- nature of investment expenditures: projects requiring capital repairs should be given priority over new fixed investments.
- leveraging domestic and foreign financing: projects where federal government financing helps to leverage higher amounts of financing from other domestic and foreign sources should be given higher priority, provided that: a) co-financing is available (e.g. comfort letters signed, a credit line agreed on, etc.); b) Treasury procedures for co-financing of investment projects from the federal budget are developed.
- extent of trans-regional benefits: projects whose economic benefits transcend regional boundaries need to be given preference over those of a purely localized regional nature.
- better performing projects: projects which are performing well as evidenced by satisfactory progress against performance benchmarks need to be supported in a timely manner in order to encourage efficiency.

4.25 The problem of choosing among these criteria can be resolved through developing: (i) a ranking system for projects against these five criteria, and (ii) an appropriate weighting system which assigns different weights to each criteria. The weighted rank of each project could then be calculated and projects ranked by it. Higher-ranked projects would have the first claim on budgetary resources for investment.

Managing Risks

4.26 Risks to the budget emanate both from the public investment program, as well as the quasi-public investments. Risks from the public investment program in Russia are of different types, including macroeconomic risks (e.g. from changes in assumptions for inflation, exchange rate, and interest rates), payment risks (from non-payment from users of investment goods and services), demand risks (e.g. from under-estimation of demand for publicly-regulated and privately-managed investments), and political and regulatory risk. Their relative importance of course varies in any given year with macroeconomic risks being most dominant during 1998 given the financial meltdown that year. Prudent fiscal management demands that adequate strategies are in place for coping with such risks through policies that reduce them, and through systems for measuring, monitoring, and budgeting for them.

4.27 Before 1999, sequestering of federal budget expenditures in Russia was a common practice, and capital expenditure—like in other transition and developing countries—was the least protected expenditure category.¹⁷ In 1999-2000, a conservative approach to budgeting revenues at the federal level enabled coverage of all budgeted expenditure needs. Yet, the Russia budget remains highly vulnerable to macroeconomic factors such as world oil prices and growth rate of the economy, which lie beyond direct government control due to structural features of the Russian economy. In addition, the year-to-year changes in inflation, exchange rates, and interest rates also impose significant challenges for the management of the public investment program (see Figure 4.2).

4.28 To minimize these risks, several measures need to be adopted:

- *consolidate macroeconomic stabilization.* Recent gains towards macroeconomic stabilization needs to be consolidated and sustained.
- *reduce uncertainty over future financing.* Reduction in uncertainty over future budgets for investment projects through, for instance, the development of multiyear budgeting as suggested above, would help reduce risks to the investment programs.
- *prepare annual budgets based on conservative assumptions.* This is an area where the Government has succeeded in 1999-2001 and will help ensure that project budgets are adequately financed. Subnational governments have even fewer instruments for control of macroeconomic factors than the federal government does; thus, this issue is even more important for subnational governments.
- *enforce culture of payment.* Timely payments for public contracts would minimize payments risks. The pernicious problem of non-payments which affected public and private contracts in Russia during the late 1990s appears to have reduced substantially. Government

Figure 4.2: Macroeconomic Volatility in Russia: 1997-2000

	1997	1998	1999	2000
Real GDP Growth	0.9	4.9	3.5	7.7
Inflation (CPI, end-of-year)	11.0	84.5	36.6	20.2
Exchange Rate (annual average)	5.8	10.0	24.8	28.2
Lending Interest Rate (annual average)	32.0	41.5	40.1	24.6
Federal Revenues (% of GDP)	12.3	11.0	13.4	16.3
Of which:	12.3	11.0	13.4	16.3
Due to Oil Price Changes (1995-97=100)	0.0	-0.7	0.4	1.5

Source: IMF, Bank staff estimates

¹⁷ See Mark Sundberg and Alexander Morozov, "Benchmarking Public Expenditure in Russia", mimeo, 2000.

- arrears are declining with Government starting to allocate targeted budgetary resources for paying off arrears accumulated during previous years.
- *improve technical quality of project appraisal.* Developing and implementing high return projects requires that the technical quality of project appraisal be very high.
 - *institute periodic reviews of investment programs and projects.* Over time, it may turn out that public needs have changed or new factors now impinge upon the project, both of which may stipulate a need to modify, or even cancel, the project. For this purpose, a regular (annual or biennial) review of investment programs and projects should be mandated.

4.29 Quasi public investments. Fiscal risks from quasi-public investments—investments undertaken by off-budget public and private entities which involve an explicit or implicit budgetary liability—are thought to be substantial. The size of such outstanding government contingent liabilities related to investment projects are reportedly significant, though precise data is not available. These are in the form of explicit loan guarantees extended by the federal and subnational governments for investments by state and private enterprises, as well as implicit liabilities based on the notion that the governments will not let banks and enterprises fail. However, since 1997, successive budget laws have sought to cap the issuance of new federal government guarantees. New guarantees and other forms of contingent liabilities (e.g. special investment bonds) are now mostly provided by subnational governments and some have already been called in recent years resulting in significant fiscal costs. While the Budget Code clearly stipulates that the federal government would not be liable for subnational debt obligations, the realization of some of these contingent liabilities imposes a serious fiscal risk to the regional governments' budgets and undermines the fiscal position of the consolidated government budget.

Conclusions

4.30 Institutional arrangements for investment budgeting remain weak. The biggest deficiencies arise from the fragmentation of the investment budget, the weak links with policy, lack of integration between investment and current expenditures, short one-year budgeting horizons, even for multi-year projects, use of non-objective criteria for financing project needs, and inadequate systems for managing multi-year risks. But there are some positive features, too, particularly in the policy basis for the federal targeted programs. Measures to strengthen investment budget preparation have to center upon consolidating some responsibilities for investment budgeting, integrating some financing windows, budgeting fully with realistic macroeconomic assumptions, costing out the recurrent cost implications of investments, and prioritizing the financing of investment projects consistent with budgetary envelopes. Good and realistic investment budgets are the first step in ensuring that budgets get implemented and budgetary outcomes are realized.

CHAPTER 5

PROJECT MONITORING AND EX POST EVALUATION

5.1 With good budgets, the challenge is to get them implemented efficiently—at least cost and with maximum economic benefits. Systems of public accountability are central to ensuring that public funds are used properly and to good effect. Noticeable improvements have taken place in investment budget execution—to a large extent due to the extension of the Federal Treasury—but there are still significant weaknesses which undermine the overall efficiency of the investment budget. The most striking of them include the lack of systems for commitment control, insufficient procedures for co-financing of federal investment expenditures, inadequate procurement processes, and weak systems for project monitoring and evaluation. This chapter examines these issues with respect to the execution of investment budget expenditures.

Adequacy of Systems for Commitment Control

5.2 Systems of commitment control for all budgetary expenditures are still at an early stage of development. The lack of adequate systems of commitment control, especially for investment projects, puts the budget at risk, since many investment projects typically have multi-year time horizons and therefore the scale of work to be done within a given time period is scaleable. Generally, the apportionment of work is linked with the financing available, but if commitment control systems are inadequate, the possibility arises that additional work may have been done even though funds may not be available, thereby generating the risk of arrears.

5.3 The development of the Federal Treasury and better enforcement of existing rules have helped over the past years to strengthen commitment control and reduce federal budget arrears. Pending the full implementation of the treasury at the federal and subnational levels of Government, the Government introduced in 1999 transitional systems for commitment control.¹⁸ These require the manual recording at the Federal Treasury of certain spending codes relating to utilities' expenditures. This requires contracts to be registered and stamped by the Treasury, which confirms that the spending units have not exceeded their authorized level of commitments. Without this registration stamp, spending units are forbidden to use federal funds to pay for the contracts, and the Treasury does not process payments. The Treasury has been generating monthly reports for each ministry, by the 25th of the following month, indicating the budget classification and the amount of commitments recorded and paid. However, the pre-registration of contracts is only an *administrative* regulation which is not supported by existing legislation (as provided for in the Budget and Civil Codes), and thereby limits the ability of the Government to enforce it legally in the case of potential disputes.

5.4 There are three Russia-specific issues which undermine commitment control. First, it is not clear who the entities are which need to be under budgetary control. The legal status of many entities belonging to the Government is not in conformity with the Civil Code, and it generates direct subsidiary responsibilities of the Government for commitments incurred by such entities. In order to clarify these relationships, the Government has started work on developing an inventory of federally-owned entities and, based on work completed so far, has asked line ministries to clarify the legal status of entities they supervise. In parallel, identified federal unitary and state-owned (*kazennye*) enterprises are being transferred to block grant financing from the federal budget so as to make the government no longer liable for their expenditure commitments.

¹⁸ Government Resolution # 806 dated July 15, 1999.

5.5 Second, investment budgeting in Russia has some peculiarities, which makes Treasury management more difficult. As discussed earlier, investment projects are often co-financed from different windows on the federal budget without full and complete clarity over financing criteria, and it is difficult, given current workloads, to determine what specific works under an investment project are eligible for federal funds under different financing windows.

5.6 Third, there is also a longer-term issue of expenditure commitments stemming from contingent liabilities of the Government. Even when subsidiary responsibility of the budget is limited to true budgetary entities, the Government may incur contingent liabilities, which come in the form of guarantees issued (explicit liability) or different forms of bail out initiatives (implicit liability). While explicit liabilities are unconditional, implicit liabilities depend on the political preferences of the government and, in principle, can be minimized. Explicit contingent liabilities are managed as a part of state debt management system.

5.7 **Recommendations.** The general weakness in the control of budgetary commitment is particularly problematic for the management of investment programs given their multi-year and scaleable nature. While some transitional measures could be introduced to strengthen commitment controls for investment projects, full commitment control over federal investments will only be established after the federal treasury system is fully operational. General measures to strengthen overall budgetary commitment control include completion of the inventory of all federal budget entities, ensuring the legal status of entities financed under the federal budget is consistent with the Civil Code, completing the transfer of non-budgetary entities to block grant budget financing, and establishing an adequate system of managing contingent liabilities

5.8 However, there is an important transitional measure specific to investment programs that could be adopted:

- *introduce Treasury registration of contracts for federal investment projects above a certain threshold.* The current system for registering contracts for utilities and communal services could be fixed *de jure* in the Budget Code and cover large investment projects also. However, the implementation of such a measure would require due consideration of the technical and human capacities of the Treasury, which are already being stretched.

