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CONCEPT STAGE

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Report No.:

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%)
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Lending Instrument	Development Policy Financing
Borrower(s)	MINISTERIO DE ECONOMIA Y FINANZAS - MEF
	Ministry of Economy and Finance Peru
Implementing Agency	Ministry of Economy and Finance
Date PID Prepared	August 31, 2015
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Estimated Date of Board Approval	November 5, 2015
Corporate Review Decision	Following the concept review, the decision was taken to proceed with the preparation of the operation.

I. Key development issues and rationale for Bank involvement

1. **Sound macroeconomic and structural policies over the last 20 years rendered significant growth and poverty reduction dividends for the country**. 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 63.4 to 23.9 percent of the population, 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, above the 4.4 percent national average. Throughout this period of growth and good external conditions, and unlike many countries, Peru saved the windfall, leaving itself with significant savings to continue to afford needed investments and strong macroeconomic buffers to face more challenging times.

2. **In response to the growth slowdown, the Government adopted a program of measures to stimulate economic activity and improve the economy’s efficiency.** Growth slowed down to 2.4 percent in 2014, but the ample macroeconomic buffers allowed the country to undertake moderate, prudent, and temporary counter-cyclical fiscal policy in 2014 and 2015, without compromising macroeconomic stability. The fiscal impulse is expected to be withdrawn gradually, starting in 2016. The fiscal deficit is projected to reach 1.9 percent of gross domestic product

(GDP) in 2016 and 1.5 percent in 2017. Monetary policy has been prudent, and the central bank adheres to a well-established inflation targeting regime. The current account is hovering around 4 percent of GDP, and remains mostly covered by foreign direct investment and portfolio investments. Foreign exchange reserves stand at 31 percent of GDP or 18 months of imports and public debt remained relatively low at 20 percent of GDP by end 2014. Peru continues to have a sound macroeconomic policy framework.

3. **As part of the overall strategy to manage the downturn the government focused on improving the institutions to manage expenditures, particularly at subnational levels, and fiscal risks coming from public-private partnerships (PPPs)**. These have been two key areas of concern for otherwise a very robust economic management framework. Fiscal responsibility of subnational governments (SNGs) is important as they account for about three-fifths of total spending. While SNGs finances are not particularly out of line in aggregate, it is important that it stays that way with the forthcoming reduction in their revenue. Similarly, appropriate management of PPPs (ongoing and new ones) is essential, both to manage fiscal obligations and risks coming from PPP projects—budget commitments for PPP projects are expected to rise from 10 to about 20 percent of the capital budget between 2014 and the 2016-18 period—and to accelerate the implementation of exiting projects. Rightly, the Government of Peru (GoP) has focused on putting in place the full legal framework and institutions to implement the recently-enacted Fiscal Responsibility and Transparency Law and the Law on Public-Private Partnership, as recently amended.

II. Proposed Objective(s)

4. **The proposed development policy financing with a deferred drawdown option (DPF-DDO) operation aims at strengthening fiscal management for the economic downturn and beyond by focusing on improving: (i) subnational governments' management of public spending and compliance with fiscal rules in the context of slowing revenue growth, and (ii) the Government's capacity to evaluate Public-Private Partnerships and accelerate their implementation within a responsible fiscal framework.** The operation supports prior actions to strengthen the two areas of public spending that can contribute to better fiscal management and support growth. These prior actions are part and parcel of the Government's medium term reform program, and have been the subject of joint analytical work and policy dialogue with the Bank. Together with ongoing structural reforms to improve the economy's efficiency these actions can lay the basis for future diversification in Peru. They are also fully aligned with the 2012-16 Country Partnership Strategy (CPS) pillar on improving public sector performance for greater inclusion.

5. **The Government's long term development plan is captured in the Bicentennial Plan: Peru to 2021 (Published in March 2011), with short and medium-term objectives discussed in the Multiannual Macroeconomic Framework *(Marco Macroeconómico Multianual,* MMM) 2016-2018 (Originally approved April 28, 2015).** The Bicentennial Plan presents long term objectives along six strategic axes, among which opportunities and access to services; state and governability; and regional development and infrastructure are included. These areas of the plan recognize the need for public and private sector involvement in order to address service delivery and infrastructure gaps, as well as increased transparency, accountability, and efforts to increase the public sector's management capacity.

