Inter-American Development Bank

Board of Executive Directors

For consideration

On or after: 5 December 2007

PR-3212
20 November 2007
Original: Spanish

To: The Board of Executive Directors

From: The Secretary

Subject: Perú. Proposal for a loan for the Program to Improve the Quality of Public Management and Expenditure III

Basic Information:	Loan type	……………………………… Programatic Loan (PBP)
	Borrower	……………………………………… Republic of Peru
	Amount	………………………………… up to US$75,000,000
	Source	……... Single Currency Facility of the Ordinary Capital

Inquiries to: Mr. Carlos C. Pimenta (extensión 1683)

Remarks: As reported to the Board of Executive Directors at its meeting on 10 August 2006, the Office of the Secretary is distributing simultaneously a document (PR-3211-1) containing the text of the electronic links of the above-referenced document.

References: GN-1838-1(7/94), DR-398-5(5/03), CS-3748(11/07)

Other distribution: Representative in Peru

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PERU

PROGRAM TO IMPROVE THE QUALITY OF PUBLIC MANAGEMENT AND EXPENDITURE III

(PE-L1027)

LOAN PROPOSAL

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Basic socioeconomic data	http://www.iadb.org/RES/index.cfm?fuseaction=externallinks.countrydata
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Tentative lending program	http://opsgs1/ABSPRJ/tentativelending.ASP?=PE&L=EN
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Independent macroeconomic assessment	http://ops/idbdocs/docsMain/getdoc.asp?docnumber=1206258

ABBREVIATIONS

COPEX	Comité de Programación de Concertaciones Externas del Sector Público [Programming Committee for Public-sector External Arrangements]
COPRE	Comisión Presidencial de Reforma del Poder Ejecutivo [Presidential Commission on Executive Branch Reform]
DGPM	Dirección General de Programación Multianual del Sector Público [General Directorate of Multiyear Programming for the Public Sector]
DNEP	Dirección Nacional del Endeudamiento Público [National Public-sector Borrowing Office]
DNPP	Dirección Nacional del Presupuesto Público [National Office of the Budget]
GDP	Gross domestic product
IFMS	Integrated Financial Management System
IFMS-PS	Integrated Financial Management System for the Public Sector
IIRSA	Initiative for the Integration of South American Regional Infrastructure
IMF	International Monetary Fund
MEF	Ministry of Economy and Finance
MMF	Multiyear macroeconomic framework
PIP	Public investment project
PPP	Public-private partnership
PRODEV	Program to Implement the External Pillar of the Medium-term Action Plan for Development Effectiveness
PROINVERSION	Agencia de Promoción de la Inversión Privada [Private Investment Promotion Agency]
SNIP	National Public Investment System
SOSEM	Operating System for Monitoring and Evaluation
SSEGP	Public Expenditure Monitoring and Evaluation System
WAL	Weighted average life

PROJECT SUMMARY

PERU
PROGRAM TO IMPROVE THE QUALITY OF PUBLIC MANAGEMENT AND EXPENDITURE III
(PE-L1027)

Financial Terms and Conditions[1]

Borrower: Republic of Peru **Executing agency:** Ministry of Economy and Finance (MEF)			**Amortization period:**	20 years
			Grace period:	5 years
			Interest rate:	LIBOR
			Disbursement period:	12 months
Source	**Amount**	**%**	**Inspection and supervision fee:***	
IDB (Ordinary Capital)	US$75 million	100	**Credit fee:**	**0.25**
			Currency:	U.S. dollars from the Single Currency Facility
			Option of conversion to Peruvian nuevos soles: Local Currency Facility (LCF)	
Total	US$75 million	100		

Project at a Glance

Project objective:
The objective of this third and final operation in the policy-based programmatic series is to complete and consolidate the reforms begun in 2005 to improve the quality of public management and expenditure, to ensure that they are fully operational and sustainable over the long term; to strengthen government capacities to analyze and monitor aspects relating to regulation, public investment, and administrative management; and to promote greater private sector participation alongside the public sector in investment and in service delivery.

Special contractual clauses:
See the Conditionality Matrix in chapter V (paragraph 5.1).

Exceptions to Bank policies:
An exception is requested to the condition regarding interruption of the Bank's access to funding as specified in paragraph 3.15 of the LCF (document GN-2365-2) (see paragraphs 1.4 and 1.5 of Annex II).

Other financial conditions:
To expand the borrower's financing options, conversion into local currency of disbursements and amounts outstanding will be subject to two financial conditions in addition to those established in the LCF: (i) more flexible repayment profiles for disbursements and outstanding balances in local currency; and (ii) pricing based on the Bank's actual funding costs in the event it issues bonds to raise local currency (see paragraph 3.4 of the Loan Proposal and Annex II).
As specified in paragraph 3.9 of document GN-2365-2, the LCF provides for local currency lending to be used for up to five operations/transactions per year. Given that this limit has been met, the Board of Executive Directors is requested to authorize use of the LCF for this operation (see paragraph 3.4).

Project consistent with country strategy:	Yes [X]	No [ ]			
Project qualifies as:	SEQ [ ]	PTI [ ]	Sector [ ]	Geographic [ ]	Headcount [ ]
Verified by CESI on: 8 June 2007					

[1] The interest rate, credit fee, and inspection and supervision fee mentioned in this document are established pursuant to document FN-568-3 Rev. and may be changed by the Board of Executive Directors, taking into account the available background information, as well as the respective Finance Department recommendations. In no case will the credit fee exceed 0.75%, or the inspection and supervision fee exceed 1% of the loan amount.*

* With regard to the inspection and supervision fee, in no case will the charge exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

I. FRAME OF REFERENCE

1.1 This is the third and final loan operation in a policy-based programmatic series, in accordance with documents CA-450-1 and CS-3633. The first operation in this series was approved and disbursed in December 2005 (loan 1699/OC-PE), and the corresponding proposal constitutes the framework document for the programmatic series (PR-2997). The second operation was approved in November and disbursed in December 2006 (loan 1805/OC-PE and proposal PR-3102). This document updates, supplements, and follows up on the first two operations in the series, in accordance with the guidelines set forth in Memorandum EVP/1/2006 (PO-LO-2006) dated 6 March 2006.

A. General context

1.2 In the past five years the Peruvian economy has been characterized by high rates of growth in a fiscally stable environment, with annual economic growth averaging over 5%. In 2006, the gross domestic product grew 7.6%, the nonfinancial public-sector surplus reached 2% of GDP, the rate of inflation was 1.1%, and the exchange rate remained stable. In recent years Peru has also adhered to its agreements with the International Monetary Fund (IMF), and in January 2007 it signed a new Memorandum of Economic and Financial Policies for the 2007-2008 period.

1.3 In September 2007 Peru's net international reserves surpassed US$23 billion, confirming that its international liquidity position is sound and sustainable. This level of reserves represents about 15 months' worth of goods imports. In addition, Peru's current account has strengthened in recent years, from a deficit of 1.5% of GDP in 2003 to a surplus of 2.6% in 2006. In the same year, the country's trade balance recorded a surplus of US$8.934 billion, owing to high international prices for its main export commodities. Moreover, Peru's country risk has decreased in recent years from an average of 199 points in 2005 to 134 in October 2007.

1.4 Public debt at the close of 2006 was US$30.497 billion, including US$21.972 billion in external liabilities and US$8.525 billion in domestic liabilities. As a percentage of GDP, total public debt fell from 44.3% in late 2004 to 32.8% in December 2006[1] and is projected by the Government of Peru to fall to approximately 29.2% by the end of 2007.

1.5 As for the external debt profile, as of the end of 2006, 35.7% of foreign debt was owed to multilateral agencies and 25.6% to bilateral (Paris Club) lenders. Meanwhile, an estimated US$6.239 billion in resources are needed for 2007 (US$3.819 billion from external sources and US$2.420 billion from domestic sources), and US$2.329 billion will be needed for 2008 (US$1.180 billion from external sources and US$1.149 billion from domestic sources). The current debt level is considered sustainable over the medium and long terms, and is indicative of

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[1] This is below the average ratio of its South American neighbors (43.6%) and of countries with a similar risk rating (49.7%).

the success of a sound debt management strategy and of the country's great strides in stabilizing public finances.[2]

1.6 With regard to the level of total domestic investment, recent figures indicate a modest but significant increase. In 2006 public investment reached 2.8% of GDP (4.2% projected for 2007), and private investment was 17.8% (18.6% projected for 2007). The Bank has contributed indirectly to some of the results achieved in recent years by supporting the government through this programmatic series, begun in 2005, to improve the efficiency and impact of public expenditures made alone or in partnership with the private sector, in order to promote high and sustainable rates of investment and growth consistent with inclusive, equitable development. .

