CHAPTER 2
Innovating the financing of infrastructure projects in Peru
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The infrastructure gap in Peru to 2020 has been estimated at US$ 68.815 million and US$ 90.734 between 2021 and 2025, representing a total of US$ 159.549 for the period 2016-2025. The gap is distributed in four productive sectors (transport, energy, telecommunications and hydro) and three social sectors (health, water and sanitation, and education), according to a study developed by the Universidad del Pacífico, commissioned by the Association for the Promotion of National Infrastructure (AFIN, 2015).

Being important to know the infrastructure gap by sectors, it is particularly relevant to know how investment in infrastructure has concentrated in regions over time, and how the gap to cover impacts on regional growth and income inequality in Peru.

Regional disparities in Peru have been addressed in several studies of economic convergence. Gonzales de Olarte and Trelles (2004) conclude that there is no evidence of economic convergence between the departments of Peru, noting that the geographical factor along with public investment is relevant in the process of economic convergence.

Referencing the work of Phillips and Sul (2009), Delgado and Rodriguez (2013) have found three convergence clubs, ie, three groups of regions with similar economic performance, the first composed by eleven departments (Ancash, Arequipa, Ayacucho, Cusco, Ica, La Libertad, Lima, Madre de Dios, Moquegua, Pasco and Tacna), with stable growth dynamics and initial levels of GDP per capita higher than the others, the second by five (Amazonas, Cajamarca, Junin, Lambayeque and Piura), with average rates of growth in GDP per capita, and the third by five (Huánuco, Loreto, Puno, San Martin, and Tumbes), with low levels of growth, while the regions of Huancavelica and Apurimac not belonging to any club and showing different dynamics than the rest.

More recently, Arpi Mayta (2015) finds evidence on the distribution of public investment in infrastructure concentrated in few regions of the country and, as a result, a high deficit of access to services required by citizens, particularly in highland regions and the jungle of Peru.

The Fund for Peace publishes annually the Fragile States Index identifying the uneven economic development as one of the important factors that explain why a state fails in the attention of the needs of its citizens. The definition of the Fund for Peace regarding the asymmetry in economic development is clear: "When there are ethnic, religious or regional disparities, the governed tend to be uneven in their commitment to the social contract" (States Index, 2016).

Inequality in citizens' commitments to social contract helps to intensify the conflicts and misunderstandings between the urban and rural sectors of the country, for the negative impact of delays and gaps in the coverage of infrastructure, beyond the capital city in the regions and the jungle of Peru, impacting on the inclusion gap and social peace, while continuing delaying the creation of a favorable environment for investment and economic development the country.

Based on the experience in infrastructure financing of PanAmerican Capital Partners LLC in New York and Financial Infrastructure Group in Colombia, in the water and sanitation sector, it has been investigated the financing needs to meet the demand for basic infrastructure for commonwealth and subnational governments in Peru, identifying the opportunity to implement a model of financing infrastructure using the domestic stock market, abundant in liquidity but lacking financial instruments, supplemented by part of the budget of resources allocated to regional and local governments.

This will allow creating, with the technical and legal support, the financial structure and technology required to establish a fund to finance infrastructure projects in commonwealths and subnational governments. Therefore, they will have access to finance long-term projects of basic infrastructure, rather than rely solely on the traditional scheme of annual budget allocations.

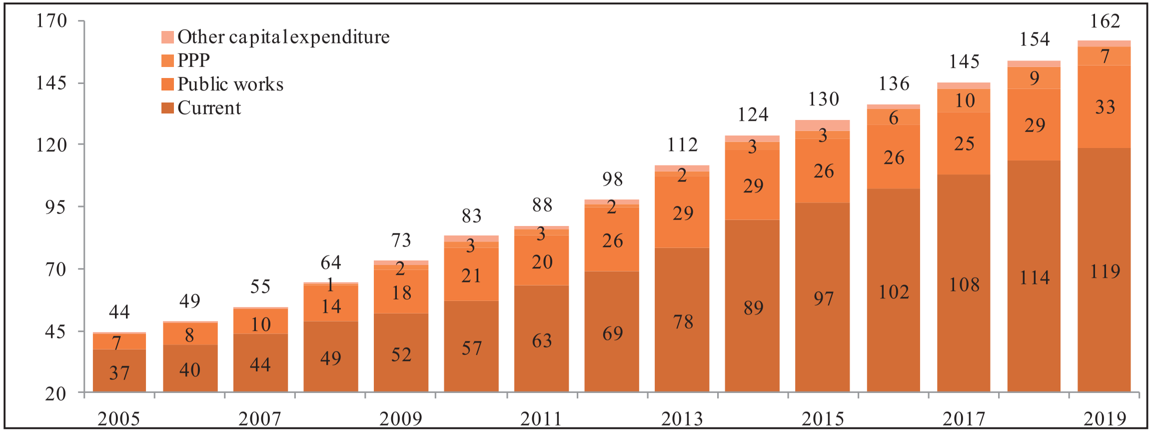
2.1 The context

The resources determined by the amounts of canon, over canon, royalties and others, as a source of financing the public budget, have declined in real terms. According to the law of the public sector budget for the fiscal year 2017, the economic resources amount S/ 17,908,875 024,00, that represents 12,5% of the total budget, compared to the same amount in fiscal year 2009, corresponding to 18% of total.