6. **The MMM reflects a combination of medium term actions targeted at strengthening Peru's competitiveness and productivity as well as complementary immediate measures addressing challenges related to the current economic deceleration.** As such, it identifies three key lines for economic policy and highlights the need for addressing capacity building challenges in the public sector, including those related to the execution of public expenditure, through measures that help build the public financial management capacities of recently elected subnational authorities, the creation of investment committees at all levels of government to monitor implementation of investment projects, and the continued support to civil service management and remuneration reforms initiated in 2012. The MMM also highlights the importance of managing fiscal risks arising from PPPs while ensuring their smooth implementation to ensure infrastructure gaps are closed.

7. **The proposed operation supports Government's efforts to manage fiscal risks in the face of negative external shocks.** The Government is committed to address the fiscal risks arising from SNGs' fiscal position and PPP projects. Within the given macroeconomic constraints, the Government also aims at ensuring a swift implementation of both SNGs spending plans and ongoing PPP projects. This proposed operation supports these efforts.

III. Preliminary Description

Policy Area 1: Strengthening SNGs management of public spending and fiscal risks

8. **To strengthen SNG management of expenditure and contain deficits and debt despite depressed metal prices and slower revenue growth, several measures has been taken.** Fiscal rules were established in 2004, but SNGs rarely complied with them. In 2014, only 50% of the regional governments (RGs) and 59% of local governments (LGs) met both fiscal rules (spending and debt limits). Since SNGs account for more than three-fifths of total public expenditure, 'business-as-usual' management of their spending creates the risk that national deficit targets may not be met. Thus, the Government's recent efforts to simplify fiscal rules to ensure that expenditures adjust down to match lower revenue and to enforce them, is laudable, though Peru has adequate fiscal buffers to deal with this risk if it materializes. Similarly, measures to improve management capacity in SNGs to deliver compliance and to implement critical investment programs are noteworthy.

9. **This first policy area supports the improvement of the incentives and the management capacity of SNGs to comply with fiscal rules as well as with reporting and disclosure requirements.** The five prior actions relating to SNGs are described below. The first four prior actions relate to implementation of the simplified fiscal rules, technical support for SNG compliance and reporting, vigilant monitoring of their compliance including the threat of sanctions, and increasing professional management capacity, and together they create better incentives for compliance and enhanced ability of SNGs to implement expenditure. The fifth prior action complements these efforts by ensuring that all critical public spending and service delivery can be maintained in SNGs that are under investigation of mismanagement cases.

Prior Acton 1: *The government has issued regulations to strengthen SNGs' compliance with fiscal rules by establishing procedures for determining fiscal targets, responsibilities for SNG reporting* *and disclosure, development of convergence targets for non-compliant SNGs and sanctions for continued non-compliance (Supreme Decree 104-2014-EF, May 10, 2014; Supreme Decree 100-2015-EF, April 29, 2015; Ministerial Resolution 432-2014-EF/15, December 29, 2014; and Ministerial Resolution 338-2014-EF/15, October 16, 2014).*

10. **Context - As the role of SNGs in the delivery of public services and in public spending has expanded, better management of their expenditure has become imperative.** In 2014, SNGs accounted for 40 percent total public sector spending, and 62 percent of total public investment (RGs: 19%, and LGs: 43%). Their ability to establish and achieve spending, deficit and debt targets as well as to ensure predictability and efficiency of spending, can not only affect national macroeconomic outcomes, but also delivery of services and social outcomes in the country.

11. However, SNGs' success in setting spending, deficit and debt targets and meeting them has been limited. The framework for subnational fiscal rules and transparency was established as early as 2004 through the Fiscal Responsibility and Transparency Law 27245 and the associated Decree No. 955. However, most SNGs did not comply with them, which had not manifested itself in fiscal problems nationally because government revenue grew robustly during that period. In 2009, partly in response to the impact of the global financial crisis, there were renewed efforts to simplify and improve coherence between fiscal rules on spending and debt limits through a reduction in the number of rules to five, however SNGs compliance was still low. In 2012, only a third of the RGs and a negligible share of the LGs were in compliance. While SNGs were required to produce multi-year fiscal management report, these reports did not need to provide information on compliance with fiscal rules, levels of borrowing or spending, or measures to achieve compliance with the fiscal architecture.

12. **There have been many reasons to explain SNG's inability to comply with fiscal rules and reporting requirements in the past.** There were too many (seven) parameters to comply with in the 2004-2008 rules, which increased complexity. In 2009, the number of parameters were simplified to five, and some of the limits eased, but even five proved too many, and objectives and relevance were still unclear. Also, the spending limits and the budget process (including multiannual planning and budgeting and financial management) were not linked. Finally, incentives (or sanctions) for SNGs to comply with rules were inadequate.