B. Specific problems and the country's actions to address them

1.7 General and specific problems were identified in the **framework document** for the programmatic series (PR-2997) in 2005, and progress in addressing them is detailed in chapter II of this document.

C. The Bank's sector and country strategies

1.8 There were no changes in how this program relates to the Modernization of the State Strategy (OP-1004) and Competitiveness Strategy (OP-1005), or to the country strategy (document GN-2205-1), from the **framework document** (PR-2997) for the programmatic series approved in 2005.

D. Program strategy

1.9 **Programmatic approach.** The programmatic approach was justified by the fact that the implementation of reforms warrants a medium- and long-term execution period, and by the change of administration in 2006. The strategy for this third operation is to complete and consolidate the reforms begun in 2005 and continued in 2006 to ensure that they are fully operational and sustainable over the long term.

1.10 **Coordination with other Bank operations.** This third operation in the programmatic series is supported by other Bank projects, such as the: (i) Institutional Sector Facility to Improve the Quality of Public Expenditure and Management in Peru (loan 1696/OC-PE); (ii) PRODEV nonreimbursable technical cooperation operation ATN/OC-9534-PE; and (iii) State Modernization and Decentralization Program (loan 1437/OC-PE).

1.11 The program is also helping to frame policies to strengthen investment in infrastructure with private sector support, which relates to the Guarantee Program for the IIRSA Northern Amazon Hub (loan 1717/OC-PE), approved in February 2006, which is supporting a public-private partnership (PPP) project by providing a guarantee.

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[2] Source of macroeconomic data: revised 2008-2010 Multiyear Macroeconomic Framework (updated August 2007), which is the most important economic document issued by the Government of Peru (http://www.mef.gob.pe).

1.12 **Lessons learned.** The initial operation in this programmatic series, approved in 2005, was the first operation approved by the Bank that was designed from its inception using the programmatic approach. One of the lessons learned is that programmatic series can be effective in promoting the continuity of reform processes during a government transition period, as was the case with this programmatic series. Another important lesson was that in order for policy reforms to take root, in addition to designing and approving rules and agreements (such as laws, decrees, resolutions, directives, regulations, etc.), it is essential to support the government in the introduction and implementation of reforms associated with institutional development, process reviews, and preparation and implementation of methodologies, manuals, and information and training systems. A final conclusion to be drawn is that in Peru's overall technical and political effort to formulate and implement policies, it is essential to support the government both in the development and organization of knowledge and in consensus-building.

E. Coordination with other donors

1.13 In preparing this third operation, the team has maintained a high level of multilateral coordination with specialists from the IMF—through the Fiscal Affairs Department—and with the World Bank Country Office in Lima. In April 2007, the World Bank signed a new loan agreement with the Government of Peru for the first programmatic fiscal management and competitiveness loan in a group of operations consisting of three to four tranches (the first one totaling US$200 million and the others to be determined), whose objective is mainly to support tax reforms and measures to strengthen Peru's international trade. Also included are some financial management and results-based budgeting measures that supplement or reinforce the activities that the IDB is supporting through this operation.

1.14 The IMF is also supporting the Ministry of Economy and Finance (MEF) through technical assistance in financial management and results-based budgeting that is compatible and coordinated with this operation. The IDB team also delivered a presentation at the April 2007 seminar "Towards Results-Based Budgeting in Peru," organized by the MEF with the participation of the World Bank and the IMF and attended by more than 350 participants from the national government and regional governments.

II. THE PROGRAM

A. Objectives and description

2.1 The objective of this third and final operation in the programmatic series is to complete and consolidate the reforms to improve the quality of public management and expenditure, begun in 2005, to ensure that they are fully operational and sustainable over the long term; to help strengthen government capacities to analyze and monitor aspects relating to regulation, budget, public investment, and administrative management; and to promote greater private sector participation alongside the public sector in investment and in service delivery.

2.2 Implementation of these reforms presupposes a stable macroeconomic environment, compatible with the program's objectives and consistent with the forecasts in the 2008-2010 Multiyear Macroeconomic Framework (MMF) (http://www.mef.gob.pe). The amounts proposed are in line with government forecasts in terms of external financing needs for this year and the coming years, and with the financing needs for 2007 set out in Bank programming.[3]

2.3 As stated in paragraph 1.5, Peru needs US$3.819 billion in external resources for 2007 (US$3.130 billion in untied funds, US$600 million in investment projects, and US$89 million in other resources), and US$1.180 billion for 2008 (US$540 million in untied funds, US$600 million in investment projects, and US$40 million in other resources). The untied funds needed for 2007 (increased by a prepayment to the Paris Club) would be covered by the sovereign bond issue[4] and support from multilateral agencies. A sources and uses matrix may be found in Table 8 of the 2008-2010 MMF (http://www.mef.gob.pe).

B. Components

2.4 This section describes each program component and the triggers set in the second operation, which was disbursed in December 2006 (1805/OC-PE). This section also presents the progress made in each specific component and subcomponent, as well as a description of activities by the Peruvian government to fulfill all of its commitments during the first half of 2008. The final commitments, adjusted during the technical coordination meetings held with the MEF in 2007, are shown in the table under paragraph 5.1. The impacts of the programmatic series can be found in the **Outcomes Matrix** (Annex I).

1. Macroeconomic stability

2.5 The objective of this component is to continue to ensure a macroeconomic environment consistent with program objectives. Fulfillment of this condition will be confirmed through information supplied by the MEF on progress in implementing its economic policy, including, among other things, the results of the new Memorandum of Economic and Financial Policies signed with the IMF for the 2007-2008 period. Also, in May 2007 the Bank approved its **independent macroeconomic assessment** for Peru.

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[3] The US$350 million in Bank disbursements of untied resources for 2007 would be covered by US$200 million from the Water Resources Reform Program I (PE-L1024) and US$150 million from the last tranche of the 2004 Poverty Alleviation and Human Capital Development Program (loan 1600/OC-PE). Bank disbursements for 2008 are to total US$250 million: US$75 million from this operation, US$100 million from the Sanitation Sector Reform Programmatic Series I (PE-L1025), and US$75 million from the Water Resources Reform Program II.

[4] On 19 July 2007, the Government of Peru issued 4.750 billion nuevos soles (US$1.504 billion equivalent) in bonds.

2. Private-sector participation in public investment

2.6 The **general objective** of this component is to achieve a sustainable increase in the quantity and quality of investment in the country's infrastructure, through greater participation by the private sector in public investment, and to make investment more efficient. To this end, the program will support policy actions designed to establish a conceptual model for PPPs that will promote fiscally prudent efficiency in public expenditure.

2.7 The **specific objective** of this component in this **third operation** is to promote the strengthening and sustainability of the institutional, fiscal, and accounting rules for PPPs implemented in the first two operations of this programmatic series, and to verify that these rules are applied in selecting and designing PPPs, with effective systems for identifying, assessing, and mitigating risks.

2.8 The **triggers** for private-sector participation in public investment, established in the second operation in 2006, were: (i) the new institutional, operational, legal, and regulatory framework for PPPs, including implementation of specific methodologies for measuring value for money and assessing contingent liabilities, is being applied to new PPP projects; and (ii) the system for recording PPP liabilities and guarantees includes information on actual and contingent liabilities for all PPP projects being executed by the national government, and it is being used by sector agencies as well.

2.9 In promoting private investment in partnership with the public sector in a context of fiscal prudence and transparency, the MEF has made significant progress in applying institutional, fiscal, and accounting rules established in the two previous operations of this programmatic series, through a process of continual improvement in processes, methodologies, and record-keeping for a broad PPP portfolio.

2.10 **Institutional aspects**. Supreme Decree 104-2007-EF of July 2007 approved the "Guidelines for the Provision of Public Services through Investment Projects Involving Cofinanced Concessions," established initially by Supreme Decree 200-2006-EF of December 2006. This document clearly defines the institutional responsibilities for the entire project cycle for new public investment projects (PIPs) involving PPPs (or "cofinanced concessions"), including project identification, appraisal, approval, design, promotion, procurement, and supervision. In this model, the MEF gives its approval, after appraisal, for a project to move to the phase of promoting private-sector participation, and the Private Investment Promotion Agency (PROINVERSION) serves as the liaison with the private sector, examining, selecting, and contracting concessionaires.