In addition to this, the public budget has been allocated mainly to the national level, having risen from 58% in 2009 to 74% in 2017. Moreover, the debt service by subnational governments is only 4,2% of the total amount allocated for that service, and this amount represents 8,2% of the total of the budget proposed for 2017. Then, the subnational government debts amount to only 0.34% of the total budget. Quite low percentages for subnational governments reveal the excessive concentration of the budget management and public finances in the national government opposing to the objectives of the decentralization process.

The Revised Multiannual Macroeconomic Framework 2017-2019 (2016) reveals not only the centralist tendency of the public budget, but also the decision to allocate more resources to public works, in contrast with projected allocations for public-private partnerships (PPPs), as shown in the following table.

Graph 1
Non-financial expenditures of the General Government
(Billions of Soles)



Source: MEF.

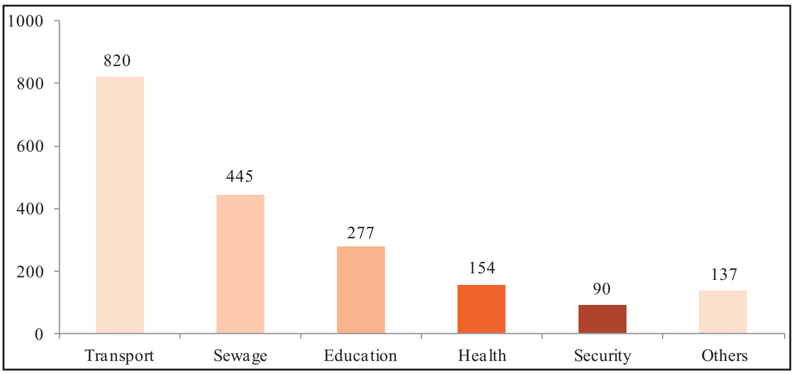
Following this trend will delay closing the infrastructure gap and enlarge the social gap mainly into the country. It is therefore important to reverse this trend and guide the actions of the next five years to the budgetary and financial decentralization.

Thus, it is a must to seek the full implementation of indebtedness mechanisms established by the current legal framework, without warranties by the Central Government. This normative states the payments of these debt transactions is addressed directly to the contracting entity in accordance with commitments assumed in contracts or respective agreements, authorized by the General Directorate of Indebtedness and Public Treasury (DGETP) of the Ministry of Economy and Finance (MEF), to deduct the necessary amounts to meet regional and local government commitments, currently restricted to the national government, under the framework of the transactions of the National Indebtedness System.

This would be a smart method to balance annual decrease of cannon flows since it will allow regional and local governments to receive credit from public and private financial institutions with the best risk rating to finance the implementation of infrastructure projects backed by their own economic resources constitutionally protected, in accordance with indebtedness limits set by the MEF.

Furthermore, this method will contribute to boost the mechanism Works for Taxes (Spanish acronym OxI) that despite its benefits, it has failed to take off since it was created (less than S/ 2.000 million in the period 2009-2015), due to a lack of a Master Plan for Infrastructure Development defining priority projects by region and commonweath covering all the steps required for the successful completion and implementation of investment projects, from financing to operation and maintenance, including financial, legal, technical and environmental aspects.

Graph 2
Works for Taxes, 2009-2015
(Millions of soles)



Source: Proinversion.

The risk that subnational governments get from medium and long term credits to execute major works with future income is reduced since access to financing in the stock market is facilitated by the investment grade and the country's macroeconomic performance, and the future flows generated once the new infrastructure is exploited. Hence, this financial model becomes sustainable for each subnational government's investment project, individually or in commonwealth.

A greater investment grade involves less risk to the country and its institutions, and that includes their subnational governments which together account today just over 4% of the obligations by debt service, as indicated in the Draft of the Public Budget Law 2017, which is not consistent with the objectives of the decentralization process.

2.2 The proposal

Regional and local governments will always have available on the Single Treasury Account (STA), managed by the MEF, their economic resources that constitutionally belong to them - being authorized by the MEF- through the proposed amendment to the General Law on Indebtedness, to deduct the amounts required to fulfill their economic and financial obligations and transfer them directly to the accounts provided for payment of debt service throughout the term of payment of financing, which will be part of a trust that constitutes an autonomous, intangible and indefeasible equity, whose contract includes an annex with the powers granted to the MEF to deduct the amounts required to meet payment commitments.