13. **Reforms - The revised Fiscal Responsibility and Transparency Law (Law 30099) enacted in 2013 and the bylaws issued throughout 2014, address these issues.** For SNGs, the new law simplifies the rule, aligning them with those for the national macro-fiscal framework. The fiscal rules were simplified to two, one restraining total (non-financial) public expenditure to the rolling average of the last four year revenue; the other restraining debt to less than 100 percent of the average of the same revenue. If SNGs are not in compliance with the fiscal rules (or converge targets to return to compliance with the fiscal rules) and reporting requirements, specific sanctions can be imposed. As previously established, SNGs in non-compliance are not allowed to contract or issue debt of any kind, thus controlling potential deterioration of their financial stances. In addition, new regulations prohibit non-compliant SNGs access to central government co-financing programs or additional transfers from special allocations (including those for stimulus purposes).

14. **The Government has issued bylaws which spell out the key implementation details for the revised law.** Supreme Decree 104-2014-EF (published May 11, 2014) defines a number of important aspects such as the types of revenues and debt included in calculation of the fiscal rules, as well as procedural details for the application of corrective measures in cases of repeated non-compliance with fiscal rules (e.g. when the list of SNGs prohibited from participating in FONIPREL calls is to be published). The regulation also provides many of the details required to effectively roll-out the multi-year fiscal management report (MYFMR) reporting requirement in Law 30099, which requires SNGS to submit (based on a gradual implementation schedule set forward in Ministerial Resolution 338-2014-EF) these reports with a description of the financial situation and establish goals for converging with fiscal rules (in cases of non-compliance). Details on required content (including information submission requirements and sworn statements stating preparers' conformity with the content) and MEF's procedures and timeline for verifying the information prior to reports' public release are spelled out. The regulation also establishes that the reports are to be prepared exclusively through a web application, developed by MEF[1], which integrates accounting and financial data for the last three years which had been submitted by SNGs, as well as the General Directorate for Fiscal Decentralization and Social Affair's role in providing technical assistance to SNGs in support of the preparation of MYFMRs.

15. **As alluded to above, the requirement for submission of MYFMRs is being gradually rolled out to regional and local governments between the years 2015 to 2020, the details of which are established in Ministerial Resolution 338-2014-EF**. From 2015 onwards, all regional governments are required to submit MYFMRs. In turn, the requirement is being more gradually rolled out to local governments via complementary selection criteria and a schedule set forward in the Ministerial Resolution. In 2015, local governments covering fifty percent of local governments' average annual income over the last four years – specifically those in the provinces where department capitals are located, as well as the local governments with the largest average annual incomes over the last four years – are required to report. Each following year, local governments representing an additional ten percent of such income (ordered in terms of size), are required to submit reports, until the entire universe of local governments is covered in 2020.

16. **For those not in compliance with the fiscal rules, MYFMR reporting requirements entail the establishment of convergence plans in order to bring non-compliant SNGs into alignment.** Ministerial Resolution 432-2014-EF (December 29, 2014) approves the methodology for the calculation of these convergence goals over the following years (with the timeline based upon the degree to which the SNG is out of line with the rule). Those with only small deviations from the rule (defined in the Ministerial Resolution as those with debt/revenue ratios no greater than 105 percent, or those with expenditure limits greater than or equal to 92.5 percent of their actual expenditures) must comply within the current year, while those with larger deviations have additional time.

17. ***Expected results:*** Through the implementation of the fiscal responsibility framework at the subnational level, these measures are expected to strengthen management of fiscal risks by improving SNG compliance with expenditure and debt limit rules, which will be measured by the percentage of regional governments (RGs) and local governments (LGs) in compliance with either

[1] https://apps4.mineco.gob.pe/simgf/

the two fiscal rules or their convergence plans.

Prior Action 2: *The government has granted authority to the General Directorate of Macroeconomic Policy and Fiscal Decentralization (DGPMACDF) in MEF to monitor SNGs' compliance and provide technical assistance to SNGs (Supreme Decree 117-2014-EF, May 23, 2014).*