2.11 Under this new project cycle, the MEF is developing the public-private comparator methodology, which will help determine whether an investment project should be implemented using the PPP approach or the traditional public investment approach, based on a value-for-money analysis of the various alternatives proposed. Nevertheless, the MEF is coordinating with private concession grantors and

PROINVERSION to set initial criteria and parameters for evaluating the advantages of executing investment projects using the PPP approach.

2.12 Recently, the MEF applied such criteria and parameters in preinvestment studies for 13 highway projects under the Costa–Sierra Program, of which only five were feasible as PPPs (or "cofinanced concessions"). The lessons learned in this process are being incorporated into the preparation of the public-private comparator methodology.

2.13 **Fiscal and accounting aspects.** The statutory ceiling of 0.5% of GDP (about US$500 million per year) on annual payments of firm and contingent financial liabilities by the national government for PPPs remains in effect, monitored, and fully respected, and the MMF annually publishes the list of active PPPs and the corresponding financial commitments.

2.14 In addition, in order to improve transparency in the way liabilities associated with PPP projects are recorded and calculated, the MEF, through Ministerial Resolution 496-2007-EF/75, ordered the quantification and recording of actual and contingent liabilities and of the income associated with projects of this type, after which the Directorate General of Economic and Social Affairs (DGAES) of the MEF, in Agency Resolution 004-2007-EF/65.01, approved the methodology for assessing quantifiable contingent liabilities.

2.15 Meanwhile, the system for recording PPP liabilities and guarantees has been implemented satisfactorily by the MEF's National Public-sector Borrowing Office (DNEP): all actual liabilities corresponding to cofinanced concessions already granted have been fully recorded, and the preliminary projection of the respective contingent liabilities has been completed, while work is under way on the interface with the Integrated Debt Management System. Coordination for implementation of the recording system in the sectors agencies and regional and local governments and related training will begin this year, starting with the Ministry of Transportation and Communications.

2.16 **Concessioned PPP projects.** Five projects for approximately US$1.150 billion have been awarded as PPPs (the Olmos, Interoceanic, and Northern Amazon highways; the port of Callao; and regional airports) and are being supervised by the respective regulatory agencies.

2.17 **PPP projects in preparation.** Four PPP projects are being analyzed for 2007 and 2008 (Costa–Sierra highway, Regional Airports Package 2, Huachipa treatment plant, and Piura–Paita sanitation services) for a total sum estimated at over US$700 million. All four operations are being processed according to the new institutional, operational, and fiscal framework for PPPs, which includes an analysis of their economic and social viability and of the advisability of their being executed as PPPs.

3. Public expenditure management at the national level

2.18 The **general objective** of this component is to help strengthen the national government's capacity to manage, analyze, prioritize, execute, monitor, and evaluate public spending, primarily capital spending. The component is divided into four subcomponents: (i) results-based budgeting and the Public Expenditure Monitoring and Evaluation System (SSEGP); (ii) the National Public Investment System (SNIP); (iii) regulatory quality; and (iv) administrative management.

2.19 The **specific objective** of this component in this **third operation** is to fine-tune implementation of the **results-based budgeting** model, help decentralize the **SNIP**, continue to implement the mechanisms for evaluating and monitoring the **quality of regulatory output** and make them sustainable, and continue to modernize the financial, government procurement, and payroll **administrative management systems**.

2.20 **Results-based budgeting and monitoring and evaluation of public expenditure.** To modernize the budget management system and create performance incentives for optimal resource allocation and execution, the second operation established as a trigger a results-based budget, to include the following aspects: (i) development and application of a budget programming methodology in five national government units that incorporates results-based budgeting concepts and instruments and lessons learned in the 2006 cost-based budgeting pilot programs; (ii) design of a competitive fund for regional and local-government PIPs; (iii) evaluation of results-based management contracts, and an increase in the number of such contracts signed and being executed; (iv) information entered in the SSEGP by all sectors, allowing for consolidated monitoring and evaluation reports to be generated that provide feedback for the budget formulation process; (v) on-schedule implementation of an action plan for results-based management; and (vi) implementation of a pilot program for evaluating institutional management.

2.21 Two laws passed at the end of 2006 established the policy framework for improving the budget management system: Law 28927 (Public Sector Budget Act for Fiscal Year 2007) and Law 28939 (which approves supplemental appropriations and the transfer of line items in the public sector budget for fiscal year 2006 and provides for the establishment of various funds). Chapter IV of Law 28927 lays the foundations for the implementation of results-based budgeting and calls for a process of gradual implementation in all government agencies, while Law 28939 provides for the establishment of the Regional and Local Public Investment Promotion Fund (FONIPREL). The actions under way for this subcomponent are detailed below.

2.22 *Results-based budgeting.* The National Office of the Budget (DNPP) reviewed and adjusted the cost-based budgeting methodology piloted at the National Agricultural Health Service (SENASA) during 2006 in order to have methodologies and instruments that would facilitate the implementation of results-based budgeting in five priority sectors: Ministry of Health, Ministry of Education, Ministry of

Transportation and Communications, Ministry of Women's Issues and Social Development, and the National Identification and Civil Status Registry. The methodology designed for strategic budget programming (an instrument defined as a component of the results-based budgeting action plan) was developed and approved through Agency Resolutions 024- and 027-2007-EF/76.01, the Directive on Public-Sector Budget Programming and Formulation, and the Directive on Strategic Programs Budget Programming and Formulation in the context of results-based budgeting for 2008. This methodology is based on application of the logical model approach to the design, execution, monitoring, and evaluation of public expenditure and includes the identification and analysis of problems affecting the population, including causes and solutions, and the determination of desirable and expected outcomes.

2.23 *Competitive resources.* In March 2007, pursuant to Law 28939, the government submitted a bill to the Congress for implementation and operation of the FONIPREL fund. The regulatory framework for operation of the FONIPREL is expected to be completed in the coming months with passage of the law and approval of its implementing regulations. These instruments will allow management and operation of the fund to be regulated and will establish the resource allocation criteria and priority areas for both investment projects and preinvestment studies.

2.24 *Results-based management contracts.* From 2002 to 2006, 239 results-based management contracts were signed with expenditure executing units of various government agencies. In accordance with Law 28927 provisions concerning strategic planning and outcome metrics, the MEF is reviewing the results-based management contract methodology to enhance its application by incorporating service-quality and transparency indicators that are better integrated with other public-sector management instruments. Thus far, two evaluations of results-based management contracts have been conducted, and the findings are supporting the MEF's methodology review. The new model for results-based management contracts will likely be geared to the strategic programs given priority under the results-based budget.

2.25 *The Public Expenditure Monitoring and Evaluation System (SSEGP).* With respect to monitoring, the sector agencies are continuing to report their performance indicators to the DNPP in accordance with the Directive on Public-Sector Budget Programming and Formulation for 2008, and this information has been used in the results-based budgeting process. In addition, as regards evaluation, information for evaluating agency budgets is continuing to be entered in the system. Both evaluation and monitoring will be strengthened through the directive on the SSEGP that the DNPP will issue in late 2007.

2.26 *Action plan for results-based management***.** The MEF is finalizing a results-based management plan that consolidates and links all existing strategies and plans relating to budgeting, financial management, public investment, procurement, auditing, planning, evaluation, monitoring, and national statistics, and includes a

consensus-building process and the identification of financial resources for its implementation. The DNPP has developed a results-based budgeting action plan, which, together with the "Guidelines for Results-based Public Management," approved in 2006 by the Advisory Committee for Strengthening Results-based Management, constitutes the basis for development of the results-based management action plan. The PRODEV technical-cooperation project (ATN/OC-9534-PE) supports this activity, and approval of the aforementioned plan would make Peru eligible for a second technical-cooperation project with resources from PRODEV Account B.

2.27 *Institutional evaluation pilot project.* Institutional management evaluations are to be conducted as part of the results-based budgeting action plan. The pilot project will evaluate a social safety-net program—the National Program of Direct Support to the Indigent (JUNTOS). This evaluation will cover all aspects related to program organization, operation, and management.

2.28 **National Public Investment System (SNIP)**. To strengthen the process of analyzing, prioritizing, executing, monitoring, and evaluating public investment in order to improve efficiency and quality, the following triggers were established during the second operation: (i) the MMF includes overall ceilings for public investment loan disbursements for 2008-2010, as well as for contingent and actual liabilities associated with PPP operations; (ii) the Operating System for Monitoring and Evaluation (SOSEM) incorporates information on execution of sector and regional-government projects; (iii) an ex post evaluation methodology is approved; and (iv) preinvestment financing mechanisms have been fully established.