Competitive Procurement

5.9 Experience from around the world has shown that competitive procurement is one of the most effective instruments for realizing budgetary savings, if it is done on a truly competitive basis. Russia has been moving steadily towards expanding competitive state procurement. This has been better achieved at the federal level than at other levels of Government. In 1999, at the federal level, 70 percent of public expenditures on the purchase of goods, works and services were done by Open tendering, which is the most competitive procurement method available under current legislation (see

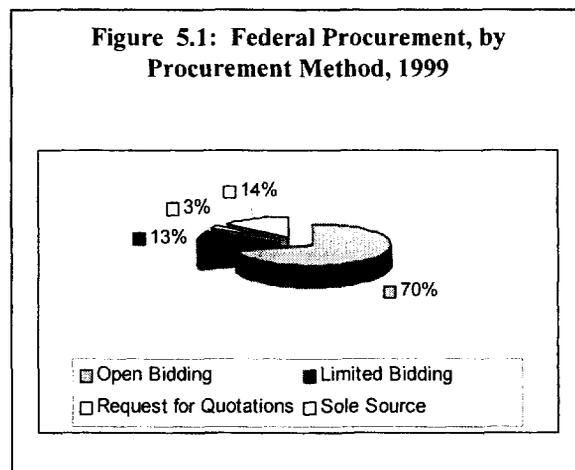


Figure 5.1).¹⁹ This compares favorably with 60 percent competitive procurement at the regional levels and 19 percent at the municipal level. This pattern is to be expected given the larger value of contracts at the federal level and hence the higher potential benefits from competitive procurement. The average value of contracts at the federal level in 1999 was \$66,000. Restrictive procurement methods, such as Limited Bidding, Request for Quotations, and Sole Sourcing, comprise a small and declining share of total federal level public procurement.

5.10 However, this does not mean that all is well with procurement in Russia. Competitiveness of Open tendering is undermined by excessive restrictions which apply to many public tenders, including limitations on participation by foreign bidders and, at subnational levels, by bidders from outside the purchaser's own region. This results in higher cost procurement and/or lower quality of procured goods and works. Moreover, many aspects of the legislation require further development. There is also a pressing need to develop the institutional and human resources to conduct competitive procurement.

5.11 **Recommendations.** Potentially large savings can be generated by further strengthening of competitive procurement. Specific recommendations are:

- *amend the Law on Procurement for State Needs*. The current law has unjustified restrictions for participation of overseas companies in public tenders in Russia, which should be redressed in order to foster greater competition.
- *establish an autonomous federal procurement monitoring agency*. Given shifting organizational responsibilities in recent years, the role of developing, monitoring and overseeing Russia's public procurement system can best be served by an autonomous federal procurement monitoring agency like in many other countries.²⁰ Such an organization should be free of any operational involvement in public procurement and be charged with developing legislation, ensuring proper application and enforcement of laws and regulations, and conducting administrative reviews of bid protests.
- *develop detailed guidelines for procurement*. While various legislative acts define the framework for procurement at the federal level, there is an absence of adequate detailed sub-legislative texts which can explain how these laws are to be implemented. These guidelines will also help agencies ensure that competition takes place among bids by independent legal entities.²¹ Such guidelines, which should be updated periodically, can also lay out relevant reference prices to be used for special standardized construction works, for instance for roads in Moscow city which has sizeable claims on the local budget.²²
- *strengthen institutional capacity in line ministries*. Investment projects are undertaken by line ministries and regional governments (and spending units subordinated to them) where capacity to conduct competitive tenders varies substantially. In many instances, line ministries reportedly voluntarily restrict access to tenders. In some cases, the Ministry for Antimonopoly Policy (MAP) has successfully appealed against non-competitive practice of certain line ministries. For instance, the Ministry for Construction of Moscow Region Government responding to an appeal from the MAP has voluntarily amended its regulations, which had restricted a list of insurance companies eligible for insuring construction risks in

¹⁹ See Russia: Country Procurement Assessment Report, WB, February 2001.

²⁰ France and Sweden are examples.

²¹ For instance, a recent tender for bridge construction in Moscow-city was performed among four bidders, which were subsidiaries of the same legal entity.

²² Some reference prices from OECD countries are used in Moscow city. Given differences in income levels and technology—and the nontradeable nature of much of construction—more realistic local price indicators should be used.

the region. While such activity is welcome, better institutional safeguards could help prevent such problems from emerging. At the subnational level, too, non-competitiveness in supposedly open tenders is a problem.

Systems for Quality Control

5.12 Two crucial dimensions of quality control are timeliness of project completion and delivery of project within budget parameters. There is some empirical evidence to suggest that the investment projects lag on both counts (see Box 5.1). There are various institutional reasons which lead to such outcomes, including weak budgeting and systems for project monitoring.

5.13 Most project monitoring focuses on the concurrent verification of the use of funds. These tasks are performed by multiple departments in the Government, and the responsibility for project monitoring again appears to be fragmented. At the primary level, and like the practice in many other countries, the line ministries (as “state customers”) are charged with supervising ongoing work under investment projects, and ensuring that quality standards are maintained. Based on periodic implementation reports for each project, additional funds are released by the Treasury. However, it is not clear to what extent these implementation reports limit themselves to the use of financial resources as against verification of work against contract plan, including dimensions of quality.

5.14 At a second level, and one-step removed from the implementing agency, is work verification by MoEDT and MoF. Some of the departments of MoEDT dealing with individual investment programs (such as regional programs) undertake on-site visits to monitor project implementation. Staff of some departments of the MoEDT go on field visits to different sites about 10-12 times per year. In special cases, especially in case of disputes, staff of the MoEDT are involved in construction sites audit even while work is ongoing. The control and audit department of the MoF also performs periodic audits of federal spending, including investment spending, but these are mostly ex post in nature (see below).

5.15 At a third level, the technical aspects of work, for instance in road construction, are monitored by the technical agencies, such as the Russian Committee for Technical Oversight. Formally, without an approval from such a technical agency and endorsement from a respective state customer, work under contract is not considered completed, and the Treasury authorization issued. Yet, reportedly, technical agencies and state customers do not always perform their roles properly.²³

5.16 Given the above systems, there is no strong link between budget management and the quality of work being accomplished by public funds during the period of implementation. Budgetary flows are often released on the basis of utilization of funds and are divorced from whether the work is being completed according to specifications. This is a serious shortcoming which needs to be addressed as the Government moves towards greater budgetary focus on the results and outcomes of budgetary investments.

²³ This is reportedly a more acute problem at the subnational level. For instance, a recent criminal investigation of Moscow-City’s newly constructed ring road by the Ministry of Interior revealed that the road is 0.2 meters narrower than it should have been according to project documents. Given the ring road’s total length of about 105 kilometers, this is equivalent to a loss of 20-25 sq. km pavement. Together with significant under spending of construction materials against the project specification, it resulted in Rb 256 million loss for the budget (*Vedomosti*, Mar. 1, 2001).

Box 5.1: Inefficiencies in Budget Execution

Inflated Costs. Inflated project cost is reportedly a generic problem in investment programs. With a weak commitment control system, such overvalued claims translate into budgetary arrears, undermining fiscal management. An illustration of this problem is the case of the Moscow ring road. An audit of the construction works performed by the Main Control and Audit Division of the Moscow-City Government in 1996-1997 revealed that Rb 179 million or 26 percent of the financial claims were not justifiable expenses. Another audit carried out by the same body in 1999 found that costs of concrete purchased for road construction was overpriced by Rb 1.1 million, and costs of construction works were overvalued by Rb 5.4 million.

A key part of the problems is reportedly due to use of obsolete norms for costs. These are typically based on historical physical and price data for construction works from many years ago and are indexed for 1990s inflation. But changes in the construction technologies and procurement of contracts have made these norms obsolete and unrealistic today.

Inflated Completion Times. While detailed statistics are not available, reports on implementation of *federal targeted investment program*, regularly published by Goskomstat, indicate that even in good years (such as 1999) when the federal budget fully financed its commitments, only 15 percent of planned investment projects were actually completed and there were no works at all on 14 percent of the construction sites.

There are several reasons for such delays: (i) planned completion times are often over-optimistic; (ii) reduced releases of resources, both from the federal budget, as well as other co-financing sources, slow progress of work; (iii) inefficient project monitoring reduces incentives for contractors to meet their contractual obligations; and (iv) poor quality of project preparation and documents.

5.17 **Recommendations.** Concurrent quality control systems for investment projects are weak. The emphasis remains on financially accounting for resources to the exclusion of the quality of work performed. In order to develop an investment budget which guarantees that state funds accomplish their true results, it would be beneficial for the MoF to:

- *enhance verification of works quality.* Administrative discipline should be strengthened so that both technical control agencies and state customers do carry administrative and, in most striking cases, criminal responsibility for quality of their controls.
- *establish an Investment Monitoring Unit in MoF or MoEDT.* Such a unit would provide real time performance audits to the MoF/MoEDT on ongoing projects on a selective basis. Such audits would integrate the physical and financial aspects of the proposed work, and would include information of the physical volume of work done, the assessment of technical quality of the work, the amount of financial resources committed or used, and comparisons of performance to original contract plan. This unit could build on the work done by the existing control and audit department of the MoF. Despite the technical aspects of the performance assessment required, it could be possible for such a unit to establish partnerships with other technical agencies and do joint performance audits. This would minimize the incremental cost to the Government. It is important to emphasize that such audits should be on a very selective basis (say, 5-10 percent of projects) and as part of a medium-term plan to improve efficiency through phased contemporaneous performance audits on different investment programs providing a breadth of both sectors and geographical coverage.
- *strengthen project planning.* Investment program and project planning should be strengthened to better reflect realistic progress and availability of financial resources.