18. **Reforms - Another key aspect of implementation of the fiscal rules has been to create an institutional "home" within MEF for the implementation support, monitoring, and compliance mechanisms set forth under Law 30099 and further detailed in the regulations discussed above.** Supreme Decree 117-2014-EF (May 23, 2014) approves MEF's Organizational and Functional Regulations (May 2014). Article 112 of the regulations note that the General Directorate of Macroeconomic Policy and Fiscal Decentralization (DGPMACDF) is the line entity of the MEF in charge of ensuring Peru's macroeconomic and financial stability, taking into account the macroeconomic environment and fiscal rules. Among its responsibilities are the permanent monitoring of public finances – including the design and evaluation of subnational fiscal rules - and approving and supervising technical assistance to SNGs related to the elaboration and presentation of MYFMRs. Within the General Directorate, the Directorate of Fiscal Decentralization Policy and Subnational Finances has specific responsibilities related to the formulation and managing technical assistance, preparation of tools and other materials needed by SNGs to project their expenditure and debt limits, and analyzing and validating the submitted MYFMRs. As many SNGs suffer from a low level of professionalization of officials, a high turnover of staff and lack of merit-based appointments to important managerial positions, the DGPMACDF's mandate to continually support SNGs and to run capacity building programs (including coaching workshops) to strengthen their ability to comply with the rules and reporting requirements, as well as to improve fiscal management more generally, will be critical to the effective implementation of the fiscal rules.

19. ***Expected results:*** Implementation of the new institutional framework supporting the fiscal responsibility framework is expected to improve accountability and lead to more effective monitoring of SNGs compliance manifested in their regular reports and enhanced capacity to deliver compliance. This will be measured through the percentage of SNGs that have submitted the multi-year fiscal management reports in compliance with their gradual reporting obligation through a six year period (2015-2020).

Prior Action 3: *The Government has issued procedures for the functioning of an independent Fiscal Council charged with providing opinions on the Government's macro-fiscal framework and related fiscal policies, including SNGs' compliance (Pending confirmation from the Government prior to negotiations)*

20. **An External Accountability framework for the fiscal rules has also been set up.** Article 23 of Law 30099 empowered the government to create an independent Fiscal Council, the first time such arrangement has been introduced. The objective of the Fiscal Council is to provide technical, independent analyses of macro-fiscal policy through the emission of non-binding opinions in areas including: 1) modification and compliance with fiscal rules, including at the subnational level; 2) fiscal projections in the MMM; 3) short and medium-term evolution of public

finances; and 4) methodologies for the calculation of the structural accounts, potential GDP, and medium term export prices. These reports are to be published on the entity's page, and if MEF does not agree with these opinions, it will be required to support its position in a report. The Council is composed of several independent experts, recognized for their good characters and experience in fiscal matters, who are to be designated by Supreme Decree (providing the Council's composition with relative stability). Members are to serve four year terms, which can be renewed once.

21. **The Fiscal Council's opinions are expected to strengthen fiscal decisions**. Every May, MEF issues estimates for each SNG about their expected revenues – since most are tied to the sharing agreement for the corporate income taxes paid by extractive industries (the so called "canon"). The Fiscal Council's oversight power provides an incentive to MEF and SNGs to better project revenues and improve budget execution.

22. ***Expected Results***: Implementation of the Fiscal Council will significantly strengthen the credibility of fiscal policies in Peru as a whole and will also support effective dissemination and reliability of fiscal targets at the subnational level

Prior Action 4: *The Government has issued regulations to implement the professionalization of managers in the civil service, creating a new class of public managers, the Public Directors, subject to merit-based recruitment and regular performance evaluation, for national and subnational governments* (*Supreme Decree 040-2014-PCM, June 13, 2014).*

23. Context - The low level of professionalization of staff and managers, have had a particularly detrimental effect on both SNG's compliance with fiscal rules and execution of spending. The National Civil Service Authority (*Autoridad Nacional del Servicio Civil*, SERVIR) estimates that recruitment or promotion in over 70 percent of key economic or budget positions in SNGs depend on political affiliation rather than professional ability or merit. Staff also move when administrations change and a new set of officials take over. As these positions include key management functions, such as planning and budget management, investment programming, administration and logistics – and account for about 4 percent of the SNGs civil service according to MEF—introducing merit based recruitment and promotion criteria for them was an urgent reform.

24. **In 2008, the government created a group of professional middle managers (the Public Managers cadre) which were deployed on a voluntary basis.** If the SNGs requested such managers, SERVIR would assign them for a period of three years. In SNGs where these such managers were deployed, there was an average improvement of 90 percent in public investment execution. Unfortunately, these managers were not kept beyond the three years, largely because it was a voluntary program and SNGs elections in 2013 interrupted what seemed to be a successful initiative.

25. **Reform - The Government approved a civil service reform program in 2013, and the relevant implementation decrees in 2014, restricting political appointments to only 20 percent of general Directors.** This reform, in addition, consolidated previously fragmented public services into a single regime and created a new group of civil servants in management positions whose terms in office are insulated from election cycles i.e. Public Directors.