2.29 The SNIP is operating at all three levels of government (in all sectors of the national government, regional governments, and more than 470 local governments). Since its establishment in 2000, more than 30,000 PIPs have been declared feasible, and 10,000 professionals have received training in social evaluation under the SNIP. In December 2006, Supreme Decree 221-2006-EF, containing implementing regulations for Law 28802—the law amending the SNIP—was approved. This decree decentralized the responsibility for declaring PIPs feasible to the national government's sector agencies and to the regional and local governments. This notwithstanding, the MEF, through the General Directorate of Multiyear Programming for the Public Sector (DGPM), continues to be the highest technical/regulatory authority for the SNIP. It establishes the technical standards and minimum levels of study required, and retains the authority to evaluate and declare the feasibility of projects requiring borrowing or a government endorsement or guarantee. In addition, the DGPM is implementing measures to further simplify and enhance the efficiency of the system, such as developing model profiles for sanitation, education, health, and transportation. With these profiles, projects will be approved while only at the study level, which will significantly shorten the

development and appraisal periods.[5] The actions under way for this subcomponent are detailed below.

2.30 *Limits on external debt and actual and contingent liabilities for PPPs.* The 2008–2010 Three-Year External Disbursement Schedule (published on the MEF website) includes the overall ceilings for public investment loan disbursements for the period, and the 2008–2010 MMF, approved by the Council of Ministers, includes limits on the contingent and actual liabilities associated with PPP operations.

2.31 *Public Investment Information System – SNIP Net (Project Bank and SOSEM).* This activity has been expanded to also include the Project Bank (http://www.mef.gob.pe/DGPM/snipnet.php), which contains some 41,000 PIP profiles that are freely accessible via the Internet, including information with the status of a sworn statement on all projects under national government sector agencies and regional governments. In addition, as a result of decentralization of the SNIP and the new evaluation system framework set forth in Law 28802, the MEF has reviewed SOSEM (set of processes, tools, and indicators used to verify progress in execution of PIPs). As specified in the new SNIP regulations and the respective General Directive, the DGPM and the investment programming offices are authorized to carry out coordinated physical and financial monitoring of PIPs, based on the definition of benchmarks for the beginning and end of the investment phase, the concept of "verification of viability" for monitoring during the investment phase (investment amount, physical targets, technical alternatives, components, and changes in institutional arrangements, etc.), and preparation of the closing report. In addition, given that the adaptation of SOSEM must in principle allow for its integration into the government procurement system, the Directive on Public-Sector Budget Programming and Formulation for 2008 provided for the creation of new budget codes for the PIPs to be executed beginning in 2008.

2.32 *Ex post evaluation of PIPs.* The DGPM plans to develop a guide for the preparation of baselines and ex post evaluations for PIPs that also includes guidelines for results-based monitoring. Accordingly, the following will be prepared: (i) a document summarizing commonly accepted concepts and terminology based on international standards in this subject area, in order to have a common conceptual basis; (ii) a general methodological guide for the preparation of baselines and ex post evaluations of PIPs that will be illustrated with brief examples applied to selected projects; and (iii) a specific guide to the preparation of baselines and impact assessments for a specific type of PIPs, detailing the steps to follow and the methodological procedures and instruments to apply.

2.33 *Preinvestment mechanisms.* The study "Design of Preinvestment Financing Mechanisms for Public Investment Projects," now complete, reviews and

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[5] Emergency Decree 014-2007 of 10 May 2007 declared an emergency for the PIPs in some sectors and authorized feasibility to be declared on approval of a comprehensive profile by 31 December 2007, the minimum content of which must be approved by the national government sector agencies in coordination with the MEF.

systematizes international experience in preinvestment financing, analyzes the perceptions of public officials at various levels of government on this subject, and proposes a number of preinvestment financing mechanisms for the nonfinancial public sector, mainly regional and local governments. In the case of the latter, given the proposals designed, the MEF is pushing for the approval of FONIPREL in order to finance or cofinance public investment projects or preinvestment studies. In addition, provisions have been incorporated in the budget bill for 2008 that authorize budgetary units to earmark 5% of shareout or investment resources for the preparation of investment profiles.

2.34 **Regulatory quality.** Activities in this area are intended to enhance the transparency, efficiency, and quality of regulations in general, through adoption of an institutional and operational system of filtering procedures for quality control, including developing methodologies for economic and legal impact analysis of regulatory output. Implementation of the institutional and operational approach for regulatory quality control in two additional entities was set as a trigger during the second operation, as was evaluation of implementation of this approach in the pilot programs at the MEF, Ministry of Health, and Ministry of Labor and Employment Promotion.

2.35 In 2007, the MEF launched the pilot program to enhance regulatory quality at two additional agencies—the Ministry of Production and the Ministry of Energy and Mines—with the review of some policies regarding specific regulations, as proposed by those agencies. At the same time, the MEF continues to support the ministries that worked on the 2006 pilot. For instance, it is helping the Ministry of Labor and Employment Promotion to prepare the guide for assessing the impact of regulatory output in the sector. In addition, the MEF and the Ministry of Health have implemented their regulatory quality procedures through manuals or standards for the preparation of regulatory documents.

2.36 The MEF is also coordinating efforts with the Ministry of Justice to amend the regulations for the Framework Law on Legislative Output and Systematization (Supreme Decree 008-2006-JUS) to require economic and legal bases for approval of national government regulations, thus incorporating the lessons learned from the pilot programs, the MEF manual on economic and legal analysis of regulatory output, and the Ministry of Health policies for the preparation of regulatory documents.

2.37 **Administrative management.** In order to streamline and simplify procedures relating to crosscutting management systems (or government administrative systems) in line with the regulations issued by their governing bodies, a gradual strategy was developed, beginning with modernization of the Integrated Financial Management System for the Public Sector (IFMS-PS) and followed by the inclusion of other systems. The following related triggers were established during the second operation: (i) inclusion of a new crosscutting management system for modernization, possibly the Civil Service Payroll System; (ii) action plan for modernizing the IFMS-PS developed based on an independent evaluation and

implemented according to the timetable agreed upon with the Bank; (iii) chart of accounts brought into line with budget classifications; and (iv) action plan for the consolidated account being implemented.

2.38 The MEF is making significant progress in modernizing several administrative systems, such as payroll auditing; the IFMS (including the chart of accounts and the consolidated cash account); and in government procurement. In addition, Supreme Decree 040-2007-PCM, of April 2007, established that the head of the MEF Cabinet of Advisors is responsible for promoting and coordinating the implementation and monitoring of actions to enhance the operation of government administrative systems, through monthly reports to the Presidential Commission on Executive Branch Reform (COPRE). Actions under way for this subcomponent are detailed below.

2.39 *Civil Service Payroll*. In 2006, employee compensation represented 28.3% of nonfinancial current expenditure, or 4.2% of GDP, warranting centralized monitoring of this category of spending. Accordingly, the MEF is enhancing the Payroll Auditing Module (MCPP) of the IFMS in order to increase monitoring and transparency with respect to national government personnel costs. The objective of the MCPP is to configure a database with information, updated monthly, on the remuneration of each national government employee based on data imported from the sector payrolls. The MCPP checks the identity of each employee included in the sector payrolls with the National Identification and Civil Status Registry, which allows for verification that the names of employees who have died have been removed from the system, and also for checking each employee's national identity documents against the respective accounts in the banks that receive salary payments.

2.40 *Modernization of the IFMS*. With the assistance of an international consulting firm hired in 2007, the MEF has prepared and is seeking agreement on a comprehensive modernization strategy for the IFMS, based on an independent evaluation calling for the incorporation of modules, a change in technology architecture, and technical, functional, and economic feasibility analysis of different alternative solutions. The IFMS modernization plan will include precise definitions as regards the future data-processing architecture and will develop greater integration with other management information systems, such as the Electronic Government Procurement System (SEACE) of the Executive Council on Government Procurement (CONSUCODE), the Operating System for Monitoring and Evaluation (SOSEM) of the DGPM/SNIP, and the Public Expenditure Monitoring and Evaluation System (SSEGP) of the DNPP.

2.41 *Chart of accounts and consolidated account.* Together with the DNPP, the National Public Accounting Office (DNCP) has prepared a proposal for harmonizing budget classifications with the chart of accounts that is in the process of final revision for application beginning in 2008. With respect to the consolidated cash account, Law 29035 (which authorizes supplementary appropriations in the public sector budget for fiscal year 2007 and enacts other measures) included provisions for regional and

local governments to deposit new transfers and resources from mining shareouts, supplemental shareouts, and royalties with Banco de la Nación, and for national financial system institutions to report movements and/or balances of public funds in general to the National Office of the Treasury (DNTP). These are among the measures that are being implemented in order to establish the consolidated account by the end of 2007, which would allow for increased efficiency in cash management while maintaining the autonomy of the different levels of government.

