PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

December 10, 2015
Report No.: AB7771

Operation Name	Public Expenditure and Fiscal Risk Management Development Policy Financing with a Deferred Drawdown Option
Region	LATIN AMERICA AND CARIBBEAN
Country	Peru
Sector	Central government administration (50%); Sub-national government administration (50%)
Operation ID	P154981
Lending Instrument	Development Policy Financing with a Deferred Drawdown Option
Borrower(s)	Republic of Peru
Implementing Agency	Ministry of Economy and Finance, Peru
Date PID Prepared	December 10, 2015
Estimated Date of Appraisal	December 10, 2015
Estimated Date of Board Approval	February 2, 2016
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the appraisal of the operation.

I. Country and Sector Background

Sound macroeconomic and structural policies over the last 20 years, also supported by favorable external conditions over the last decade, rendered significant growth and poverty reduction. Peru grew at an average of 4.5 percent per year during 1990–2013 (compared to regional and global growth of around 3 percent). Under a more favorable external environment for its commodities, Peru grew at an even faster average rate—above 6 percent per year—during the last decade. Growth helped Peru to reduce poverty from 55 to 24 percent of the population between 2001 and 2013, faster than other countries with similar income levels. Growth was also widely shared: between 2004 and 2013, real income per capita of the bottom 40 percent grew at an average 6.8 percent, faster than the national average. Growth was the main driver of poverty reduction and inequality primarily through improved labor incomes rather than redistribution policies, and in the context of a smaller size of the state relative to other higher middle income countries.

Peru continues to have a sound macroeconomic policy framework. Throughout the period of high growth and unlike many countries, Peru saved the commodities' windfall, leaving itself with significant savings to continue to afford needed investments and strong macroeconomic buffers to face more challenging times. Indeed, domestic savings increased from just above 10 percent of gross domestic product (GDP) in the early 1990s to 24 percent in 2014, with public sector savings playing a key role over the last 10 years. Growth slowed to 2.4 percent in 2014. The recovery is expected to be gradual since Peru's growth potential in the following years is likely to be lower compared to that of the last decade under the assumption of a non-temporary price adjustment in the country's main exports. The current account is hovering around 4 percent of GDP, and remains mostly covered by foreign direct investment (FDI) and portfolio investments. Foreign exchange reserves stood at 31 percent of GDP or 20 months of imports by the end of October 2015. Monetary policy has been prudent, and the Central Bank adheres to a well-established inflation targeting regime. The strong macroeconomic buffers have allowed the country to undertake a moderate and temporary fiscal impulse with the aim to smooth the economic transition to the less favorable external environment without compromising macroeconomic stability. A gradual fiscal policy tightening is expected to begin in 2017—the fiscal deficit is projected to peak at 3 percent of GDP in 2016 and come down to 2.5 percent in 2017. Public debt remained relatively low at 20 percent of GDP and net public debt was 3 percent of GDP in June 2015 (one of the lowest in the world).

As part of its overall reform program, the Government of Peru (GoP) has focused on improving the public management and reporting framework for subnational levels, and the basis to evaluate fiscal risks coming from public-private partnership (PPP) projects. These have been two key areas in need of improvement for an otherwise very robust economic management framework. Fiscal responsibility of SNGs is important as they account for about 38 percent of total non-financial public sector spending and 60 percent of total public investment spending. Although subnational governments' (SNG) finances are not particularly out of line in the aggregate, it is important that they stay that way with the forthcoming expected reduction in their revenue while also improving their management capacity to implement public investment programs. Similarly, appropriate management of PPPs is essential, both to manage fiscal obligations and risks coming from PPP initiatives and to accelerate the implementation of existing projects. Rightly, the GoP has focused on putting in place the full legal and institutional framework to implement the recently-enacted *'Fiscal Responsibility and Transparency Law*' and the '*PPP Law*.' This DPF-DDO will help maintain the dialogue with the next government, facilitating the implementation of the reform agenda in these important areas.

II. Operation Objectives

The proposed operation aims at supporting the Government of Peru's efforts to improve: (i) the management and reporting of public expenditures in subnational governments (SNGs), and (ii) the Government's legal and institutional framework for public-private partnerships (PPPs).

The Government's long term development plan is captured in the Bicentennial Plan: Peru to 2021.[1] The Plan was published in March 2011 and presents long term objectives along six strategic axes: (i) citizen's rights and dignity; (ii) opportunities and access to basic services; (iii) state and governance; (iv) economic growth, competitiveness, and employment; (v) regional development and infrastructure; and (vi) natural resources and environment. Both, this operation and the parallel and complementary development policy financing with a deferred drawdown option (DPF-DDO) support key elements of the Bicentennial Plan. This operation supports the third and fifth axis.