26. ***Expected Results****:* The creation of the new Public Directors posts is expected to strengthen management capacity at the subnational level, translating into improved public expenditure execution and compliance of fiscal rules. Effective implementation of this action will be measured by the number of professional Public Directors as a percentage of total managerial positions in RGs.

Prior Action 5: *Parliament provided the government with powers to secure business continuity in SNGs where the Controllers' Office freeze accounts while it investigates alleged mismanagement and corruption* (*Law 30231, July 12, 2014).*

27. **Context - A recent transparency and anti-corruption drive, while essential and commendable, has also negatively impacted the continuity of public services and investment programs in SNGs.** In the fall of 2014, twenty two of the twenty five regional presidents leaving office were under investigation for embezzlement, three were held remanded prior to trial, and another had fled. In these cases, the Controller's office, the Ministry of Interior, and the Ministry of Justice can request that MEF temporarily freeze SNGs' accounts (on a monthly basis) to safeguard affected public funds and track financial evidence. These measures have sent a strong and decisive signal that corruption will not be tolerated. Partial continuity of basic administrative functions and social programs was maintained by ensuring MEF processed wages, pensions and social programs during the time in which accounts were frozen. However, other expenses, such as those associated with investment projects and operational services were suspended during these periods, undermining implementation of needed projects for the community and unnecessarily building up arrears at the subnational level.

28. **Reform - The Government broadened the authority of MEF to process payments while a given SNG accounts remain frozen.** The new measure expands, during the first month of the sanction, the list of expenditures on which payments can be made by these SNGs to include insurance, basic public services, operational costs, municipal taxes, ongoing investment projects and other public services. Also the new regulation allow for the establishment of an Executing Unit at the central government level that can take charge of fiscal management of a SNG and execute all spending on behalf of the SNG, a solution that can be used in case of protracted investigations (more than one month) at the request of the competent entity that requested the accounts suspension.

29. ***Expected results*****:** Expansion of the types of expenditure items permitted during periods of account suspension and the creation of an Executing Unit is expected to strengthen budget credibility by restoring expenditures for the provision of basic public services and for investment projects in SNGs affected by mismanagement investigations. This will be measured through the improved average budget execution rate in affected SNGs during suspension.

Policy Area 2: Strengthening the management of public-private partnership (PPPs)

30. **This operation supports Government's efforts to make PPP project evaluation more rigorous than before, to minimize fiscal risks, and to facilitate PPP project implementation.** Specifically it supports actions to harmonize evaluation of all PPP projects (especially those that

were unsolicited) and subject them to budgetary allocation process, to enhance MEF's role in appraising and approving the risk associated with PPP projects. It also supports the creation of structures to facilitate PPP speedy project implementation and completion, and to better handle unsolicited proposals and dispute settlements.

31. **Peru has used different financing mechanisms to increase private participation through PPP projects.** Throughout the past decade Peru has offered generous government guarantees to PPPs, especially for contractual and performance risks generally left in the private sector hands. Still, the legal framework includes important features, such as the conditions for government co-financing of a project through various forms (e.g., payments against advances in construction in the form of cash and titles that at an initial stage were tradable), non-financial contractual guarantees, financial guarantees, as well co-financing for PPPs (some of which comes through the "unsolicited" proposals channel).

32. **As a result, PPP projects have expanded rapidly, increasing their demand on the budget.** Between 2006 and 2014, contracts were signed for 70 PPP projects amounting to more than $30 billion, of which 10 projects amounting to $14 billion were signed in 2014. These are at different stages of implementation and completion. These projects have focused predominantly on infrastructure, like highways, bridges, rails and electricity. While they all contribute to closing the country's significant infrastructure gaps, the trend has nonetheless heightened fiscal risks.

33. **For this pipeline, the state is involved in either providing direct co-financing of PPPs, or providing contractual/performance guarantees**. In 2014, approximately 0.7 percent of GDP was spent on PPPs out of the budget, of which about 0.5 percent of GDP due to direct financing of capital expenses (CAPEX) generally in the form of a (quarterly) payment for construction progress (PPO). While still small, CAPEX spending represented 10 percent of the public investment budget, a share that is expected to increase to about 16 percent by 2017 – or about 1 percent of GDP. PPPs have also generated direct liabilities by using debt instruments to facilitate project finance (e.g., Certificates for construction progress – CRPAOs; titles to compensate for investment made -- RPIs). By the end of 2014, these amounted to 0.6 percent of GDP, while other explicit guarantees (financial and non-financial) to PPPs were at 2.7 percent of GDP (which does not include all of the contractual guarantees offered).