2.42 *Procurement*. A joint IDB–World Bank mission visited Peru in March 2007 and assisted the government in preparing a proposed medium-term reform plan for the government procurement system. On the basis of this plan, the Peruvian government has adopted reform measures including reorganizing the Executive Council on Government Procurement and submitting a new bill on government procurement to the Congress. In addition, the government would, as appropriate, include actions under the reform plan in the action plan for results-based management mentioned in earlier paragraphs.

4. Public expenditure management in the context of decentralization

2.43 The **general objective** of this component is to promote stable and sustained revenue transfers by the national government to the regional and local governments and to improve the quality of expenditure management at this level of government. Also, progress in decentralization should be evaluated from an economic perspective, based on indicators of economic activity. This component has three subcomponents: (i) fiscal stabilization and regional economic growth; (ii) incentives-based budgetary reform; and (iii) public investment at the regional level.

2.44 The **specific objective** of this component in this **third operation** is to make progress in **stabilizing the execution** of transfers to regional and local governments and promote better **regional compensation**, promote sustainability in the preparation of **indices** of regional economic activity, begin implementing the criteria for **incentives-based budgetary reform**, and continue to build **regional governments' investment analysis capacity**.

2.45 **Fiscal stabilization and regional economic growth**. The triggers established during the second operation are: (i) the MEF document analyzing the stability of transfers (condition 10(i) of 2006) has been updated; and the fund to improve regional compensation has been established; and (ii) the index of regional economic activity has been calculated for all departments for 2006.

2.46 The *fund to stabilize transfers* to regional and local governments, originally proposed by the MEF in the first operation of this programmatic series, did not receive the necessary political support in Congress for its approval. Nevertheless, other factors and measures are helping to achieve similar results, such as the application of technical and administrative systems, creation of the FONIPREL, and activation of the Regional Compensation Fund (FONCOR).

2.47 With respect to administrative systems, although capital expenditure by regional and local governments accelerated in relation to revenue transfers during 2006, transferred resources deposited with the financial system are continuing to accumulate, owing to compliance with various technical and administrative rules for the design, feasibility, and execution of PIPs.

2.48 As mentioned earlier, the MEF won legal approval in December 2006 for establishing the FONIPREL, with 650 million soles in competitive funds, to support regional and local governments—preferably those not receiving support from shareouts—by providing resources for investment projects and preinvestment studies. The FONIPREL will distribute resources to regional and local governments that submit investment projects approved in accordance with the bidding conditions set by its board of directors. The bill implementing and regulating operation of the FONIPREL was sent to the Congress in March 2007; it provides for resources to be transferred from this fund in inverse proportion to the allocations from shareouts and other transfers, effectively helping to improve the interregional equity of transfers. Lastly, the FONIPREL will have a preinvestment window, to help regional and local governments with the formulation of investment projects.

2.49 With regard to the FONCOR, in August 2007 the MEF issued Ministerial Resolution 484-2007-EF/15, approving new distribution ratios for the fund in order to correct distortions in the distribution of resources transferred by the national government to regional governments. Owing to their characteristics, the two funds substitute for the original proposal for a stabilization fund for transfers from the national government to regional and municipal governments.

2.50 As for the index of regional economic activity for 2006, as agreed upon with the MEF, the National Institute of Statistics and Data Processing (INEI) has calculated the GDP by department for 2006, published the 2001-2006 series, and expects to continue to do so from now on.

2.51 **Incentives-based budgetary reform**: The trigger established during the second operation was that the 2008 budget would call for implementation of an action plan for budget reform in national government agencies to be decentralized that year, and would contain preliminary multiyear forecasts consistent with the action plan. With the action plan, the transfer of services from the national government to regional or municipal governments would have a fiscally neutral impact.

2.52 The guidelines for identifying and quantifying resources associated with the transfer of functions, funds, programs, and projects to regional and local governments were published in December 2006 through Ministerial Resolution 664-2006-EF/10, which established that the various ministerial agencies were to quantify the costs of the functions expected to be decentralized to those levels of government. This resolution was ratified through the Directive on Public-Sector Budget Programming and Formulation for 2008, approved by Agency Resolution 024-2007-EF/76.01. This work is being done by the DNPP, so that the MEF can

prepare the corresponding multiyear action plan (2008–2010).[6] This calculation is essential to gradually adjusting the national government budget, in step with the transfer of services. Meanwhile, in February 2007, Emergency Decree 005-2007 was approved, providing for future needs in terms of personnel transfers from various sector agencies as part of the decentralization process, and a bill amending Law 276 for the same purpose was submitted to the Congress.

2.53 **National Public Investment System at the regional level**. The trigger established during the second operation was evidence of an improvement in the quality of investment projects declared feasible by the regional governments.

2.54 Progress is being made in the quality of public investment spending at the regional and local level (which exceeds public investment spending by the national government), mainly as a result of massive technical assistance and training provided to regional and local governments. More than 6,000 officials have been trained in the past two years and various methodological guidelines and procedures have been posted on the MEF website. To monitor the quality of this expenditure, the MEF, through the DGPM, will make annual sample-based evaluations of the declarations of feasibility by the competent bodies of the SNIP, including regional and local governments. This will enable it to verify progress and take corrective action as appropriate.

C. Cost and financing

2.55 This is the third and final operation in the programmatic series of policy-based loans for improving the management and quality of public expenditure in Peru, and will be disbursed in a single tranche of US$75 million during the first half of 2008.

III. PROGRAM IMPLEMENTATION

A. Borrower and executing agency

3.1 The borrower is the Republic of Peru, and the executing agency is the Ministry of Economy and Finance (MEF). The National Public-sector Borrowing Office (DNEP) is responsible for negotiating the financial aspects of the operation, while the Sector Lending Coordination Unit (UCPS) will coordinate technical aspects of the program. Technical responsibilities will be shared by the various MEF units as set forth in the **framework document** (PR-2997) of 2005 and updated in the document for the second operation in 2006 (PR-3102).

B. Program and programmatic series execution and management

3.2 Virtually all technical actions and decisions needed to implement the program are under the jurisdiction and leadership of the MEF, which, through each of the

[6] To include quantification, timetable for transfers, easing of civil service restrictions to allow for personnel transfers, fiscal decentralization, and periodic evaluation and updating of the plan.

corresponding bodies, will be responsible for adopting decisions and implementing specific measures.

3.3 This is the third and final operation of the programmatic series begun in 2005, and the work plan has been adhered to thus far.

C. Local Currency Facility

3.4 The Government of Peru has made a request to the Bank for use of the Local Currency Facility (LCF). The Program to Improve the Quality of Public Management and Expenditure III will be implemented with United States dollars from the Single Currency Facility of the Bank's Ordinary Capital and will be subject to the Operational Framework for Lending in Local Currency (document GN-2365-2). To ensure the possibility of minimizing foreign exchange risk, the Government of Peru would be entitled, under the provisions of the LCF, to convert disbursements and outstanding balances into nuevos soles. To expand the borrower's financing options, the conversion of disbursements and amounts outstanding into local currency will be subject to two financial conditions in addition to those established in the LCF: (i) more flexible repayment profiles for disbursements and outstanding balances in local currency; and (ii) pricing based on the Bank's actual funding costs in the event it issues bonds to raise local currency. These conditions are expanded on and justified in Annex II and its Appendices, as is the exception to the LCF regarding the nonapplicability of the clause relating to interruptions in the Bank's funding. As specified in paragraph 3.9 of document GN-2365-2, the LCF provides for local currency lending to be used for up to five operations/transactions per year.[7] Given that this limit has been met, the Board of Executive Directors is requested to authorize use of the LCF for this operation, using resources from the Single Currency Facility of the Bank's Ordinary Capital, in order to meet the need expressed by the Government of Peru to develop a public borrowing strategy with increasing local currency components.

D. Monitoring and evaluation

3.5 There were no changes in the monitoring and evaluation mechanisms approved in the 2005 framework document for the programmatic series, and, pursuant to Memorandum EVP/1/2006 (PO-LO-2006) sent to the Loan Committee on 6 March 2006, project performance monitoring reports will be prepared annually, one for each operation; and a single project completion report will be prepared at the end of the programmatic series.

E. Analysis of initial outcomes of the programmatic series

3.6 Early indications suggest that the impacts of this programmatic series, which are presented in the **Outcomes Matrix** and are expected to materialize between 2008

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[7] The five operations for which the Board of Executive Directors has authorized use of the LCF are: PR-3153 (Brazil); PR-3102-2 and PR-3167 (Peru); and PR-3171 and PR-3173 (Chile).

and 2011, are very likely to be achieved, and the Government of Peru has expressed its intention to continue to monitor the evolution of these outcomes.