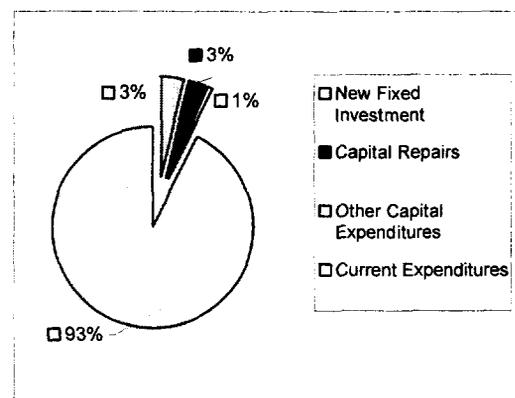
- *develop unified contract forms and templates for publicly financed construction works.* Rights and obligations of all parties under investment contracts should be clarified, including sanctions for improper works quality, late works completion and late payments.
- *develop Treasury co-financing procedures.* Disbursement of federal funds should be made conditional on timely disbursements from other sources of financing under co-financing agreements with subnational governments and/or private investors carrying full responsibility for timely payments under investment contracts with contractors.
- *cancel problem projects.* Problem programs or projects which have systemic difficulties in getting completed, despite availability of adequate funding from the federal budget (and other sources), should be cancelled. This would not only help to improve the portfolio of federal investment projects, but also free up scarce investment funds for other priority projects.

Timely Payments of Contracts

5.18 Delayed payments of claims on the budget has been a particular problem for Russia in recent years, though arrears on investment accounted for an insignificant portion of overall arrears (see Figure 5.2). Since 2000, the overall levels of arrears have fallen with more timely payments of government obligations. This has been made possible primarily through improved fiscal position (from higher oil receipts), but also from tightening of budgetary planning and payments discipline. The latter included conservative budgeting of budget revenues and matching expenditure commitments to them, special provisions in the budget law for repayment of stock of budgetary arrears, limits on spending on certain types of expenditures, and the progressive development of the Federal Treasury.

5.19 For most federal investment projects, payments are undertaken by the Treasury which verifies payment documents produced by state customers of investment projects. The Treasury's domain has been growing with the incorporation of the Federal Road Funds budget in 2001, but there are exceptions. For instance, payments against earmarked funds and foreign tied loans are not executed by the Treasury. With the expansion in coverage of the Treasury, other public expenditures from the federal budget, including those on investment projects, are expected to be fully integrated into Treasury operations.

Figure 5.2: Budgetary Arrears of Consolidated Budget in 1998



5.20 In addition to these systemic problems which affect the whole budget, there are specific payments issues with respect to investment programs. First, the quarterly limits for disbursements which are established by the Treasury—for instance, on federal targeted programs—are based on simplified time slice distributions of total annual budgets for these programs and does not fully take cognizance of the special investment project financing needs in terms of technical work flow requirements or of seasonality of work related to weather cycles. Significant budget allotments often arrive at year end when additional budgetary revenues are appropriated, which leaves very little time for state customers to organize work under investment projects at the time of the most unfavorable weather conditions for construction works. Second, these quarterly limits are often not fully honored, even in the face of full work completion, when

revenue flows or other expenditure exigencies impinge upon the budget. The explicit procedures for some investment programs—such as the federal targeted programs—is that a state customer is responsible for finding alternative sources of program financing if allocations and disbursements from the federal budget are less than stipulated in the program. Under current financial climate, such a requirement is unrealistic and results—when alternative financing is not possible—in significant delays in implementation of federal targeted programs, as well as in arrears to contractors.

5.21 It is also reported by the MoEDT that despite official discontinuation of non-cash operations, some federal targeted programs in 1999 were partially financed by *veksels* (promissory notes). Such practice (if it is still continuing) should be stopped.

5.22 **Recommendations.** Two sets of measures can help with timely payments of contracts and prevention of arrears:

- *ensure adequate financing for investment programs.* Not only should federal budget allocations for investment programs be realistic and adequate for the task at hand, the budget should ensure that funds are available in time. Unanticipated shortfalls in budgetary financing impose serious risks to project completion. Changes in the financing plan should be the subject of mutual agreements and not unilateral cuts. The requirement for state customers to find alternative sources of investment program financing in case of underfinancing from the federal budget should be eliminated.
- *extend Treasury coverage.* Special financing arrangements for federal earmarked funds and foreign investment loans (via project implementation agencies) are contrary to effective cash management and subject to serious financial and performance risks. These should all be brought within the control of the Federal Treasury. It may make sense in the transition to form a special Task Force on transferring the function of control over foreign investment loans to the Treasury. Such a Task Force could consist of Treasury experts and technical experts (knowledgeable in work and payment verification) to develop a time-bound action plan for this.

Reporting Requirements

5.23 Accurate and timely reporting on budgetary operations is an important feedback mechanism for decision makers. As was discussed in Chapter 2, there are also substantial methodological and data problems of economic classification of budgetary operations, which negatively affect further stages of budget process. First, federal targeted programs as a centerpiece of the federal investment program are not monitored and reported as such by the Treasury during budget execution. They appear in budget laws as such in Annex 39, where federal expenditures on each of the programs are formally divided into three groups: investment, R&D and other current expenditures. However, the economic nature of budgetary operations does not directly correspond to such a division, which simply mirrors existing institutional structure of program management: (a) category ‘other expenditure’ on federal programs of regional development represents mainly new fixed investment; (b) category ‘other expenditure’ on federal targeted programs includes a chunk of procurement of capital goods; and (c) overall structure of federal targeted programs is not linked with the economic classification at all. The programs are not singled out in the General Ledger of the Treasury, and are monitored and supervised by line ministries – state customers for these programs. It is only in the ‘comments’ field of Treasury payment registers, where the purpose of payments is linked to a federal targeted program, and some Treasury field offices (e.g. in Kaluga region) are to use their own software extension modules to somehow track program execution. “State customers” prepare and send the MoF reports on actual program financing once a month.

5.24 Second, regional and central Treasury offices receive information on budgetary transactions from local offices in the aggregate form by functions. This information is based on an accounts classification, which is not consistent with the economic and functional budget classifications. The Treasury also does not have access to detailed transaction data, which would have permitted it to prepare monthly budget execution reports by economic classification. It is only at the end of each quarter, when the line ministries submit their own reports to the MoF, the Treasury reconcile them with data of local Treasury offices, specially prepared by economic classification. The delays in availability of such data negatively affect expenditure monitoring. Unfortunately, this problem can not be easily fixed. It requires significant investment in Treasury technologies, hardware and software.

5.25 Third, economic classification of budgetary transactions is to be reviewed. Sometimes, there is an apparent misclassification of the transactions. For instance, expenditures on maintenance of roads and road infrastructure in 2001 federal budget General Ledger are classified as a part of capital expenditure, namely, expenditure on 'other capital repairs'. It is not a purely accounting issue. Besides distorting the overall picture of budget operations, it may also cause delays in budget execution, because local Treasury offices are not allowed to authorize payment in lieu of de facto current expenditures, if they are intended to be capital expenditures. In practice, such disputes are resolved only when the head office of the Treasury or the Minister of Finance himself issues a special clarification, which takes time.

5.26 Fourth, required reporting on the use of budgetary resources is not always made properly and in a timely manner. Similar problems are identified for statistical reporting. State customers (or entities, which were delegated some functions of state customer) sometimes ignore a requirement to submit reports on federal investment programs execution to the upper level of the government, which compromises program monitoring.

5.27 **Recommendations.** Current problems and inadequacies in the budget classification system need to be addressed as a priority so as to enable timely and accurate reporting of investment expenditures by economic and functional classification. Specific measures include:

- *extend standard economic and functional classification.* For policymakers to have proper information on the investment programs, data on investments needs to be made available by standard economic and functional classification. This requires that detailed functional expenditure classification incorporates federal targeted programs. The consistency of the economic nature of budgetary operations needs to be checked with economic classification and Order #38H of MoF dated 28.05.1999 revised correspondingly, as well as para. 28 of Government Resolution # 594 of 26.06.1995 in order to properly classify expenditures under targeted programs.
- *revise the accounts classification in line with the economic and functional budget classifications.*
- *enforce new standards for reporting.* Line ministries and the MoF should be given clear authority to reject financing requests from state customers for the following quarter if reports on the use of budgetary resources during the previous quarter are not submitted, or not properly prepared, as stipulated by the MoF Order No. 54H of 15.06.2000.
- *publish on a timely and comprehensive basis the actual budget execution data by their economic and functional classification; present Budget Law data in the same format.* This should be done for federal, subnational and consolidated budgets.

Ex Post Evaluation and Audit

5.28 With budgetary programs—particularly those dealing with investments—it is essential to ensure that systems of accountability are in place so that the intended results are being achieved and that the lessons of experience are being learned. Such arrangements should cover program evaluation by all implementing agencies, selective internal audits of work performance by centralized ministries, and selective external audits of programs by an independent organization. In Russia, while some institutional arrangements to evaluate investment programs are in place, much more needs to be done to develop their effectiveness.

5.29 Program evaluation is not very common though for some types of program, such as the federal targeted programs, a serious effort is made by the relevant department of the MoEDT. As required by the Government Resolution #594 of 26.06.1995 with later revisions, the MoEDT prepares a report on the completion of each program on an annual basis. This review provides information on work progress and includes efficiency evaluation. The review is prepared by March 1 of each year for the preceding year and after review by Government, it is submitted to the Duma by May. The review is primarily based on reports prepared by Program Directorates. While the review provides some relevant information on program outputs, the evaluation takes only a limited look at broad program objectives and outcomes. Recommendations made are not project specific, though they present a good summary of generic problems of programs implementation. Unfortunately, mechanisms for feedback do not exist which can help to back channel the recommendations into future programs. It is not clear if limited systems of performance evaluation exists for other investment programs.