Given that the amounts available in the STA will always be greater than those required for debt service; the probability of default is technically zero, as the MEF has the responsibility to obey the constitutional mandate to enable economic resources that constitutionally belong to regional and local governments, which is the main guarantee of payment of the financing.

In the case that canon flows were reduced by 40% over the previous year, the worst scenario, the amount for debt service would always be less than the total amount available, never exceeding the 25% of the annual subnational resources, in order to always maintain fiscal balance of subnational governments, taking into account the limits established by fiscal rules for debt service regarding current income.

The MEF has been used to enforce the accomplishment of the annual budget guidelines and the budget framework approved for every fiscal year. This proposal requires a multi-annual approach to address not only the small scale infrastructure that can be completed in a year, but also larger scale projects needed mainly in regions, provinces and districts in our country, which takes more than a year to run, since its technical study to its implementation, and whose amount is payable in medium or long terms, considering its size.

Therefore, it is required to modify the text of the Sixteenth Complementary and Transitory Provision of the General Law of Indebtedness:

> *Payments to the National Government and, if applicable, in favor of financial companies with a credit rating similar to sovereign risk belonging to debt commitments generated under domestic indebtedness transactions under the scope of the National System of Indebtedness assumed by Local and Regional Governments, Regional and Local Commonwealth to finance their public investment projects are made through trusts.*
>
> *When granting the resources provided for such payments is made through financial allocations, the Directorate General of Indebtedness and Public Treasury is entitled to deduct the necessary amounts to meet those obligations and transfer them directly to the accounts provided for payment of debt service identified in the trusts, during the full term of payment, whether it is equal or greater to the duration of the mandate of the respective authority.*

It is the responsibility of public entities, including regional and local governments who are in charge of such obligations, the anticipated issuance of the Certification of the respective Budget Credit, in the framework of the legal regulations in force, for the amount of obligations and in attention to the schedule established for the compliance of debt service.

In the case of payments in favor of financial companies with a credit rating similar to sovereign risk, the Directorate General of Indebtedness and Public Treasury is authorized to issue the necessary provisions to be required to Regional and Local Governments, and Regional and Local Commonwealths, to finance their public investment projects, giving priority to those with higher standards of effectiveness in the execution of investment and in the quality in the expenditure execution.

This amendment to existing legislation, under the current process of submission and approval of the respective budget and public debt laws for fiscal year 2017, will be possible to implement the proposed structure in the first instance together with the Development Finance Corporation (COFIDE), by financing firstly infrastructure projects in water and sanitation, including technology and processes for improvement in the management of EPS in charge of municipalities, then by moving to the development of other infrastructure and projects declared viable under the National Public Investment System (SNIP), mainly in sectors such as health and education, where the infrastructure gap is large and mechanisms such as Works for Taxes are still insufficient.

The model to be implemented in conjunction with COFIDE also requires improvements in Legislative Decree 1224 and its regulations, approved by Supreme Decree No. 410-2015-EF, that states that when the Ministry, the Regional Government and the Local Government require to form trusts for the management of payments and income from cofinanced Public Private Partnership contracts, they must request favorable opinion to the Ministry of Economy and Finance (MEF), which would be enough with the prior report of the Comptroller General of the Republic.

2.3 Expected results

The proposal is a viable alternative for access to finance infrastructure projects, strengthening the domestic stock market and involving the private sector resources in the development of basic infrastructure of subnational governments, helping to optimize the use of public funds effectively and transparently, via the mechanism of public-private partnerships in the financial field.

Contributing to strengthening regional and local public finances for subnational governments may access long-term financing on more favorable terms than currently available conditions, will substantially improve its cash flows, promoting especially subnational management mainly via commonwealths. Besides, it seeks to improve the quality of infrastructure projects promoting the participation of engineering firms with extensive experience in monitoring and project development at the subnational level.

Taking advantage of the successful experience of similar mechanisms of financing in subnational governments, as in the case of Colombia, replicating the model in Peru jointly with the Development Finance Corporation (COFIDE), aims to make feasible the financing of infrastructure projects with the guarantee of the capital resulting from the issuance of financial instruments that are part of the proposal, in fields covering first projects of water and sanitation at the regional and local level, then other types of infrastructure and projects declared viable under the National Public Investment System (SNIP), particularly in social sectors such as education, health and security.

Mechanisms such as Works for Taxes allow establishing public-private partnerships that help to close the infrastructure gap existing in the country, mainly in social sectors such as health, education, water and sanitation, but have proven to be insufficient, given the size of the gap.

It is relevant to innovate the existing mechanisms with instruments that are components of a financing structure that will close the infrastructure gap in shorter terms and improve the quality of services to be provided. This can be achieved via the proposed structure by accomplishing the borrowing limits and fiscal rules established by the MEF to ensure higher standards of effectiveness in the execution of investment and the quality of the expenditure execution.