3.7 The **gross fixed investment rate**—with a baseline of 18.6% of GDP in 2004 (public and private investment)—was expected to rise to 25% of GDP in 2008, and recent figures point to rates of 18.9% (2005), 20.6% (2006), and 22.9% (2007 estimate), leveraged by public investment, both alone and through public-private partnerships (PPPs). Meanwhile, **investment in infrastructure** (public and private) was expected to increase to at least 2% of GDP in 2008 (baseline 1.5% of GDP in 2003); and recent figures indicate that this estimate will be surpassed. Lastly, the **share of investment in public expenditure**, identified as 16.3% of general government expenditure in 2005 (baseline), was estimated to be 26.6% for 2008, and recent figures were 17.2% (2006) and 22.8% (2007 estimate).

F. Policy letter

3.8 The Bank and the Government of Peru have agreed on the sector and macroeconomic policies in the policy letter sent by the MEF in 2005 and its updates for 2006 and 2007 (see link).

IV. VIABILITY AND RISKS

A. Institutional and socioeconomic viability

4.1 There have been no changes in the institutional and socioeconomic viability described in the 2005 **framework document** for the programmatic series.

B. Environmental and social impact

4.2 The program has no adverse social or environmental impacts. The institutional capacity of the concessioning agencies has been strengthened during implementation of the PPP processes. Specifically, the Ministry of Transportation and Communications has an Environmental Affairs Department that is being strengthened through the Highway Rehabilitation and Improvement Program (PE-0197) and the Departmental Roads Program (PE-0236); and PROINVERSION has a Social and Community Affairs Department (DASC) responsible for community consultation and dissemination processes. Likewise, the Supervisory Agency for Investment in Public Transport Infrastructure (OSITRAN) has incorporated mechanisms to monitor compliance with social and environmental commitments in concession contracts. The Committee on Environment and Social Impact has classified the program as a category "C" operation.

C. Benefits and beneficiaries

4.3 There have been no changes in the benefits and beneficiaries described in the 2005 **framework document** for the programmatic series.

D. Risks

4.4 Three main risks were identified in 2005, and can be summarized as: (a) lack of political support; (b) institutional implementation problems; and (c) insufficient interagency coordination in planning and evaluation, considering the proposed process for institutionalizing a new National Strategic Planning System. In 2006 a new, fourth risk was identified in relation to the MEF's loss of authority to declare PIPs technically viable, which could undermine the quality of the SNIP. Thus far none of these risks has materialized to the point of endangering the achievement of the proposed policy objectives, and hence they are not expected to be an obstacle to the planned series of reforms.

4.5 As for the risk identified in 2006, relating to the decentralization of the SNIP, the MEF continues to have the authority to declare externally financed investment projects technically feasible, while the authority to declare feasibility for other projects has been decentralized to the programming and investment offices of each national government ministry and to the regional and local governments. This decentralization is not expected to adversely affect the quality of projects, since the MEF, through the DGPM, continues to be the lead agency of the SNIP, and the amendments to Emergency Decree 14, of 10 May 2007, have strengthened the MEF's position in this process.

V. POLICY AND CONDITIONALITY MATRIX

5.1 The policy matrix consolidates all the reform objectives and actions for the 2005-2008 period. The commitments for the third programmatic operation (this loan) were established based on the review of triggers established in 2006, and are consolidated in the **Conditionality Matrix** for 2007 below. The adjustments resulting from this review process were minimal, and the rationale for them is presented in chapter II under each specific component and subcomponent.

Disbursement conditions for 2007	Means of verification
1. The overall **macroeconomic policy** framework is consistent with the program objectives and the guidelines established in the sector policy letter.	**Information** provided by the MEF and the independent evaluation report from the Bank
2. **Private-sector participation in public investment**: (i) the public-private comparator methodology, which includes the concept of measuring value for money applied to new PPP projects, has been approved; (ii) the methodology for assessment of PPP contingent liabilities has been approved; and (iii) the module for recording PPP liabilities and guarantees includes information on actual and contingent liabilities of all active PPP projects and its use is extended to the transport sector.	(i) **DGPM directive** approving application of the public-private comparator methodology, using the concept of value for money; (ii) **ministerial resolution** approving provisions on the quantification and recording of actual and contingent liabilities, and **agency resolution** approving the methodology for assessment of quantifiable contingent liabilities, published in the Official Gazette *El Peruano*; and (iii) Bank verification that information on all actual and contingent PPP commitments is entered in the **recording system**, that the Ministry of Transportation and Communications has access to the system, and that the interface with the Integrated Debt Management System is in operation.

Disbursement conditions for 2007	Means of verification
3. **Results-based budgeting and monitoring and evaluation of public expenditure**: (i) a budget programming methodology that incorporates results-based budgeting concepts and instruments and lessons learned in the cost-based budgeting pilot programs in 2006 has been developed and is being applied in five national government budgetary units; (ii) a competitive fund for regional and local government PIPs has been designed; (iii) the strategy of results-based management contracts has been evaluated and the new model for such contracts has been adopted; (iv) information entered in the SSEGP makes it easier to link the evaluation and budget formulation processes; (v) an action plan for results-based management approved and agreed on with the government is being implemented; and (vi) a pilot program for evaluating institutional management has been implemented.	(i) **DNPP directives** on programming and formulating the 2008 budget and on results-based budgeting, which include results-based budgeting criteria, published in the Official Gazette *El Peruano*, and the public sector **budget bill** submitted to Congress for fiscal year 2008, incorporating these criteria; (ii) **bill** submitted to Congress for implementation of the Regional and Local Public Investment Promotion Fund (**FONIPREL**); (iii) evaluation **document,** and **DNPP agency resolution** approving the new model for results-based management contracts published in the Official Gazette *El Peruano*; (iv) **DNPP directive** on the SSEGP providing for a mechanism for effective feedback between the evaluation and budgeting processes; (v) **action plan for results-based management** approved by the COPRE through a **memorandum** and published on the MEF website; and (vi) **document** on the pilot program, approved by the DNPP.
4. **National Public Investment System** (SNIP): (i) the 2008–2010 Three-Year External Disbursement Schedule includes the overall ceilings for public investment loan disbursements for the period, and the 2008–2010 Multiyear Macroeconomic Framework (MMF) includes contingent and actual liabilities associated with PPP operations; (ii) the Public Investment Information System – SNIP Net (Project Bank and SOSEM) incorporates information on sector and regional government projects; (iii) the conceptual and methodological framework for ex post evaluation of PIPs is approved; and (iv) preinvestment financing mechanisms have been established at the regional and local government levels.	(i) The **2008–2010 Three-Year External Disbursement Schedule** and the **2008–2010 MMF** published on the MEF website; (ii) Bank **verification** of use of the public investment information system, and the **DGPM agency resolution** published in the Official Gazette *El Peruano*; (iii) **document** containing concepts and terminology for ex post evaluation of PIPs, approved by the DGPM; and (iv) **2007 law approving supplemental appropriations,** published in the Official Gazette *El Peruano*, and the public sector **budget bill** for fiscal year 2008 sent to the Congress.
5. **Improved regulatory quality**: the institutional and operational system for regulatory quality control has been implemented in the Ministry of Production and the Ministry of Energy and Mines; and implementation of the system in pilot programs at the MEF, Ministry of Health, and Ministry of Labor and Employment Promotion has been evaluated.	(i) **Reports** on the pilot programs at the Ministry of Production and the Ministry of Energy and Mines, reviewed and cleared by the General Directorate for International Economic Affairs, Competition, and Private Investment (DGAEICIP); and (ii) **reports** evaluating the regulatory impact and typology system at the MEF, Ministry of Health, and Ministry of Labor and Employment Promotion, approved by the DGAEICIP.
6. **Administrative management:** (i) the Payroll Auditing Module (MCPP) has been modernized; (ii) the action plan for modernizing the IFMS, developed on the basis of an independent evaluation, has been approved; (iii) the chart of accounts has been brought into line with the public sector budget classification; (iv) the action plan for the consolidated account is being implemented; and (v) reforms to the government procurement system: reorganization of the Executive Council on Government Procurement (CONSUCODE) and the proposed amendment to the Government Procurement Act have been approved.	(i) **DNPP directive** on application of the new version of the MCPP published in the Official Gazette *El Peruano*, and Bank **verification of the system**; (ii) **official letter** from the Deputy Minister of Revenue approving the action plan; (iii) National Public Accounting Office (DNCP) **document** on the chart of accounts brought into line with the budget classification, approved by the Deputy Minister of Revenue; (iv) National Public Treasury Office (DNTP) **document** on progress in implementing the consolidated account action plan, approved by the Deputy Minister of Revenue; and (v) **Supreme Decree** approving the new regulation on organization and functions of CONSUCODE, published in