5.30 With respect to internal audits, such systems are weak or nonexistent in line ministries. A recent investigation by the Chamber of Accounts found that neither the state customer, nor the MoEDT, nor MoF carried out an internal field audit of the program for the whole year of 1999.²⁴ The MoF also has a control and finance department which conducts periodic reviews of work. However, these audits are primarily concerned with proper use of budgetary funds and not on work performance. The audit reports are provided to the respective sectoral policy department of the MoF and to the Treasury only if violations are discovered. If excess payments have been made, then the MoF seeks reimbursements to the Treasury by the relevant state customer. Serious infractions can also lead to criminal prosecutions. However, for most minor infractions, there are no administrative means for remedy or a systematic way of incorporating feedback to improve future procedures.

5.31 Efficiency of budget execution varies by programs. Specifically, in 1999, investment projects under federal targeted programs were reported to have a much higher budget execution rate as compared to ad hoc investment projects added to the FTIP—98 percent and 49 percent respectively. Since ad hoc investment decisions usually bypass the regular clearing procedures and are politically driven, quality of documents for such projects is compromised, and there were reported cases when investment projects were approved even without project documentation. It is one more evidence of high inefficiency of ad hoc investment decisions.

5.32 External audit is the responsibility of the Chamber of Accounts, which is an independent agency reporting to the Duma. The scope of the Chamber of Account's audits is much broader than the one of the internal audit and covers accountancy, appropriations, and financial audits. Audits typically focus on Government and parastatal transactions to verify the legal, economic and financial aspects, and on investigations into the working of major programs so that any fraud

²⁴ Accounts Chamber report on the use of federal funds for investment to agro-industrial enterprises in Kursk Oblast in 1997-2000. *Bulletin of the Accounts Chamber*, 2000, No.8.

can be detected and actions taken to ensure that they do not recur. However, not much emphasis is placed on performance audit to establish whether value-for-money has been received. Methodologies and staff capacity to deal with these issues need to be strengthened. While the reports of the Chamber are publicly available, there is no clear process for their legislative review and enforcement.

5.33 **Recommendations.** Adequate systems of evaluation and accountability are essential for the budget and are easiest to introduce for investment projects since they have well-defined objectives and utilize lumpy investments. However, such systems are still nascent in Russia. If the efficiency of investment expenditures is to be improved, then this must be a priority area for early action. Specific measures that the Government should undertake include:

- *strengthen capacity within the Chamber of Accounts.* A medium-to-long-term program of capacity building needs to be launched within the Chamber of Accounts to help develop appropriate methodologies for audits, which would support a shift towards performance-based audits. As a first step in this direction, consultations may be held with International Organizations of Audit Institutions (Vienna) to gain an insight into the roles and contribution of those bodies in other OECD countries. Perhaps a twinning arrangement with an OECD audit agency can be arranged.
- *strengthen legislative oversight over external audit.* Supplementing the above, it is also necessary to ensure that the reports prepared by the audit agency are reviewed by an oversight body such as the Duma's Budget Committee. This would enable the Chamber of Accounts to assist the legislature in performing its oversight and accountability functions, while also providing the Chamber of Accounts with a vehicle to ensure that its recommendations are given due consideration.
- *strengthen internal audit.* This needs to be done in the context of a Government-wide program of developing and strengthening the institutional arrangements for internal audit.
- *develop guidelines and manuals for project efficiency analysis.* This would be particularly useful both for program evaluation by program directorates, as well as by internal audit departments.

Conclusions

5.34 Systems for investment project monitoring and ex post evaluation are weak at the federal level. A serious effort to strengthening them is a necessary complement to the reforms of project selection and budget preparation discussed in earlier chapters. Measures in this direction need to include the strengthening of systems of commitment control, greater use of competitive procurement, establishment of concurrent systems for quality control which links budget management to quality of work, timely payments of contracts, and strengthening of internal and external audit systems.

CHAPTER 6

CONCLUSIONS AND ACTION PLAN

6.1 The need for improving the efficiency of budget expenditures in the Russian federation is obvious. What is often undervalued by policymakers in this context, is that the efficiency gains the government can obtain in terms of both the quantity and quality of public services per ruble of public money spent, helps to increase public trust in the government and improve the people's willingness to pay taxes.

6.2 Within an overall integrated plan for improving the efficiency of public expenditures, the special characteristics of multi-year investment programs require special attention. A first step towards improving investment budgeting in the Russian federation needs to start with the federal public investment budgeting. This would have strong positive demonstration effects for other levels of government and enable the federal Government to lead by example. Subsequently, steps could be planned for improving investment budgeting at the subnational and local levels also.

6.3 While data inadequacies hamper any serious estimation of investment expenditures, it is reasonable to argue that at about 4 percent of GDP, investment expenditures in the Russian federation are neither too high nor too low relative to other industrialized and industrializing countries. This suggests that improvements in the efficiency of public investments—both across sectors and in terms of its cost-effectiveness—are more important than changes in the levels of public investment. From a review of the institutional arrangements for investment budgeting, it is also clear that these need to be strengthened, particularly in the areas of budget preparation, implementation, and ex post evaluation and accountability. The analysis in this report has identified several areas of strength as well as weaknesses in reviewing federal investments.

6.4 First, developing a reasonable estimate of federal public investments, and analyzing its composition, has proven difficult in the face of data and informational problems. Budget execution data by economic and functional classification is not available from the Ministry of Finance. The expenditure analysis for this report had to utilize data from Goskomstat. Improvements in the federal Treasury should by now have made it possible to generate such data to a reasonable degree of accuracy. The lack of good quality data on actual expenditures is a serious impediment to the conduct of expenditure analysis. But, more importantly, it is an even more serious constraint for policymakers who need good quality and timely data in order to make good economic choices, and for the public and its representatives who also need to have access to such data in order to exercise oversight and accountability on the functions of the state, necessary for a healthy democratic policy.

6.5 Second, federal investment budgeting is fragmented, which imposes high coordination costs and risks duplication of effort and financing. The fragmentation is at many different levels. The federal Government has multiple investment programs, each having many projects. Different agencies and departments are responsible for the development, monitoring and implementation of each of these programs and projects. The financing of these programs goes through different financing 'windows' of the federal budget. There is little evidence of coordination among the various departments, which seriously increases the transaction costs and risks undermining the cost-effective preparation and implementation of investment programs and projects. Clearly, efficiency gains can be derived through some consolidation and certainly through better coordination.

6.6 Third, while some investment programs, such as the federal targeted programs, do have specific policy linkages and are governed by normative acts of Government, other programs do

not have clear policy rationale. Even where the policy rationale exists, it is in a very narrow context and not linked to broader national objectives.

6.7 Fourth, project selection is not governed by objective criteria. The rationale for public intervention is not clear in many programs, nor why public financing and ownership of assets is the preferred choice compared to other forms of intervention. While many projects in the investment program may have high economic rates of return and may be fully justifiable on economic criteria, their selection is not based upon objective cost-benefit analysis. While final project selection may well be determined by political choices and tradeoffs, the establishment of a rules-based system will introduce some degree of discipline to the process, ensure that the costs or tradeoffs are clearly laid out, and promote the financing of those projects which satisfy some basic requirements.

6.8 Fifth, the monitoring of implementation and systems of ex post evaluation and accountability need to be strengthened. Project monitoring focuses on the use of funds rather than the scope of work done while audits focus also on financial rather than performance criteria. The federal targeted programs have perhaps the clearest system of monitoring based on an annual report on these programs, which is sent to Government and the Duma. Such a system should be institutionalized for all programs, as they would enhance the oversight that the elected representatives of the people could provide on these expenditures.

6.9 And finally, capacity within the federal Government and related agencies to embark upon modern tools of project analysis and audit is nascent. Any serious effort, therefore, to improve the system of investment budgeting will necessarily need to include the upgrading of skills of key staff in central and line ministries who are involved in the process. This would require the development of a program of training for which financing will need to be provided. In this context, it would be useful for the Government to explore possibilities for external support including twinning arrangements with investment and audit agencies in OECD countries.

6.10 The key issues and recommendations of the report are summarized in Table 6.1, which lays out both short- and medium-term recommendations. The agenda for improvements is vast. Some prioritization is essential, particularly in the context of what may be feasible over the next 6 months of 2001. In that context, a short-term Action Plan is suggested.

A Ten-Point Action Plan

6.11 Two factors are used to guide the development of the Action Plan— measures that need to be initiated now, even if some are medium-term in nature, so as to start the process of institutional strengthening, and measures which can provide quick efficiency gains in investment budgeting, possibly with savings for the budget. The sequencing of these measures is also important in order to ensure maximizing the benefits from them. Specific guidance on *how to* implement these specific measures have been developed in further consultation with the Government (see Annex 6.1). A recommended Action Plan would include the following ten priority measures:

- (i) *Develop an inventory of all investment programs (including FTPs, non-program investments, sectoral investments, and foreign-tied investment loans) entitled to federal support under existing normative acts.* This would be the first step towards developing an integrated approach to federal investments and would help implementation of subsequent measures;