[1] http://www.mef.gob.pe/contenidos/acerc_mins/doc_gestion/PlanBicentenarioversionfinal.pdf

- **State and Governability**: Under this axis, the Government aims at supporting a democratic and decentralized state that is efficient, effective, and accountable. Improving the policy and institutional articulation between the three existing levels of government and the key functions of the state is high in this agenda. Broad reforms to the public administration, at the central and subnational levels, are highlighted, such as: (i) improving the management capacity of subnational governments, (ii) strengthening the public career path of the national and subnational civil service, and (iii) supporting citizen participation through transparency of public information and accountability.

- **Regional Development and Infrastructure**: Under this axis, which is the mirror area of the axis of State and Governability but looking at private sector development at regional levels, the Government aims at generating decentralized development of productive economic activities including social services. The aim is to achieve a balanced territorial development via enhancing the competitiveness of regions. A key instrument to achieve the objectives under this axis is the promotion of PPPs in support of decentralized investment in productive and basic services infrastructure (also highlighted under the axis of Opportunities and Access to Services).

The short and medium term reforms and objectives of this plan under the strategic axes (iii) and (v) are further detailed and reflected in the recently approved Government's rolling three-year Multiannual Macroeconomic Framework (Marco Macroeconomico Multianual, MMM) for 2016-18, highlights the need to enhancing fiscal management. In addition to presenting the basic parameters of the 2016 budget, the 2016-18 MMM highlights the tools that the Government is deploying to improve the management of SNGs and PPP projects. The 2016-18 MMM also briefly summarizes measures to help build the public financial management capacity of the recently elected subnational authorities, and the continued support to civil service management and compensation reforms initiated in 2012. The MMM also includes measures being deployed to improve the management of the risks arising from PPPs. The actions proposed in the DPF-DDO are well-aligned and cover both long-term strategic and medium-term objectives in the Bicentennial Plan and the MMM.

From a financing perspective, the proposed DPF-DDO is an important element of the authorities' medium term financial plan and a buffer to negative shocks. The proposed operation supports the authorities' medium term financing plan, debt maturity, and costs strategy and as a buffer against negative shocks. The authorities see the DPF-DDO as a very useful contingent alternative, particularly as borrowing costs for emerging economies may increase in the context of the tapering of monetary policy in the United States. They also value the hedging feature of the DDO, particularly in times of volatility in international capital markets. This type of contingent financing may also help as a buffer for other shocks if they materialize beyond expectations. For example, the climatic phenomenon El Niño may have a strong adverse effect on the country's infrastructure and on economic sectors such as agriculture and fisheries. Like in past engagements with DPF-DDOs in Peru (e.g., in 2008-9), and highlighting the strong institutionalism of macroeconomic management, authorities in one government use disbursements out of DDOs, but leave new contingent financing options to future governments.

A DPF-DDO is also important for policy and institutional reform continuity. The authorities also value the technical support of the World Bank's policy-based financing. This support is embedded in the proposed DPF-DDO design and preparation, and supervision. With a Presidential election in mid-2016[2], this instrument signals an ongoing commitment to policy reforms. That is, by focusing on policy changes with long-term impact, which are also anchored in the widely backed medium-term reform programs of the country that go well beyond 2016, this operation supports policy and implementation continuity beyond the financing option for the incoming administration.

III. Rationale for Bank Involvement

The proposed operation is consistent with the Bicentennial Plan - Peru to 2021 - and the 2016-18 MMM. As highlighted in the Plan and MMM, Peru has come long way in improving its public expenditure management institutions and in particular its public investment management framework at the national level. However, the rapid decentralization process in Peru and the rapid expansion of PPPs programs in the past decade have together posed new challenges to the existing framework. SNGs are now empowered to develop, evaluate, approve and implement their own investment projects, but face technical and incentive difficulties to follow the rules and, often, also face issues absorbing available resources. The framework to manage PPP projects was appropriate but an additional step was needed to fully integrate them into the public investment system and to deploy a proper decision making process for the assumed fiscal risks. This operation supports efforts in these directions. In the future, the GoP plans to broaden and deepen these reforms throughout the three year envisaged span of this operation, which allows the World Bank to support and reinforce this process. Joint multi-year technical and analytical work with the World Bank will continue in these two areas. In particular, both the policy notes and the Systematic Country Diagnostic will feature topics relevant to the operation and the Authorities have recently requested a Public Expenditure Review that could also be used as vehicle for further dialogue and follow up.