Disbursement conditions for 2007	Means of verification
	the Official Gazette *El Peruano*, and the **government procurement bill** sent to the Congress.
7. **Fiscal stabilization** and regional economic growth: (i) MEF document analyzing stability in transfers to regional and local governments has been updated and regional compensation mechanisms improved; and (ii) the Calculation of Gross Domestic Product by Departments, 2001–2006, has been published.	(i) updated General Directorate of Economic and Social Affairs (DGAES) **document** on transfers to regional and local governments with analysis of actual transfer flows; a **ministerial resolution** approving the distribution ratios of the Regional Compensation Fund (FONCOR); and a **bill** to implement the FONIPREL submitted to the Congress; and (ii) INEI **report** "Producto Bruto Interno por Departamentos 2001-2006 [Gross Domestic Product by Department, 2001–2006]."
8. **Incentives-based budgetary reform**: The multiyear action plan (2008-2010) for budgetary reform of the national government entities to be decentralized has been approved.	**Ministerial resolution** approving the action plan
9. **Public investment at the regional level**: authority to declare PIPs viable is decentralized; application of SNIP technical standards and criteria for development and evaluation of PIPs remains mandatory.	**DGPM agency resolution** published in the Official Gazette *El Peruano*; and **document** estimating the December 2006 baseline quality of PIPs approved by regional and local governments

OUTCOMES MATRIX
PROGRAM TO IMPROVE THE QUALITY OF PUBLIC MANAGEMENT AND EXPENDITURE III (PE-L1027)

Objectives	Indicators and 2005 baseline	Outcomes (expected impacts for 2008/2011)
General objective: To improve the quality of public management and expenditure by strengthening government capacities to analyze and monitor aspects relating to regulation, budget, public investment, and administrative management, and by promoting greater private sector participation alongside the public sector in investment and in service delivery.	1. Increase in the gross fixed investment rate in Peru (2004 baseline: 18.6% of GDP (public and private investment)) 2. Improvement in the efficiency and effectiveness of public investment (value for money) as measured by a sampling of PPP projects in specific infrastructure sectors	1) The gross fixed investment rate tops 25% of GDP as of 2008. 2) In 2011, savings in the cost of delivery of public services—calculated as the average difference between the net present value of the cost of service delivery via PPPs and the estimated cost of public delivery of the same service—are at least 10% in a sample of at least three PPP projects.
A. Private sector participation in public investment		
I. Public-private partnerships (PPP) Design and implement a PPP policy with a transparent conceptual, legal, institutional, and operational framework that promotes competition, for executing projects that are economically feasible, attractive to investors, and fiscally responsible and prudent, including criteria and priorities for public investment projects (PIPs). Create PPP implementation capacities at sector agencies, to contribute to better public management and increase the quantity and quality of investment in infrastructure and related services, in line with sector policies and national priorities.	1. Annual payment for works to the private sector under PPPs as a percentage of total public investment in infrastructure (baseline: 0% at the end of 2004) 2. Increase in total annual public and private investment in infrastructure as a percentage of GDP (baseline: 1.5% of GDP in 2003 covering transport, telecommunications, and energy) (Source: MEF / BCR/ Telefónica del Perú / Preinversión / Córpac / Enapu / MTC)	1) In 2010, annual payment for works to the private sector, based on PPPs formed, are equivalent to at least 20% of public investment in the sectors involved. 2) At least 2% of GDP beginning in 2008

Objectives	Indicators and 2005 baseline	Outcomes (expected impacts for 2008/2011)
B. Public expenditure management at the national level		
I. Results-based budgeting and monitoring and evaluation of public expenditure Improve and modernize the budget management system to create incentives for optimal resource allocation and execution; and increase the availability and use of information on government performance.	1. Percentage of national and regional government executing units using results-based budgeting (baseline: 0%) 2. Percentage of additional public funds (excluding financing, social security, and personnel outlays) allocated and programmed using technical criteria in the budgeting process (baseline: 0%) 3. Number of executing units with management results evaluated against results-based contracts	1) For budget programming, 50% in 2011 (estimated at 15% for 2008); and for budget execution, 70% in 2011 (estimated at 10% for 2008) 2) 20% of additional funds (excluding financing, social security, and personnel outlays) are allocated using technical criteria by 2008; and 60% are by 2011. 3) 55 units are evaluated by 2008.
II. National Public Investment System (SNIP) Strengthen the processes of analyzing, prioritizing, executing, monitoring, and evaluating public investment in order to improve efficiency and quality.	1. Percentage of PIPs that require borrowing and adhere to the guidelines for arranging external loan operations to finance PIPs, established by the COPEX (baseline: 0%) 2. Percentage of PIPs using the public investment information system SNIP Net (Project Bank and SOSEM) (baseline: 0%) 3. Number of projects (of the type defined by the guide) with ex post evaluation consistent with the guidelines in the ex post evaluation guide (baseline: 0%) 4. Percentage of nonfinancial public expenditure allocated to investment (baseline: 16.3% of general government expenditure as of 2005, including government obligations for PPPs—source: MMF)	1) 100% by 2008 2) 100% by 2010 3) In 2010, 100% of the PIPs provided for in the directive governing their implementation 4) At least 25% of general government nonfinancial expenditure is allocated to investment beginning in 2008.
III. Improving regulatory quality Enhance the transparency, efficiency, and quality of sector regulations in general, through adoption of economic impact analysis and an effective regulatory process.	1. Percentage of approved regulations that have been subject to publicly disclosed regulatory impact analysis in sectors covered by the regulatory quality improvement system (baseline: 0%)	1) 45% of sector regulations by 2008, and 70% by 2010

Objectives	Indicators and 2005 baseline	Outcomes (expected impacts for 2008/2011)
IV. Administrative and financial management Streamline and simplify procedures relating to crosscutting management systems in line with the rules issued by their governing bodies. Develop and implement version II of the Integrated Financial Management System (IFMS), ensuring better integration of the current IFMS by incorporating supply, inventory control, and payroll procedures.	1. Savings realized through corporate procurement measured in a sampling of at least three procurements of significant value 2. Percentage of national and regional executing units using IFMS II (baseline: 0%) 3. Percentage of general government cash flows handled outside the Treasury (baseline: 29% in 2005) 4. Percentage of public agencies issuing quarterly budget and financial reports (baseline: 15%)	1) No later than 2008, savings in the cost of the selected procurements—calculated as the difference between the estimated procurement cost and the actual cost—amount to at least 10%. 2) 100% by 2010 3) 0% by 2008, with introduction of the consolidated treasury account (estimated at 15% in September 2007) 4) 90% by 2007
C. Public expenditure management in the context of decentralization		
I. Fiscal stabilization and regional economic growth Stabilize revenue transfers from the national to subnational governments. Conduct an economic evaluation of progress with decentralization by calculating economic activity indicators and analyzing the factors that affect regional growth and the advantages of setting up interdepartmental regions and adopting targets for revenue collection, expenditure reallocation, and budget resource management.	1. Average volatility of revenues transferred by the national government for investment expenditure by regional and local governments (volatility = annual investment spending (AIS) / AIS for the previous year). 2. Quantity of estimated departmental economic indicators (departmental GDP) (baseline: 0% in 2005)	1) Volatility is less than 40% for the 2008-2011 period: (2008AIS/2007AIS – 1 + 2009AIS/2008AIS – 1 + 2010AIS/2009AIS – 1 + 2011AIS/2010AIS – 1) / 4 years (estimated at 34% for the 2004-2008 period). 2) 100% in 2007
II. Incentives-based budgetary reform Reconcile the transfers of revenue and responsibilities to regional and local governments, so as to ensure a neutral net fiscal effect and enhance budgetary stability.	Budget adequacy indicator, to be defined upon analysis of transfer agreements signed at the sector level.	Difference between the increase in payroll costs for regional and municipal governments, owing to the decentralization process, and the decrease in payroll costs for the unit or sector agency whose functions were transferred (DNPP), net of exogenous effects. The target is that this figure shrink to zero once the new methodology is in place, around 2008.