- (ii) *Publish on a timely and comprehensive basis the actual budget execution data by their economic and functional classification; present Budget Law data in the same format. It should be done for federal, subnational and consolidated budgets.* This would require changes in the existing functional and economic classification, expansion of their coverage to cover all investment expenditures (including on FTPs), and their proper enforcement. Ongoing work on improving the classifications for the budget and the Chart of Accounts, with technical assistance from the IMF and the World Bank, is in the right direction and needs to be accelerated;
- (iii) *Develop a policy statement on the objective criteria to be used for investment programs and projects; define clearly through a Government resolution, areas where the Federal Government would undertake new investments.* Current developed procedures for FTPs and investment loans from IFIs could, with some modification, be adapted for other investment programs also;²⁵
- (iv) *Uniform procedures and consolidate management of investment programs, in each of MoEDT and MoF, into a unified Investment Policy and Program Department.* Within the MoEDT, such a department would prepare standards for project appraisal, provide technical assistance to investment units within spending agencies, ensure the application of common rules and procedures, and screen projects above a certain threshold. Within the MoF the investment department would consolidate funding of investment from the federal budget and, jointly with the Treasury and the MoEDT, develop and apply procedures for resource allocation and disbursement. This would facilitate the integration and internal consistency of investment programs;
- (v) *Introduce Treasury pre-registration of ALL federal investment contracts above a certain threshold through amendments to the Budget and/or Civil Codes.* Implementation of this would have to take into account the existing capacity within the Treasury. A start could be made by pre-registering investment contracts from specific sectors, regions, or those above a high threshold, and gradually extended;

For the 2002 Budget

- (vi) *Include only those investment programs and projects which can be adequately financed—that is, for which the financing is consistent with efficient work flow.* This would require from “state customers” (line ministries) estimates of work and related financial flows (at least on the larger projects);
- (vii) *Ensure that recurrent cost implications of all investment projects are included in their proposals and provided for in the Budget for approved projects.* “State customers” should be required to estimate these costs over the medium term, which should then be verified by MoEDT and be a factor in decisions to finance the project. A phased approach could again be adopted here with a start being made with selected multi-year investment programs;
- (viii) *Eliminate those programs which specifically: (a) have commercial orientation and do not meet the criteria for federal public investment; (b) have been going on for too long without much success of completion; or (c) are non-programmed investments in the FTIP.*

²⁵ This would require amendments to Government Resolutions No. 594 of June 26, 1995 and 1470 of November 22, 1997.

If necessary, normative acts which may have sanctioned such investments from the federal budget will need to be amended or rescinded;

- (ix) *Prioritize for investment spending (a) completion of existing programs and projects, particularly those close to completion, rather than new projects, and (b) capital repairs and purchases of new equipment for which greater allocations need to be made. For this to take place, the MoF will need to ensure that line ministries make such reallocations within agreed verifiable returnable expenditure limits; and*
- (x) *Develop Treasury disbursement procedures for co-financed investment projects wherein disbursement of federal funds would be conditional on timely disbursements from other sources of financing (e.g. with subnational governments or private investors). This would require the inclusion of a special article in the federal Budget Law for 2002 and an amendment to the Budget Code.²⁶*

²⁶ Over time, a better separation of financing of projects from federal and regional sources needs to be developed, which would ensure that the investor is also the owner and obviate cofinancing problems.

TABLE 6.1: KEY ISSUES AND RECOMMENDATIONS

Key Issues	Recommendations	
Key Issues	Short-Term (<6 months)	Medium-Term (6 months-3 years)
<p>DATA ISSUES</p> <ul style="list-style-type: none"> ➤ Difficult to put together a picture of total public investments since some data not available by economic classification. ➤ Data definitions not consistently used. ➤ Budgeting and reporting of capital expenditures mixed with current expenditures. <p>No data on age profile of projects in implementation.</p>		<ul style="list-style-type: none"> ➤ Improve classification of expenditures. ➤ Make publicly available actual budgetary execution data by its economic and functional classification. ➤ Develop a database to track characteristics of investments programs and projects, such as age profile, total costs, estimate costs, percentage of work done, etc.
<p>PROJECT SELECTION</p> <ul style="list-style-type: none"> ➤ While there are specific laws and resolutions which define investment programs, and criteria for projects, project selection is not based on specific rationale for government intervention and financing and links with policy are not uniformly strong. ➤ Project selection is largely a subjective process. No clear objective criteria is laid out by the federal government. This risks making the public investment program highly politicized. ➤ Government-level responsibilities for federal investment not defined clearly. 	<ul style="list-style-type: none"> ➤ Project selection should be based on OBJECTIVE criteria based on: (i) rationale for public intervention; (ii) rationale for FEDERAL government intervention; and (iii) appropriate choice of instrument (as public financing may not always be the only or the best option). This would help to de-politicize the process. ➤ The Federal Govt. should clearly lay out RULES for the type of investment projects that would be financed through the federal budget as opposed to regional budgets. These should essentially cover programs and projects deemed 'strategic' because of national security interests, but also because: (i) their coverage may be multi-regional; (ii) they have positive spillover effects 	<ul style="list-style-type: none"> ➤ Medium-term economic/sectoral policies should EFFECTIVELY guide the development of investment programs and projects, also in a medium-term horizon. A 3-year pipeline of investment projects should be developed in the light of medium-term economic and sectoral policies (as suggested above).

<ul style="list-style-type: none"> ➤ Inadequate guidelines issued for the methodology to be used for justifying projects (for instance, cost-benefit analysis) along with the macroeconomic assumptions to be used, etc. Risks selection of low-economic return projects. ➤ A large element of the public investment program is commercially oriented which suggests that it is being used as an instrument of the Government's industrial policy. ➤ Capacity for economic analysis of projects weak or non-existent. 	<p>from one region to another; and (iii) they are meant to offset regional inequalities in economic development outcomes.</p> <ul style="list-style-type: none"> ➤ Public co-financing for commercial projects should be discontinued. Private sector financing should be sought for these type of investments. 	<ul style="list-style-type: none"> ➤ Provide detailed guidelines for preparation of projects to include: (i) project identification; (ii) project justification (including cost-benefit analysis); (iii) multi-year costing (including macroeconomic assumptions to be used); and (iv) technical feasibility studies for complex projects. ➤ A program of training should be started for relevant staff at federal and regional levels on modern methods of project selection, including cost-benefit analysis.
BUDGETING PREPARATION		
<ul style="list-style-type: none"> ➤ Multiple windows of financing sometimes finance the same program and project, which risks "double-dipping" and increases transactions costs (particularly of coordination). ➤ Allocations largely a fraction of total costs (e.g. 20% for regional programs). MoF does not verify/investigate reasonableness of program/project cost estimates and alternative sources of financing. ➤ Recurrent costs implications for current, as well as future, years is not developed. It is not clear what linkages, if any, exist for adequately budgeting for the recurrent costs of current investment stock given the lack of an inventory of it. ➤ There is no strategic decision on the breakdown of capital expenditures among new investments, capital repairs, and purchase of equipment and machinery. New construction takes the lion's share of expenditures, crowding out other capital expenditures. ➤ Foreign-financed expenditures not adequately shown in budget; not clear whether domestic financing is leveraging foreign financing of investment projects. 	<ul style="list-style-type: none"> ➤ Windows providing similar types of financing should be integrated. ➤ Require all proposals to have recurrent cost implications worked out; provide adequate funding for these costs. ➤ Clearly prioritize investment spending, e.g. for completion of on-going works as against new investments, and for capital repairs and purchases as against construction. 	<ul style="list-style-type: none"> ➤ MoF, working together with MoEDT, should: (i) develop an aggregate target for total investment spending in the context of the overall medium-term macroeconomic framework; (ii) detail the desired breakdowns among new investments, purchase of capital and machinery, and capital repairs; and (iii) within these limits, decide upon individual project allocations on the basis of a thorough analysis of the reasonableness of project cost estimates and review of alternative sources of financing available. Medium term fiscal costs—both investment and current—should be fully factored in. ➤ Establish procedures for how budgetary financing could be modified to reflect changes in project costs due to exogenous factors. ➤ Budget should ensure adequate leveraging of foreign-financing for public investments, consistent with the Government's overall external debt policy, through adequate provision of matching funds/recurrent costs.

BUDGET IMPLEMENTATION		
<p><u>Commitment Control</u></p> <ul style="list-style-type: none"> ➤ Unclear legal status of entities under budgetary control. ➤ Limited system of pre-registration at Treasury for current expenditures on utilities. ➤ Multiple financing windows for investment programs makes it difficult to track commitments. ➤ Expenditure commitments from unknown stock of contingent liabilities likely to be large; no system to manage them. 	<ul style="list-style-type: none"> ➤ Complete inventory of budget entities. ➤ Extend Treasury registration to contracts for investment projects. 	<ul style="list-style-type: none"> ➤ Extend treasury system to cover all federal expenditures, including those on investment programs. ➤ Develop a system for estimating, monitoring, and managing contingent liabilities from investment projects in the context of an overall system for managing ALL contingent liabilities.
<p><u>Competitive Procurement</u></p> <ul style="list-style-type: none"> ➤ Growing trend towards competitive procurement. 70% of federal contracts by open tendering, but some excessive restrictions on process. ➤ Limitations on participation by foreign bidders. ➤ At subnational level, limitations on bidders from out-of-state. ➤ Adequate legislation but under-developed normative guidelines for implementation. ➤ Weak human capacity in line ministries to undertake competitive procurement. ➤ Shifting organization responsibility for procurement. 		<ul style="list-style-type: none"> ➤ Develop detailed sub-legislative texts as an aid to the implementation of procurement laws. ➤ Amend Law on Procurement for State Needs to eliminate unnecessary restrictions. ➤ Train staff in public procurement and develop a cadre of specialists. ➤ Establish an autonomous federal procurement agency for developing, monitoring and overseeing the public procurement system, but without operational involvement in procurement.
<p><u>Quality Control</u></p> <ul style="list-style-type: none"> ➤ Separation of verification of work (including technical quality) from use of budgetary resources. The former is done independently by the technical agencies, such as the Russian Engineering, while the latter is done both by the relevant "state customers" and the central agencies (MoEDT and MoF). ➤ Budgetary releases based on use of budget funds only. 	<ul style="list-style-type: none"> ➤ Establish an Investment Monitoring Unit in MoF/MoEDT to provide real-time performance audits on ongoing projects on a selective basis. 	<ul style="list-style-type: none"> ➤ Link financial releases to verification of quality of work.