Prior Action 6: *Parliament has amended the PPP framework law to: (i) harmonize evaluation processes for all types of PPP projects; and (ii) establish procedures to reduce risks and (iii) ensure spending units (PPP promoters) allocate budget according to usual budget process and consistent with the macro-fiscal framework (Law 30167, March 2, 2014 and RM N° 249-2014-EF/15).*

34. **Reforms - The amendments to the PPP framework law No. 30167 in 2014, and subsequent decrees, comprise another major effort to modernize the PPP framework in Peru and earn the recognition as one of the most modern legislations in LAC (Infrascope, 2014).** Among others, the amendments set up a process to identify a coherent and complementary portfolio of projects (so as to ensure that the total impact of the selected projects is larger than the sum of the impact of each project), matched with feasible financial resources, as opposed to proceeding in an ad-hoc manner selecting one to one projects. It also introduced actions to bring

PPPs under budget scrutiny, to enhance MEF's role in appraising and approving such projects, to facilitate their speedy implementation and completion, and to clarify the handling of unsolicited proposals and dispute settlements. These actions are expected to strengthen the management of public spending and fiscal risk related to PPP projects. The amendments set up the fiscal rules and criteria for government support to PPP projects, such as subsidies and direct funding. Several instruments for project selection (Value for Money methodology, RM N° 249-2014-EF/15), project preparation and complementary procedures, were also issued.

35. **The amendments also introduced public resource management best practices.** The revised procedures and rules for PPP projects covering the entire project-cycle (proposal, appraisal, selection, approval, allocation, and contracting) are now identical to typical public investment projects fully funded by the Government and managed by sector ministries. The new system ensures that the total allocation for investment projects for the next year or the medium term, as well as their recurrent expenditure requirement, is consistent with the growth objective of the country and the approved budget framework. These harmonized processes for PPP and publicly funded investments ensures that the overall budget constraint – and line ministries' expenditure ceilings – apply irrespective of whether a project is a PPP or not. Perhaps most important, it allows the government to compare explicitly and systematically the relative benefits of one type of project versus the other. The relevant sector ministries will have to prioritize among them when choosing how to allocate their capital and recurrent budgets.

36. ***Expected Results.*** The main expected result from these measures is a reduced fiscal risk associated with PPP portfolio, measured through the ratio of contingent liabilities the non-financial public sector associated with PPPs assumed by the Government to total PPP investment commitment (about US$6 billion out of US30billion at the end of 2014 or a 20 percent ratio).

Prior Action 7: *Established the General Directorate for Private Investment Policy (DGPPIP) in the Ministry of Economy and Finance (MEF) to: (i) liaise with Pro-inversion and line ministries on the fiscal implications of the PPP project design: (ii) issue an opinion at different stages of a PPP contract (design, negotiation, and renegotiation) and if necessary, veto the signing of a PPP contract (in consultation with other units within MEF); (iii) monitor closely the evolution of risks associated with PPP projects that are under construction or in operation; and (iv) operate and manage the registry of all PPP contracts (Supreme Decree 117-2014-EF, May 23, 2014).*

37. **Context - This Prior Action ensures MEF can temper with fiscal prudence the growth goal of PPP promoters**. It allows MEF to play the role provided under Law 30167 in reducing the current significant bias in Peru for the government to bear most of the construction risks through payment for construction progress (PPO), compensation for investment titles (RPI) and the like. Also, if the pace of approval of projects is likely to place excessive demands on the budget, MEF can contribute to managing the approval process and thus the fiscal risk emanating from the projects.

38. **Reforms - In 2014 MEF created the General Directorate of PPP Policy (DGPPIP) (D.S. N° 117-2014-EF) and was implemented with around 30 qualified staff, enhancing the role of the MEF in PPP contract design, risk-allocation and approval as well as in continuous monitoring of risks and maintenance of records.** The DGPPIP in MEF has decision-making

authority on when and what types of fiscal support may be provided to PPP projects. While this authority existed before at the final stage of a PPP project approval, it could be circumvented. Previously, a PPP project classified as "self-financed" did not have to go through MEF approval because it did not require budget funds. However, during execution and implementation, it could transition into a "co-financed" project, without having been subjected to MEF scrutiny. Now MEF has a role in all PPP projects irrespective of initial classification as well as the team necessary to exercise these responsibilities.

39. **Additionally, the DGPPIP is expected to work closely with Pro-inversion at the proposal and design stage, involving MEF early in the process**. This avoids common complaints of late interventions or possibility of circumvention. MEF's obligation to provide opinions on proposals and selection will require explicit justification of its decisions, so that all other parties involved can review the reasoning. Moreover, as the fiscal risks of PPP projects assessed at contract-signing change during implementation and/or operation, their continuous monitoring will avoid fiscal surprises.