The proposed operation is consistent with the World Bank Group's (WBG's) Country Partnership Strategy (CPS) for Peru for 2012-2016 (Report No. 66187-PE). The CPS is built around four strategic objectives: (i) increased access and quality of social services for the poor, (ii) connecting the poor to services and markets, (iii) sustainable growth and productivity, and (iv) improved public sector performance for greater inclusion. This operation is well aligned with this last pillar, which anticipated support to strengthening management frameworks at the national and subnational levels, balancing the need to maintain quality control of investments with accelerated expenditure execution through a DPF.

IV. Tentative financing (Development Policy Financing with a Deferred Drawdown Option)

Source:	($m.)
Borrower	0
International Bank for Reconstruction and Development	1,250

[2] The first round of the Presidential election is planned for April 2016 and the second round, if needed, would take place in June 2016.

Others (specify)		
	Total	1,250

V. Institutional and Implementation Arrangements

The Ministry of Economy and Finance (MEF) has strong arrangements to monitor the progress of the proposed operation during the entire drawdown period. The General Directorate of Macroeconomic Policy and Fiscal Decentralization (DGPMACDF) and the General Directorate for Private Investment Policy (DGPPIP) will provide progress reports, including indicators, to the World Bank for the two policy areas supported by the DPF-DDO. This will be facilitated given that the monitoring framework is built on the basis of existing statistics and reports that are regularly published by MEF. The Debt Management Unit of the MEF will coordinate the operation's financial aspects. MEF has requested that the World Bank supervise both the macroeconomic management and the implementation of the program supported by the DPF-DDO during the drawdown period on a quarterly basis. In doing so, MEF intends to also benefit from receiving World Bank's expertise on specific issues that might arise.

VI. Risks and Risk Mitigation

This operation entails an overall moderate level of risk. The most relevant risks that could affect achievement of the program development objective (PDO) defined for this operation and which have been rated moderate are: (i) political and governance, (ii) macroeconomic, (iii) institutional capacity for implementation and sustainability, and (iv) stakeholders.

Political and governance risks are considered moderate and are associated with election dynamics. The main internal risk relates to domestic politics (presidential elections in 2016) and their potential impact on reforms. These risks are mitigated as policy continuity is very likely and unrelated to election results, partly because it is entrenched in a technically sound middle-level management in the public sector.

Macroeconomic risks to the results of this operation are considered moderate. Peru's solid macroeconomic policies and fundamentals allow the government to respond to shocks. The less favorable external environment affects all countries in the Latin America and the Caribbean (LAC) region, including Peru. China is also a significant export destination for Peru, and further deterioration of export demand in this country would continue to affect trade balances. While commodities represent 65 percent of total exports, they account for about 13 percent of GDP, and only around 2.3 percent of fiscal revenues in Peru. The climatic phenomenon El Niño is expected to have a strong adverse impact over the next 12 months and is expected to worsen, for example, the exports of the fishery sector in 2016. Nonetheless, throughout the past period of growth and favorable external conditions, and unlike many countries, Peru saved the commodities windfall, leaving itself with significant savings to continue to afford needed investments and strong macroeconomic buffers. Foreign exchange reserves stood at 31 percent of GDP or 20 months of imports by the end of October 2015. Public debt remained relatively low at 20 percent of GDP and net public debt was 3 percent of GDP in June 2015 (one of the lowest in the world). The Fiscal Stabilization Fund (*Fondo de Estabilización Fiscal*) provides an additional buffer in case of continued negative external shocks (standing at US$8.6 billion by end 2014 or 4 percent of GDP).

Risks related to institutional capacity for implementation are considered moderate. Public sector capacity constraints at the subnational level are considerable and have constituted a major challenge to executing public expenditures efficiently. In addition, sub-optimal inter-institutional cooperation among different levels of government could limit the impact of the GoP's reform program. However, the GoP has implemented several measures to mitigate institutional weaknesses. Moreover, the proposed operation seeks to mitigate these risks in several ways. First, it focuses on a few key policy areas with implementation responsibilities relying on a small number of government directorates, all of them reporting to the MEF. Second, MEF has been progressively investing in building capacities at the subnational level of government. Third, the operation builds on ongoing initiatives as opposed to introducing new ones.

Stakeholder risks are considered moderate as relevant affected parties, SNGs in the case of policy area 1 and potential private investors in the case of PPPs may require time to absorb proposed reforms. SNGs, in particular small local governments, will require time and support to fully adopt fiscal regulation and increase their management capacity. However, actions supported by this operation are specifically geared to address these issues through extensive communication and training. Potential PPP private sector partners may see new regulations as a limitation to participate but enhanced quality requirements will attract more experienced and stronger players, particularly for bigger investments, which will at the end result in more convenient arrangements for the public sector and more effective implementation of PPP projects.