<p><u>Timely Payment of Contracts</u></p> <ul style="list-style-type: none"> ➤ While the coverage of the Treasury has been expanding, it still does not cover all budget execution including investment operations. ➤ Quarterly budget releases are based on simple time-slicing of annual budget plans and do not always take into account the seasonality of work or needs of individual programs and projects. ➤ Uncertainty of budgetary releases even against planned releases because of revenue shortfalls or expenditure pressures from other sources. 	<ul style="list-style-type: none"> ➤ Make budgetary releases consistent with work flow requirements. ➤ Ensure adequate financing for investment programs. 	<ul style="list-style-type: none"> ➤ Extend the coverage of the Treasury to cover ALL expenditures including those on investment programs.
<p><u>Reporting</u></p> <ul style="list-style-type: none"> ➤ Proper budgetary economic and functional classification not available. ➤ Regional and central Treasury offices do not receive detailed data for adequate classification. ➤ Delays in timely reporting of investment budget execution data. 	<ul style="list-style-type: none"> ➤ Extend standard economic and functional classification; make it available in budget documents and in reports on budget execution. ➤ Enforce new standards for reporting. 	

EX POST EVALUATION		
<ul style="list-style-type: none"> ➤ Program evaluation by program directorates and MoEDT practiced systematically only for federal targeted programs. ➤ Weak internal audits. Focus on extensive financial audits, less on <i>value for money</i>. <i>Out-dated audits methods</i>. ➤ No systematic system for feedback of audit results into budgetary processes except for sanctions for serious violations of financial rules. ➤ External audit by Chamber of Accounts is limited to accountancy, appropriation, and financial audits; not much emphasis on performance audit to establish whether value-for-money has been received. ➤ Inadequate legislative oversight to enforce recommendations of external audits. ➤ Weak methodologies and staff capacity to deal with performance audits. 	<ul style="list-style-type: none"> ➤ Require program evaluation of ALL investment programs. 	<ul style="list-style-type: none"> ➤ Develop guidelines and manuals for project efficiency analysis. ➤ Develop a program to strengthen internal audit. ➤ Integrate internal audit in systems for planning and budgeting. ➤ Develop a program for extending performance based external audits. ➤ Strengthen legislative oversight over external audit. ➤ Strengthen human and technical capacity for modern systems of audit in internal audit departments and within the Chamber of Accounts.

ANNEXES

Annex 3.1: Federal Investment Programs Aggregated by Type of Asset Created

	1999	2000	2001
	in million rubles		
Federal Investment Program	8,560	21,459	28,773
of these:			
Social Complex	5,170	12,405	18,145
of these:			
Housing and communal construction	2,978	4,900	8,658
Central organization	222	2,807	3,978
Education culture and public health	1,129	2,816	3,878
Of these:			
Culture	384	595	1,061
Education	260	405	907
public health	486	1,083	1,767
Science	239	333	499
Production complex	3,016	8,009	8,678
of these:			
Fuel and power complex	682	1,073	1,072
of these:			
electric power engineering	489	774	693
gas Industry	36	222	150
Commercial/semi-commercial nature	556	1,937	3,920
Agro-industrial complex	242	851	750
Spezcomplex	6	918	2,717
Medical complex	56	85	169
Metallurgy Complex	25	1	44
Chemistry - forestry Complex	156	6	142
Mechanical Engineering Complex	31		47
Light industry		10	11
Construction complex	40	67	41
Transport and Communication	860	1,862	3,548
Of these			
Transport	462	1,828	3,478
of these:			
Marine	25	185	377
River	114	346	845
Air	58	138	203
Railway		114	78
Construction of the underground	350	1,046	1,950
Communication		34	70
Water management	184	193	657
Special works	925	3,623	4,249

Source: Appendix Tables from Budget documents for 1999, 2000, and 2001.

Notes: Subcategories do not add up, since only major categories are included; Construction of underground has been reclassified to transportation, and moved from Social complex in the budget documents to Production here.

Annex 3.2: Example of Simple Cost Benefit Analysis for Highway Construction

	<i>Preexpansion Level F₁ (I)</i>	<i>After Expansion to F₂ (II)</i>	<i>After Expansion to F₃ (III)</i>
<i>Estimation of benefits to users</i>			
1. Time per trip (minutes)	30	18	16
2. Time cost of trip (\$4 per hour)	\$2.00	\$1.20	\$1.07
3. Other cost per trip	\$1.75	\$1.90	\$1.95
4. Total variable cost per trip	\$3.75	\$3.10	\$3.02
5. Number of trips per year	1,000,000	1,500,000	1600000
6. Total variable costs per year	\$3,750,000	\$4,650,000	\$4,832,000
7. Cost savings per trip	-----	\$0.65	\$0.08
8. Cost savings on previous number of trips	-----	\$650,000	\$120,000
9. Cost savings on additional trips	-----	\$162,500	\$4,000
10. Total benefits per year	-----	\$812,5000	\$124,000
11. Present value of benefits (8 percent, 25 years)	-----	\$8,673,438	\$1,323,700
<i>Estimation of project cost</i>			
12. Capital cost	-----	\$4,000,000	\$2,000,000
13. Annual maintenance cost	\$50,000	\$60,000	\$68,000
14. Increase in maintenance cost	-----	\$10,000	\$8,000
15. Present value of increased maintenance cost (8 percent, 25 years)	-----	\$106,750	\$85,400
16. Total project cost, present value	-----	\$4,106,750	\$2,085,400
<i>Evaluation</i>			
17. Benefit-cost ratio (line 11 ÷ by line 16)	-----	2.11	0.63
18. Present value of net benefits (line 11 – line 16)	-----	\$4,566,688	-\$761,700
19. Internal rate of return (percentage)	-----	20	3

From Musgrave and Musgrave, 1989. Cost estimates for various types of vehicles and roads are given in Marshall F. Reed, Jr., *The Economic Cost of Commuting*, Technical Study Memorandum 13, Washington, D.C.: Highway Users Foundation, 1975; also see *Road Use Benefit Analysis for Highway Improvements*, Washington, D.C.: American Association for State Highway Officials, 1977.

Annex 6.1: Elaboration of the Action Plan.

This Annex details those ten measures contained in the Action Plans developed in Chapter 6 and also presented in the Executive Summary. This Annex is designed to explain the essence of the proposed Action Plans and to describe the way in which they may be implemented.

Action Plan 1: Develop an inventory of all investment projects.

It would be useful for the Government to perform an inventory of ALL investment projects in 2001 as a starting point for screening what should be retained and what should be eliminated. Such a consolidated list is not available right now, though such lists in their most adequate form exist for objects of targeted programs which form part of the Federal Targeted Investment Program. However, even here, only construction projects are singled out, whereas insufficient consideration is given to equipment purchases and capital repairs. It appears most appropriate to consolidate all data within the investment policy department of the Ministry for Economic Development and Trade on the basis of information provided by sectoral ministries, federal targeted budgetary funds and federal non-budgetary funds. This work could be done in two stages:

- *At the first stage*, it would be helpful to provide a list of objects according to the format outlined below under each of the investment programs—the targeted component of the Federal Targeted Investment Program, objects of the Regional Development Fund, and non-targeted objects of the Federal Targeted Investment Program. These should, in turn, be separated into capital construction, equipment purchases, and capital repairs and other investment sub-items of the economic classification of the budget expenditures.
- *At the second stage*, the list should be expanded to include investment projects under the other sections of the budget, including the federal targeted budgetary funds. Ideally, this list should also include investment projects financed from the federal non-budgetary funds. Special attention at the second stage should be given to state investment expenditures funded by tied foreign and domestic credits which go through the federal budget.

Format for inventory of federal investment projects, 2001							
Targeted Program or other evidence (type of document)	Investment Project	Capital Expenditure Type	Budget for 2001	Quality Indicator			
				Years under way/Planned # of Years (%)	Expenditures to Date/Total Project Cost (%)	Work Done/ Total Work Planned (%)	Probability of Completion (High, Medium, Low)
Hypothetical example: Program "Children of the North"	School, Inta, Komi Republic	New fixed investment	RUR 1 million at the expense of additional funds	50%	70%	50%	Medium
Decision of the Government	Purification facilities, Kyzyl, Tuva	New fixed investment	RUR 2 million	50%	10%	5%	Low

List of actions:

1. First stage of inventory: fourth quarter of 2001. An order by the Minister is necessary for performing the first stage of an inventory. Coordination and consolidation should be vested in the investment policy department and the deputy minister in charge of this department (Ministry for Economic Development and Trade).

2. A decree by the RF Government is necessary for performing the second stage of an inventory (the draft of the decree is to be developed in the third quarter of 2001 and the Decree is to be adopted in the fourth quarter). The inventory itself will take up 3-4 months (Ministry for Economic Development and Trade).

Action Plan 2: Publish on a timely and comprehensive basis the actual budget execution data by their economic and functional classification; present Budget Law data in the same format. It should be done for federal, subnational, and consolidated budgets.

First, federal budget draft as presented to the Duma should be made publicly available in the standard economic/functional classification. This can be done in several ways—publication of special bulletins, and posting on the web-sites of the Finance Ministry, the State Duma and the Chamber of Accounts.

Second, the presentation of the Federal Targeted Investment Program and applicable Annexes in the draft budget should meet budget classification requirements. For example:

- the List of federal targeted programs and federal programs of regional development, which are earmarked for financing from the federal budget, should outline expenses for equipment purchases as part of capital expenditures, in addition to State investments (mostly construction projects).
- the Regional Development Fund should be shown separately and its expenses should be segregated between capital expenses and recurrent costs instead of other expenses being shown in a separate line item.
- expenses for capital repairs should be presented as an integral part of investment expenditures.

The itemized list of investment projects in the form of an appendix to the Federal Budget Law may be provided in the format of the first four columns of the Inventory template in Action Plan 1.

Third, the annual budget performance report should also be presented in the budget classification format, particularly as regards the economic/functional items of budget expenses, including capital expenditure.

Fourth, the functional classification of budget expenditures should provide information on the federal targeted program.

And finally, all budgetary classifications, while satisfying the needs of the policymakers, should be amenable to international reporting according to the standards of the IMF's government financial statistics.