40. The reforms also require that the DGPPIP establish and maintain a comprehensive registry of PPP projects and contracts, which will be a valuable start to consolidating the data and information base on PPPs in the country in one place. Data on PPP projects are currently dispersed across the country, including at subnational levels, making it difficult to have a comprehensive view of PPPs in the country. All central and subnational government ministries and agencies will now be required to inform the MEF and submit their PPP projects for clearance and approval, allowing the systematic consolidation of PPP data. While the MEF clearance and approval process ensures that only good projects with high and desired impact, aligned with country strategy are approved, establishing the registry can contribute to better accounting and managing of medium and long term fiscal commitments and fiscal risks. Thanks to the registry and the unit, the MEF produced its first comprehensive report on fiscal contingencies in March of 2015.[2]

41. A stronger MEF role in the project cycle, particularly in the evaluation of the risk matrix and the project financial structure, is also likely to address the causes of re-negotiation of contracts. By making the whole system for processing PPP projects more rigorous, it is expected to remove, or at least reduce substantially, the problems of inadequate project preparation, incomplete or poor quality contracts, ambiguous allocation of risk between two parties, and so on, which had been frequently cited as reasons behind such a large number of re-negotiation of contracts and resulting delays.

42. ***Expected Results.*** The expected result of this reform will be measured through the same indicator under Prior Action 6 given that these two prior actions complement and reinforce each other.

Prior Action 8. *The Government enhanced institutional arrangements to implement PPP contracts expeditiously by creating a delivery unit for investments in the Ministry of Economy and Finance to resolve bureaucratic obstacles faced by a concessionaire (*Supreme Decree 041-2014-EF, February 27, 2014)

[2] http://www.mef.gob.pe/contenidos/pol_econ/informes/Informe_Contingencias_Explicitas.pdf

43. **Context - Implementation and completion of construction of contracted PPP projects has typically taken an inordinately long time.** This was in part because there was no designated government agency with requisite authority to cut through the thick bureaucracy to obtain numerous licenses and permits that are required for construction, land acquisition, and resettlement. The cumbersome steps are not easy for private operator to navigate without organized government support.

44. **Reforms – To mitigate institutional bottlenecks and accelerate private and public investment in infrastructure, the government set up a delivery unit in the Ministry of Finance (MEF).** This unit collaborates closely *DGPPIP*, but sits directly in the cabinet of the Minister. This strategic location for the delivery unit empowers it to work with ministries and other government agencies that are directly responsible for removing barriers and bottlenecks to construction and implementation of PPP projects. The unit has promoted improvements in several regulations and authorizations and licensing processes, including in areas that require careful assessments, such as environment or archeological permits, expropriations and water rights (e.g., D.S. 054-2013-PCM). They have also fostered improvements in the operational procedures of various government agencies that help to accelerate public and private investment in national and subnational governments.

45. **The new institutional arrangement for expediting implementation and construction of PPP projects is a measure that can reduce their fiscal cost and advance their growth impact.** Peru's PPP experience had been plagued by delayed implementation, in part because there are a number of permits in all levels of government and the lack of an institutional responsibility for supporting the PPP entrepreneurs after signing the PPP contract.

46. ***Expected results.*** The expected result of this reforms is a reduced **c**ost to the state associated with delays in investment implementation, measured as the percentage of PPP projects that are implemented according with their timelines.

Prior Action 9: *Issued bylaws to Law 30167 (PPP Law) to establish procedures for: (i) unsolicited PPP proposals, including roles and responsibilities of the key government agencies (initiatives government agencies, Pro-inversion and MEF) and; (ii) operation of a voluntary settlement of disputes for PPP contracts, involving the advice of an independent third party (Supreme Decree 127-2014-EF, May 31, 2014)* (DS Nº 081-2015-EF, and Nº 136-2014-EF).

47. **Context – This action is targeted at reducing frictions by ensuring a transparent process for unsolicited proposals and for voluntary settlement of contract disputes.** Unsolicited proposals for PPPs can drain public sector resources even only at the stage of reviewing proposals that may not be aligned with policy priorities. They also pose risks to the concept of "value for money" in projects, depending on the process that a country follows to develop and procure the specific project. Unsolicited proposals, however, can fill-in important gaps in the infrastructure planning system of a country like Peru, if they are transparently processed followed a set of predefined rules.