Objectives	Indicators and 2005 baseline	Outcomes (expected impacts for 2008/2011)
III. National Public Investment System (SNIP) at the regional level Strengthen and adapt the SNIP at the regional level to improve the quality of public investment spending by raising regional governments' capacity for analysis, prioritization, execution, monitoring, and evaluation of public investments under their responsibility.	Percentage of PIPs declared feasible by the programming and investment offices of the regional governments with an appropriate analysis according to the methodologies established in the SNIP (baseline: 35% in the 2004-2005 period)	Increase to 45% by no later than 2010 (38% of the representative sample of 2004 and 2006 projects are expected to have been properly declared feasible by 2008).

LOCAL CURRENCY LOAN
PROGRAM TO IMPROVE THE QUALITY OF PUBLIC MANAGEMENT AND EXPENDITURE III
(PE-L1027)

1.1 The Ministry of Economy and Finance has set the objective of achieving better debt management. One of the key elements in its strategy consists of adopting mechanisms enabling it to measure and control the risks associated with the composition of the public debt portfolio, one of the main ones being the exchange risk derived from foreign-currency debt. The Government of Peru has set ambitious targets for reducing this risk by moving to a public debt composition that gives greater weight to domestic debt and debt denominated in nuevos soles. Another of the government's objectives is to reduce refinancing risk exposure by planning and reducing the concentration of repayments over time. In this connection, the government is already making use of changes that the World Bank introduced in its loan products to allow for a flexible repayment plan for loan operations. Accordingly, within certain limits, the Government of Peru can use this flexibility in servicing the World Bank debt as a liability management tool. In keeping with its debt management strategy, the government requested use of the Local Currency Facility (LCF) for this operation during the preparation and negotiation phase.

1.2 As requested by the Government of Peru, through use of the LCF, the borrower may ask the Bank to convert the disbursement of all or part of the loan proceeds, as well as outstanding loan balances with the Bank, into local currency. In this regard, the LCF:

a. Provides that loans will continue to be approved in one of the four currencies offered under the Single Currency Facility (Swiss francs, euros, Japanese yen, or U.S. dollars) and in U.S. dollars under the Dollar Window (DW), Emergency Lending Facility (ELF), or Private Sector Lending (PSL);

b. Enables borrowers to request that: (i) all or part of future disbursements of a loan be made in local currency; (ii) in addition, and where possible, already outstanding balances be converted into local currency on a case-by-case basis; and (iii) in both cases, the Bank provide financing denominated in local currency, subject to currency availability and market conditions;

c. Establishes that each transaction requires that: (i) the borrower obtain timely authorization from the government; (ii) the Bank fund its local currency financing in the most efficient way possible through the various mechanisms available on the market; (iii) the financial terms offered reflect the prevailing market conditions at the time of disbursement or conversion, with respect to the type of funding requested by the borrower; and (iv) the financial risks be mitigable;

d. Provides that the Bank mitigate the risks derived from these operations by matching the cash flow from local currency disbursements to the cash flow from its financing to be obtained on the market (matching finance), on the basis of two pillars: (i) maintenance of the Bank's loan profile (as regards terms and repayment schedule); and (ii) Management's recommendation to the Board of Executive Directors (specified in the LCF) that, as a general rule, the Bank refrain from carrying liquidity in local currency.

1.3 To expand the borrower's financing possibilities, the conversion of disbursements and outstanding balances into local currency for financed projects would be subject to two financial conditions in addition to those established in the LCF:

a. **With respect to the repayment profile.** The terms and repayment schedules for the conversions requested by the borrower could be set in relation to the final maturities and their weighted average life (WAL). In this respect:

(i) The program will maintain a matching-finance type of design through adaptation of the Bank's loan profile to the financing terms it obtains on the market. The Bank would thus be in a position to offer local currency financing to the borrower under the best conditions to be found on the market.

(ii) Subject to market conditions, and in coordination with the borrower, the Bank would modify the profiles of each disbursement so that, in each case, it could have a different repayment structure with respect to final maturity and the WAL of the original contract. Nonetheless, this flexibility would be limited by the restriction that the WAL and the final deadline for the amended amortization and disbursement periods as a whole not exceed those of the corresponding original contract. Accordingly, repayment structures could be of the "bullet" type (a single payment on maturity), with shorter maturities and/or extensions of the grace period, without, as a result: (a) the Bank's lending authority or the Total Equity-to-Loan Ratio (TELR) being affected; or (b) the borrower enjoying different financial conditions than other Bank borrowers (Appendix I).

(iii) The modified repayment structures would be designed by common agreement between the borrower and the Bank, to ensure that fulfillment the program's development objectives would in no circumstances be affected.

b. **With respect to pricing based on actual funding costs.** In cases where it is operationally feasible (basically, when the Bank can issue bonds to raise the funds needed for local currency financing): (1) a pass-through of the Bank's actual funding costs to the borrower would be possible; and (2) the lending rate on the corresponding conversions would reflect these funding costs plus the prevailing margin on Ordinary Capital loans. Accordingly, the risk

premium provided for in the LCF would not be applied, and it would become feasible to make the repayment profiles more flexible (Appendix II).

1.4 Conversions into local currency of disbursements and outstanding balances require an exception to paragraph 3.15 of document GN-2365-2, regarding the nonapplicability of the clause relating to interruptions in the Bank's funding. In this regard:

a. Interruptions in the Bank's local currency funding would occur only: (1) if its financing source was the swaps market; (2) if there had been nonperformance by the counterparty in such operations; and (3) if such nonperformance were combined with a market interruption such that the Bank was unable to replace its local currency funding (for the remaining maturity of the disbursement and with the same type of basic rate) despite doing everything possible subject to its internal policies and directives.

b. In the event of an interruption in funding, the Bank's risk exposure would consist of the probability of the occurrence of this event, and its potential impact (Appendix III). In this regard:

(i) The likelihood of interruption is considered very low, given that:

- In cases where the Bank issues bonds to raise funds, there is simply no chance of an interruption in its funding;
- Assuming that the Bank is funding itself through swaps, the likelihood of nonperformance by the counterparty is considered minimal, since: (1) the Bank is governed by strict policies that require counterparties to have a high rating from risk-rating agencies (A+ or higher); (2) it takes more than five years, on average, for a counterparty to migrate from a high credit rating to a default rating, which enables the Bank to mitigate these risks during that period by replacing the counterparty; and (3) it is considered even less likely that a market interruption would prevent the replacement of the swap counterparty during its credit migration period.

(ii) The impact is considered limited since existing restrictions on credit exposure with swap counterparties establish a ceiling which requires the Bank to diversify its risk among several counterparties and to limit its exposure with each one. Nonetheless, assuming an interruption in funding occurs in a swap, the potential loss for the Bank could be a substantial portion of the amount swapped with the counterparty in question (Appendix III).

1.5 In any event, if the Bank found itself in an exchange mismatch situation as a consequence of an interruption to its local currency funding under the assumptions analyzed, this: (i) would be the consequence of circumstances

particular to the banking industry that emerged subsequent and in relation to initial transactions designed to avoid such mismatch; and (ii) could entail financial risks that would need to be handled with appropriate management criteria. The requested exception to the policy governing the LCF does not violate any of the provisions of the Agreement Establishing the Inter-American Development Bank, as indicated in the legal opinion issued by the Bank's Legal Department on 8 August 2006 (Appendix IV).

APPENDICES

Appendix I: **Flexibilización en los cronogramas de amortización de préstamos: Vida Promedia Ponderadea [Greater flexibility in loan repayment schedules: Weighted average life]**
http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1169147

Appendix II: **Precio basado en el coste actual de captación del Banco en el caso de que su fondeo se realice a través de una emisión de bonos [Price based on the Bank's actual funding cost in the case of a bond issue]**
http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1169178

Appendix III: **Riesgos Financieros si no se Incluye una Cláusula de Sustitución de Moneda en los Contratos de Préstamo en Moneda Local [Financial risks in the absence of a currency substitution clause in local currency loan contracts]**
http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1169219

Appendix IV: **Legal opinion issued by the Bank's Legal Department on 8 August 2006**
http://idbdocs.iadb.org/wsdocs/getDocument.aspx?DOCNUM=1169294

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

PROPOSED RESOLUTION DE-__/07

Peru. Loan ____/OC-PE to the Republic of Peru
Program to Improve the Quality of Public
Management and Expenditure III

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the Republic of Peru, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a program to improve the quality of public management and expenditure III. Such financing will be for an amount of up to US$75,000,000 from the Single Currency Facility of the Ordinary Capital resources of the Bank, and will be subject to the Financial Terms and Conditions and the Special Contractual Conditions of the Project Summary of the Loan Proposal.

LEG/SGO/PE-1168714-07
PE-L1027