List of actions:

1. Make amendments to Government Resolution #594 of June 26, 1995 (as amended later) relating to the expenditure classification under the federal targeted programs (Ministry for Economic Development and Trade, Ministry of Finance — third quarter of 2001).
2. Duly authorized government bodies should decide on the publishing of the budget performance reports by a standard economic classification (third quarter of 2001).
3. Make amendments to the budget classification to reflect the federal targeted programs (Ministry of Finance, third quarter of 2001).
4. Make amendments to the budget classification with a view to reporting compliance with the standards of the international government financial statistics (Ministry of Finance, 2002-03).

Action Plan 3: Develop a policy statement on the objective criteria to be used for investment projects; define clearly, through a government resolution, areas where the federal Government would undertake new investments.

The draft State investment policy of the Russian Federation, prepared by the Ministry for Economic Development and Trade (draft dated March 27, 2001), may be used as a basis for this document, which is proposed for approval by a decree of the Government. It appears necessary to stipulate in this document that the guidelines of non-financial investments and other capital expenditures from the federal budget should be those objects of the social and production *infrastructure*, which are necessary for promoting the stable growth of the economy and society, but which are not attractive for private investors (see Chapter 3, especially Box 3.1). It means that the state should not compete with private investors, but should rather differentiate their respective areas of investment. This would require state investments and loans for commercial projects to be excluded, nor should the state be concerned over increasing revenue from State investment (page 5 of the draft by the Ministry for Economic Development and Trade).

The following may be used as the key criteria of selecting investment projects for financing from the federal budget (consistent with Box 3.2):

- the estimated economic return on a given project is substantially higher than the financial rate of return.
- it is impossible to reduce project investment risks and secure commercially attractive financial returns by means of using alternative (primarily regulatory and administrative) instruments of the State investment policy.
- an investment project is of a national or inter-regional nature.
- project implementation is consistent with the approved development program for the appropriate sector (usually in the form of a federal targeted program).
- federal budget financing for the project does not create a critical burden on the budget throughout the period of project implementation and upon its completion (in the form of current expenditure).
- investment projects in each sector are classified according to the norm of economic return of State investments.

The probable algorithm of investment project selection is detailed in **Action Plan 8**. Furthermore, the methodology developed by the US Office of Management and Budget can be used for this purpose.²⁷

List of actions:

1. Draft a Government resolution on the state investment policy and principles underlying investment project selection for financing by the federal budget (Ministry for Economic Development and Trade, fourth quarter of 2001).

Action Plan 4: Unify and consolidate administration of investment programs within MoEDT and MoF.

As a first step, it is proposed to extend the basic procedures applicable in the development and implementation of investment programs or projects under the federal targeted programs or investment credits from international financial institutions to other investment programs or projects financed by the federal budget. Government Resolution #594 of June 26, 1995 (as amended later) and Government Resolution #395 of April 3, 1996, as well as the FCPF-developed procedure for efficiency evaluation of investment projects and technical assistance projects, can be used as a basis for this purpose.

²⁷ Office of Management and Budget, 2001, *Analytical Perspectives*, Washington (web-site at: <http://www.gpo.gov/usbudget>).

Special attention should be paid to specification of Items 5 and 13 of Resolution #594, and Item 10 of Resolution #395, concerning the evaluation of the social economic efficiency of investment programs or projects. It is necessary to:

- a) make the application of the “Methodological Recommendations for Efficiency Evaluation of Investment Projects” as approved by the Ministry of Economy, Ministry of Finance and the Gostroi (State Committee for Construction) in 1999 mandatory; and
- b) develop and approve methodologies for cost-benefit evaluation for individual sectors of the economy.

For coordination of the process of unification of the procedures for development and implementation of investment projects as applied to various investment programs financed with the budget resources, it is necessary to identify a unit (department) authorized to do so in the Ministry of Economic Development and Trade, as well as in the Ministry of Finance. It would be efficient to vest this responsibility in the investment policy department of the Ministry of Economic Development and Trade, and in the sector financing or macroeconomics department of the Ministry of Finance.

In the future, after the procedures have been unified, it would be appropriate to also simplify the organizational arrangements for the administration of diverse investment programs or projects both in the Ministry of Finance and in the Ministry of Economic Development and Trade.

List of actions:

1. Make amendments to Government Resolution #594 of June 26, 1995 (as amended later) and Government Resolution #395 of April 3, 1996 (Ministry of Economic Development and Trade, third quarter of 2001) concerning the mandatory application of the approved “Methodological Recommendations for Efficiency Evaluation of Investment Projects” (Ministry of Economic Development and Trade, third quarter of 2001).
2. Develop methodological recommendations on the model methodologies for cost-benefit evaluation for individual sectors (Ministry of Economic Development and Trade, Ministry of Finance — an order, second quarter of 2002).
3. Draft the directives by the Ministry of Finance and the Ministry of Economic Development and Trade to specify the functions of certain departments in the respective ministries and a Government resolution to establish the role of the Ministry of Economic Development and Trade as the coordinator of any investment projects financed by the federal budget or federal extra-budgetary funds (Ministry of Economic Development and Trade, Ministry of Finance — third–fourth quarters of 2001).

Action Plan 5: Introduce Treasury pre-registration of ALL investment contracts above a certain threshold through amendments to the Budget and/or Civil codes.

In principle, this recommendation should refer to all government expenditures and will be ensured with the full implementation of the commitment-based treasury management system. However, pending this, some transitional arrangement is needed to minimize risks to budget management arising from large investment contracts which are typically multi-year in nature and impose heavy recurrent costs. This could be done in a legally credible manner by including an article in the law on effectiveness of the new provisions of the Budget Code/Civil Code a time-based schedule for phasing in the application of procedures for registration of various contract types, beginning with contracts for delivery of utility services to budgetary organizations (where actual registration already takes place) and extending it to large investment contracts in excess of a certain threshold value. An appropriate threshold value should be determined upon completion of the inventory of investment projects so that a relatively few contracts would enable control over a greater portion of the investment expenditures. This would help reduce any onerous burden of contract registration on the Treasury, as well as contractors.

After the respective draft amendments to the current legislation have been passed, it would be necessary to prepare and bring to the notice of the Treasury units and budgetary organizations the methodology and procedures for mandatory preliminary registration of contracts with the Treasury.

List of actions:

1. Draft amendments to the Budget Code / Civil Code to establish mandatory preliminary registration with the Treasury of contracts concluded by the budgetary organizations and a time-based schedule for phasing it in (Ministry of Finance, third quarter of 2001).
2. Develop the methodology and procedures for mandatory preliminary registration with the Treasury of contracts concluded by the budgetary organizations (an order by the Ministry of Finance, first quarter of 2002).

Action Plan 6: Include in the budget only those investment projects which can be financed in full—that is, for which the financing is consistent with efficient work flow.

This would require three things:

- (i) Rank all projects in terms of their priority (see Action Plans 8 and 9 below);
- (ii) Require all investment funding needs (above a certain threshold) to be backed by *realistic* estimates of the volume of outstanding work planned in the budget year, financing from alternative sources, and expected financing from the federal budget; and
- (iii) Ration funds to highest priority projects, that is, finance fully the highest ranked projects and go down the list until available investment funds are exhausted.

List of actions:

1. Prepare the procedures for matching the investment projects with the budget funding available (Ministry for Economic Development and Trade, an order, first–second quarter of 2002).

Action Plan 7: Ensure that recurrent cost implications of investment projects are included in their proposals and provided for in the Budget for approved projects.

This is a simple requirement that ALL requests for funding investment projects should detail subsequent recurrent expenses (including the costs of operations and maintenance) that would be required on that project over a period of 3-5 years. A rule of thumb equivalent to the asset-specific depreciation rate may be used. This information could be an input into the decision whether to finance the project in the federal budget or not (if a project has very high recurrent costs, then that would weigh against the selection of that project). In the future, as cost-benefit analysis takes root in economic planning, such costing would be included in the cost-benefit assessment of projects and, therefore, factored into the decision-making process. However, it still would need to be made explicit so that future budgets could provide for it adequately.

List of actions:

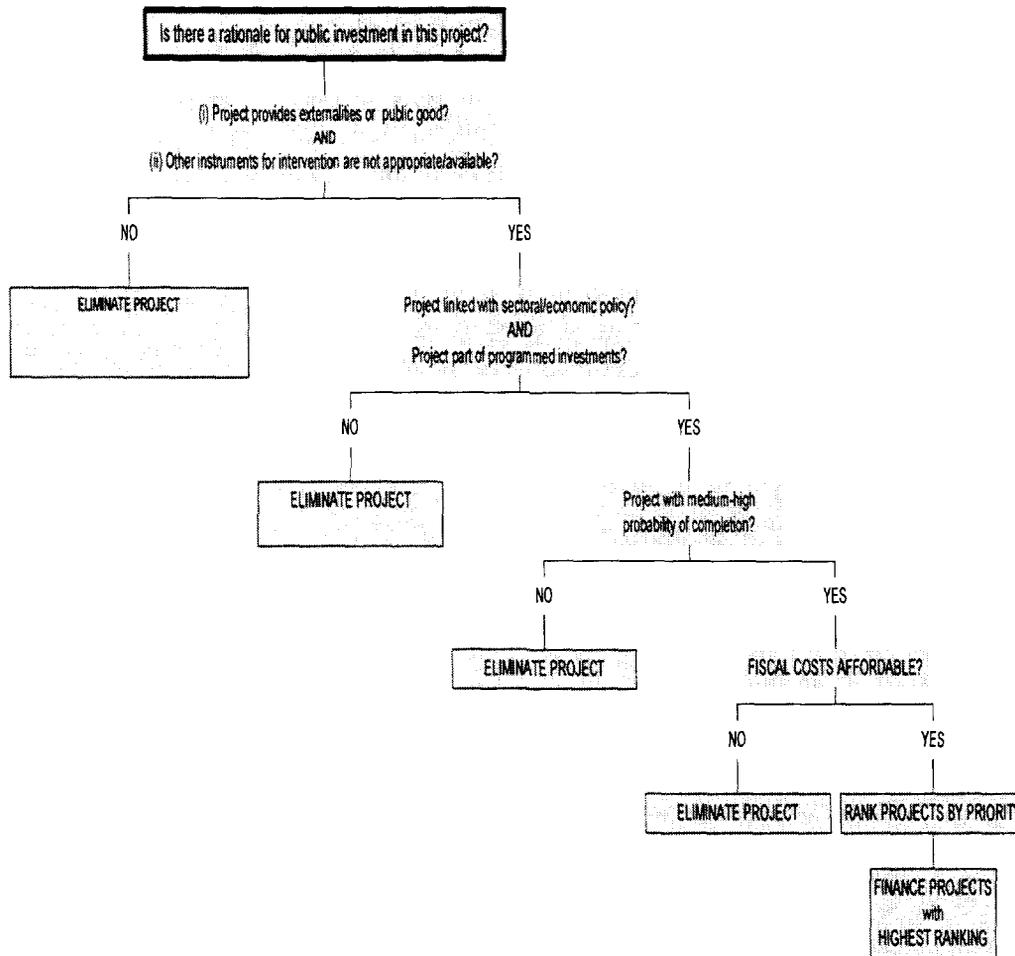
1. Inclusion of future recurrent costs in the Procedures for Submitting Investment Project Applications (order of Ministry of Finance/Ministry of Economic Development and Trade).