48. Another important issue for Peru was the lack of a complete framework for

renegotiating PPP contracts. The incidence of renegotiations in Peru has been quite significant: more than sixty percent of the contracts are renegotiated and often the same contract is renegotiated several times, and fairly quickly after awarding the project. While the incidence of renegotiations is expected to decline given the larger involvement of MEF at different stages of PPP cycle, expeditious conflict resolution instruments such as voluntary settlements based on third party independent advice needed to be introduced in order to further reduce renegotiation occurrences.

49. Reforms - Unsolicited proposals will now go through the government's Public Investment System (SNIP) that processes all public investment projects. The new regulations (DS Nº 081-2015-EF, and Nº 136-2014-EF) set up an open an annual window to receive unsolicited proposals, establish criteria for project selection, government support (guarantees and subsidies), roles and responsibilities for clearances, and also clarify and set up terms for responses of public entities involved in the decisions, devolution of costs of studies requested by the government, improving competition and transparency rules. They built on the 2013 legal amendments that created a Fund and the initial set of specific regulations for unsolicited proposals (D.S. Nº 005-2013-EF). Together, these regulations have set up a new mandate for the PPP agency (Proinversion) and regulate all the stages of the PPP cycle for unsolicited proposals (minimum requirements, timing, terms, fiscal clearances, etc.). The same Supreme Decree introduces the concept of voluntary settlements based on a third party independence advice.

50. ***Expected Results.*** The new procedures for screening unsolicited proposals should result in fewer proposals accepted, but those accepted will have a higher quality. Since direct measurements of the quality of an unsolicited PPP proposal do not exist, this will be measured through the number of unsolicited proposals accepted as a share of the total presented in the Proinversion system.

IV. Poverty and Social Impacts and Environment Aspects

51. **The set of measures that are supported by this operation are likely to have positive poverty and social impact in at least in 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 diversification of PPP projects are expected to contribute in 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; the latter will prevent the larger ones from excess spending and thus crowding out the smaller ones, as is often the case.

52. **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 incomes 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 year and per capita income of the bottom 40 percent grew by 6.5 percent, which exceeded rise in the country's per capita income of 5.3 percent. When external shocks reduced economic growth sharply to 2.4 percent in 2014, various Government policies to protect growth, including several supported by this operation, are being implemented to ensure that growth averages at least 4.5 percent during 2015-17.

53. **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 growth impact on the economy; this operation explicitly addresses this problem, among others.

54. Strengthening SNGs staff and managerial capacity for public spending will affect social spending and services favorably, given their dominant role in this area. During the last decade, income from labor contributed the most to poverty reduction[4]. Improving education was found to be an important factor in differential poverty reduction across districts, though better access to a combination of assets/endowments (water, roads, health, etc.) had an even more dominant factor. 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 local level[5], thereby expanding endowments of the poor and contributing to future poverty-reduction.

55. Additionally, t**he measures related to facilitating PPPs are expected to have indirect effects on poverty reduction due to important complementary effects of infrastructure investments which are typically favored by PPPs.** Escobar (2005) finds that there are complementary effects of infrastructure investments (roads, electricity, telecommunications, water and sanitation) that allow for a sustained growth effects on rural incomes in rural areas in Peru. Consequently, expanding access, facilitated through prior actions under Policy Area 2 could potentially provide a boost for reducing poverty and increasing rural productivity. Notably, households with access to four key basic services in rural areas is still low (20% in 2013).

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[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')

[4] On a national level labor income accounted for 78 percent of poverty reduction and in rural areas, for 98 percent. (refer Background paper 3)

[5] Though expenditure management is not the only problem of improving access to services, better capacity to spend, could help a lot, going forward. During the period of rapid poverty reduction in Peru for example, improved access to services reduced chronic under-five malnutrition in the poorest two quintiles from 75 to 59 percent (2009-13) and raising residential access to public water networks from 71.3 to 83.2 percent (2001-13) did contribute.

56. **The specific policies supported by the DPF series are not likely to have significant effects on Peru's environment, forests, water resources, habitats or other natural resources.** The policy areas covered by the operation are the strengthening of: (i) SNGs management of public spending and fiscal risk; and (ii) the management of public-private partnership (PPPs). The risk of unanticipated adverse effects to the environment and natural resources is very small. Credible scenarios for any significant, direct or indirect negative impacts appear very unlikely. Peru has adequate environmental controls in place and environmental legislation and regulations are aligned with best international practices. In particular, Peru has adopted international guidelines for integrating environmental assessments into project planning and programming for both public and private projects.

V. Tentative financing

Source:		($m.)
Borrower/Recipient		
IBRD		900
Others (specifiy)		
	Total	900

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