VII. Poverty and Social Impacts and Environment Aspects

The set of measures that are supported by this operation are likely to have positive poverty and social impacts in at least three ways. First, economic growth, adversely affected by external shocks, will be supported by better management of public spending by SNGs as well as spending on PPP projects. Second, social services are likely to be strengthened because SNGs are responsible for much of the country's public spending on social programs and because the diversification of PPP projects is expected to contribute to the expansion of social services. Third, poorer parts of the country are likely to benefit more from SNG spending, because the program focuses on improving capacity for public expenditure management, which is likely to have a greater impact in SNGs with weaker capacity, as well as on greater compliance with fiscal rules by all SNGs.

Specifically, measures to strengthen public spending by SNGs and on PPPs, and to contain fiscal risk will have a favorable impact on poverty by protecting growth. Peru's decade-long growth has been highly successful in reducing poverty and raising the income of the bottom two-fifths of households. In fact, economic growth accounted for three-quarters of the reduction in national poverty and more than nine-tenths of that of rural poverty.[3] Between 2003 and 2013, poverty fell by more than 35 percentage points as the economy grew by more than 6 percent a

[3] The Datt-Ravallion decomposition show that GDP growth accounted for 72 percent of the decline in poverty on a national level. More than 90 percent of the decline in rural poverty can be attributed to growth. (see Background Paper 3, prepared for the 2015 flagship report on 'Growth and Productivity')

year and per capita income of the bottom 40 percent grew by 6.5 percent, which exceeded the growth in the country's per capita income of 5.3 percent. In particular, labor income was the main source of income behind poverty reduction. Since external shocks reduced economic growth sharply to 2.4 percent in 2014, various Government policies to protect growth and support internal demand, including several supported by this operation, have been implemented to ensure that growth recovers.

Since public spending by SNGs and capital spending on PPPs are both significant in size, actions that improve their effectiveness will benefit growth at a difficult time. More than three-fifths of total public spending is done by SNGs, including the bulk of social sector expenditure. PPP projects are projected to comprise nearly a quarter of total public capital spending, as well as private investment, with most of this spending on infrastructure. Delayed implementation and re-negotiation of PPP contracts not only increases their cost but also delays their operation and thus their growth impact on the economy; this operation explicitly addresses this problem, among others.

Strengthening SNGs staff and managerial capacity for public spending will affect social spending and services favorably, given their dominant role in this area. In Peru, shared prosperity can be limited by large gaps in infrastructure, both in terms of access and quality of services (World Bank, 2015).[4] In addition, inequalities in coverage across regions limit the return of other development initiatives such as investments in education, health, and social programs. Importantly, there is evidence that contextual factors such as access to infrastructure and basic services explain a large share of income disparities across districts in Peru (Bazan, et al, 2015). SNGs spend a significant share of total public expenditure on education, health as well as water and rural roads. Thus, enhanced capacity to manage and implement expenditure programs, as is supported by this operation, can contribute to better educational and other outcomes at the subnational level, thereby expanding endowments of the poor and contributing to future poverty-reduction.

The risk of unanticipated adverse effects to the environment, forest, and natural resources from specific policies supported by the DPF-DDO is very low. The actions supported by this DPF-DDO, particularly those aimed at improving the management and reporting of public expenditures in SNGs, indirectly entail positive environmental effects by improving the conditions under which SNGs can hire technical staff in general and to deal with environmental issues – understaffed subnational socio-environmental units has been highlighted as an issue for the implementation of the environmental framework.

The Bank has supported environmental reforms under the Programmatic Environmental Development Policy Finance between 2009 and 2015, including the strengthening of the National System for Environmental Impact Assessment (SENACE and SEIA) and institutions such as the Ministry of Environment (MINAM) and the National Service for Protected Areas (SERNAP). Improving country environmental management systems is also a concern of the GoP that is currently preparing, with the WBG support, an Investment Project

[4] Cord, Louise; Genoni, Maria Eugenia; Rodriguez Castelan, Carlos. 2015. *Shared Prosperity and Poverty Eradication in Latin America and the Caribbean*. Washington, DC: World Bank. © World Bank. https://openknowledge.worldbank.org/handle/10986/21751 License: CC By 3.0 IGO."

"Investments in Environmentally Sustainable Development" to enhance environmental quality control at the national level. This investment program will include strengthening the main controlling and enforcement agency of Peru, the Environmental Evaluation and Auditing Agency (OEFA), and local Environmental Evaluation and Auditing entities (EFAs); and, improving environmental transparency and accountability of national and regional development decisions. All public investment projects, including those implemented through PPPs are subject to the National System for Environment Impact Assessment. The public investment management system (SNIP) duly enforces these requirements.

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