Action Plan 8: Eliminate those programs which: (a) have commercial orientation and do not meet criteria for federal public investment; (b) have been going along for too long without much success of completion; or (c) are non-programmed investments.

These proposals apply only to existing projects, primarily to those which make part of the federal targeted investment program. Item (c) should not apply to other investment programs funded from the federal budget.

The likely algorithm which may be followed by the authorized State body (Ministry for Economic Development and Trade) in selecting investment projects for inclusion in the State budget as part of the federal targeted investment program and other parts of the budget is shown below.

Decision Tree for Screening Public Investment Projects



List of actions:

1. Draft the regulation on selection of investment projects to be financed by the federal budget in 2002 (Ministry of Economic Development and Trade, an order, third quarter of 2001).

Action Plan 9: Prioritize for investment spending on: (a) completion of existing programs and projects, particularly those close to completion, rather than new investment projects; and (b) expenditure for capital repairs and equipment purchases.

This applies to those existing projects which have passed the test of Action Plan 8, as well as to new projects. The following approach can be used for ranking projects according to an explicit objective criteria based upon the developmental priorities of the Government. A sample approach is presented below with some ideas for criteria and some hypothetical weights. Both the criteria and the weights to be applied to them would need to reflect these priorities.

Sample approach for prioritizing projects

<i>1. Economic Internal Rate of Return</i>	
Given criterion is useful for comparing projects distinguished by various risk levels. Projects with higher internal rate of return (IRR) value shall have more priority compared to projects with lower IRR.	IRR>60% - 7 points 60%>IRR>40% - 5 points 40%>IRR>30% - 3 points 30%>IRR>20% - 2 points 20%>IRR>10% - 1 point <u>IRR<10% or no calculation – 0 points</u>
<i>2. Social significance of a project</i>	
Evaluation of a project is based on adequacy to the following aspects of social significance: <ul style="list-style-type: none"> • Provision of housing for public servants and re-deployed servicemen • Improving employment of the population and reduction of unemployment • Improving access to the quality health services • Improving access to the quality education services • Poverty reduction: <ul style="list-style-type: none"> - Provision of sufficient potable water supply to the population - Reduction of death-rates - Improving the scope of secondary education cover - Enhancement of economic opportunities for the poor - Ensuring access to provision of social services for the poor - Coverage of distant back-country districts • Environmental concern of the project 	Evaluation is based on summing-up of applicable aspect-specific points. <ul style="list-style-type: none"> 4 points 2 points 2 points 2 points 4 points 2 points 2 points 4 points 4 points 2 points 4 points

<i>3. Environmental safety of the project</i>	
<p>Evaluation of environmental safety of the project (taking into consideration environmental pollution contingencies and utilization of limited irreplaceable natural resources).</p> <ul style="list-style-type: none"> • Environmental safety of a project • A project involves avoidable contingencies • A project bears high hazard of risk for the environment 	<p>4 points</p> <p>2 points</p> <p>(-4) points</p>
<i>4. Internal co-financing (from the budgetary resources) requirement</i>	
<p>Considering certain difficulties with provision of internal co-finance, absence of the requirement demanding obligatory participation of the Government in co-financing of a part of a project's cost is thought an advantage.</p>	<p>Up to 10% of the overall cost of a project – 4 points</p> <p>10% to 20% of the overall cost of a project – 2 points</p> <p>More than 20% of the overall cost of a project – (-2) points</p>
<i>5. Terms of procurement within the framework of a project</i>	
<p>A project that implies procurement of work, goods or services based on competitive bidding, invites maximum possible amount of participants to take part in the bidding and has no restriction on amount and pattern of bidding participants, shall have more priority over the projects that impose restrictions on bidding.</p>	<p>No restriction on bidding – 4 points</p> <p>Purchase of work, goods and services from domestic sources only – (-2) points</p> <p>Bidding is not allowed (instead, work, goods or services are purchased directly) – (-4) points</p>
<i>6. Project-related risks</i>	
<p>Priority of a project depends on the level of risks involved. Higher risks result in substantial decrease of a project's priority.</p>	<p>Insignificant risks – 3 points</p> <p>Moderate risks – 2 points</p> <p>Substantial risks – 1 point</p> <p>High risks – 0 points</p>

<i>7. Project implementation evaluation (for current projects)</i>	
<p>Based on use of special indicators, each of the projects is evaluated in terms of implementation and accomplishment of tasks and goals set within the framework of the project. Unsatisfactory implementation of a project shall result in less priority compared to the successfully accomplished ones.</p>	<p>Procurement quality:</p> <ul style="list-style-type: none"> - Satisfactory – 1 point - Unsatisfactory – (-1) point <p>Compliance with the project implementation timetable:</p> <ul style="list-style-type: none"> - Compliant – 1 point - Non-compliant – (-1) point <p>Project finance development rates:</p> <ul style="list-style-type: none"> - Satisfactory – 1 point - Unsatisfactory – (-1) point <p>Quality of work, goods and services:</p> <ul style="list-style-type: none"> - Satisfactory – 1 point - Unsatisfactory – (-1) point <p>Compliance with the tasks and goals of a project:</p> <ul style="list-style-type: none"> - Compliant – 1 point - Non-compliant – (-1) point - Evaluation of compliance is premature – 0 points
<i>8. Evaluation of implementor's capacity for maintenance and exploitation of the resources acquired</i>	
<p>Should the end-implementor have no sufficient amount of finance to maintain and utilize/exploit resources purchased on account of borrowed funds (including specialists who are knowledgeable, skillful and experienced enough to be capable of maintaining and utilizing resources purchased), the consequence is less priority of a project.</p>	<p>Sufficient capacity / amount of finance – 2 points</p> <p>Insufficient capacity / amount of finance – (-2) points</p>
<i>10. Inspecting quality of preparation for a project</i>	
<p>Quality of preparation for a project is being appraised based on availability of detailed project documentation (terms of reference), as well as project auditing results. Absence of detailed Terms of Reference, as well as negative auditing results, considered disadvantage at evaluation of a project.</p>	<p>Available terms of reference and the auditing results are positive – 2 points</p> <p>Terms of reference are not available or in the making – 0 points</p> <p>Terms of reference are available, yet auditing results are negative – (-2) points</p>

<i>11. Availability within executive agency (ministry / department) of a structural unit responsible for administering sector investment projects associated with the project under consideration</i>	
Availability within executive agency (ministry / department) of a structural unit (several structural units) that is responsible for administering sector investment projects associated with the project under consideration, and has experience of implementing various international projects, is considered advantage at evaluation of the project.	Availability of such executive agency and correspondent experience in implementation of international projects – 2 points Availability of such executive agency – 1 point Absence of such unit – 0 points
Maximum aggregate result: 37 points	

The above weighting scheme gives higher weights to projects for capital repairs and equipment purchases, and against new construction. This is important to address the rapid depreciation of the capital stock and its efficiency. The weighting scheme also gives preference to projects with low future recurrent costs which would help to minimize future costs and enable the sustainability of the new investments.

List of actions:

1. Draft the regulation on the objective criteria for investment project ranking after careful assessment and modifications to the above (Ministry for Economic Development and Trade, an order, second quarter of 2002).

Action Plan 10: Develop Treasury cofinancing procedures for investment projects.

It appears possible to take the following approach to cofinancing investment projects (and budgetary expenses as a whole).

At the stage of preparing budgets for all investment programs and projects, the ownership of projects upon their completion should be specified. If the right of ownership is vested in federal authorities, then project financing should be provided in full from the federal budget.

In case of federal budget cofinancing for certain investment projects, which will be owned by regional or local authorities, the disbursement of federal resources (e.g. on a quarterly basis) should be made contingent on a faster allocation of resources available to other investors in accordance with investment agreements. Following the presentation of documents (work delivery and acceptance reports, payment orders, contractor account statements confirming the receipt of funds remitted by other investors within the required scope), a department (branch) of the Federal Treasury should authorize the remittance of funds from a customer's current account to the contractor's bank account with the Treasury. Otherwise, federal resources should not be remitted from the Treasury's current accounts.

List of actions:

1. Incorporate an article establishing a procedure for funding State expenditures on the basis of cofinancing with lower-level budgets and from non-State sources (Finance Ministry, draft amendments — third quarter of 2001) in the Law on the Federal budget (and then in the Budget Code).

2. Develop an order of the Finance Ministry on cofinancing procedures (Finance Ministry, fourth quarter of 2001).