

Peru's Works for Taxes Scheme: An Innovative Solution to Accelerate Private Provision of Infrastructure Investment

Created in Peru in 2008, Works for Taxes is an innovative approach to accelerating infrastructure investment. It allows private firms to “pay” their income taxes in advance through the execution of public works projects. By accepting infrastructure projects in lieu of future taxes, national, regional, and local governments can forego mobilization of public funds and reduce the burden on government budgets, as the private sector assumes the upfront costs and management of new infrastructure projects. The mechanism's success derives from its ability to align public and private sector incentives for better quality projects and more efficient use of funds. Works for Taxes has great potential for replication in other emerging market countries with similar obstacles to infrastructure investment.

In 2008 the Peruvian government devised a unique public investment mechanism called “Works for Taxes” that allows private firms to “pay” a portion of their income taxes in advance in the form of public works—from public buildings to transport infrastructure and beyond. The goal of the mechanism is to accelerate and improve the quality of investment in public works and services, many of which have been severely underfunded.

The Works for Taxes mechanism can currently be applied to public investment in urban development, telecommunications, agriculture, water and sanitation, tourism, public safety, transport, education, health, fishing, sports, protection and social development, culture, environment, and rural electrification. Figure 1 shows the distribution of projects by sector.

Prior to Works for Taxes, the mining and extractive industries enjoyed a revenue boom due to higher commodity prices. Yet despite significantly increased tax revenue from mining profits paid to the central government and transferred to regional and local governments where the extractive industries operate,¹ subnational governments lacked capacity to effectively provide public works,

spending significantly less than their annual budgets on them. For example, regional and local governments spent less than half of their annual budgets on public works in 2007.² Local communities remained impoverished and lacked basic public services, creating tensions between them and the extractive companies.

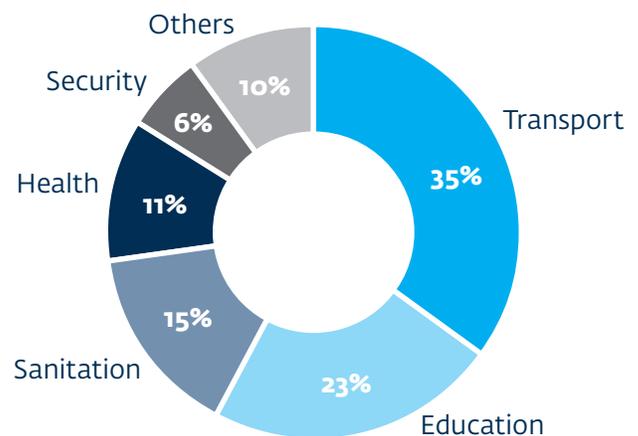


FIGURE 1 Awarded and concluded projects by sector, 2009–2017 (% of total investment amount)

Between 2009 and 2017, more than \$1 billion was invested through Works for Taxes, benefiting more than 15 million Peruvians. Source: ProInversion

Works for Taxes offered those and other companies a new level of accountability and an opportunity to incorporate public works into their social responsibility efforts, while at the same time ensuring that their tax payments directly benefited local communities.

Local Infrastructure Gap

Works for Taxes was created to address infrastructure gaps in Peru, as well as multiple obstacles to investment in public works, including:³

- A lack of technical criteria to properly identify and select public investment projects
- Low quality pre-investment and investment studies that failed to match real costs and work schedules
- Substantial cost and project overruns
- Numerous disputes with construction companies at the judicial and arbitration levels.

The Peruvian infrastructure gap has been estimated at approximately \$160 billion over the 2016–2025 period.⁴

The Process

Although Works for Taxes was initially created to support public works for subnational governments, the legal framework has since been simplified to allow almost all entities throughout Peru’s three levels of government to implement it.⁵

To be eligible, a project must close an existing infrastructure or service gap in the local community. Projects can either be

part of the stock of available projects in the public investment system (public initiative) or proposed by the private firm or group of firms interested in financing it (private initiative). Subsequently, the project is awarded by public contest to a private firm or a group of firms associated with the construction firm, previously selected in a private contest.

Once an agreement is made with the government, private companies (financing firms) pay for the public works with their own resources in lieu of future income tax payments. The financing firm receives certificates from the Ministry of Economy and Finance after the project has been checked for quality and approved by the government. These certificates can be used annually to deduct up to 50 percent of a firm’s annual income tax until the total value is used up, or they can be sold in the market to firms interested in buying debt. The certificates have a 2 percent annual revaluation for the unpaid balance and keep their value for 10 years from the date of issuance. After this period, companies can request a devolution from the National Superintendence of Tax Administration.

The value of the certificates is charged by the Ministry of Economics and Finance to the accounts of the public entity (a ministry, subnational government, or other entity) that signed the agreement. Future transfers of up to 10 years are discounted from the public entity royalty accounts or other income sources applicable to the mechanism.

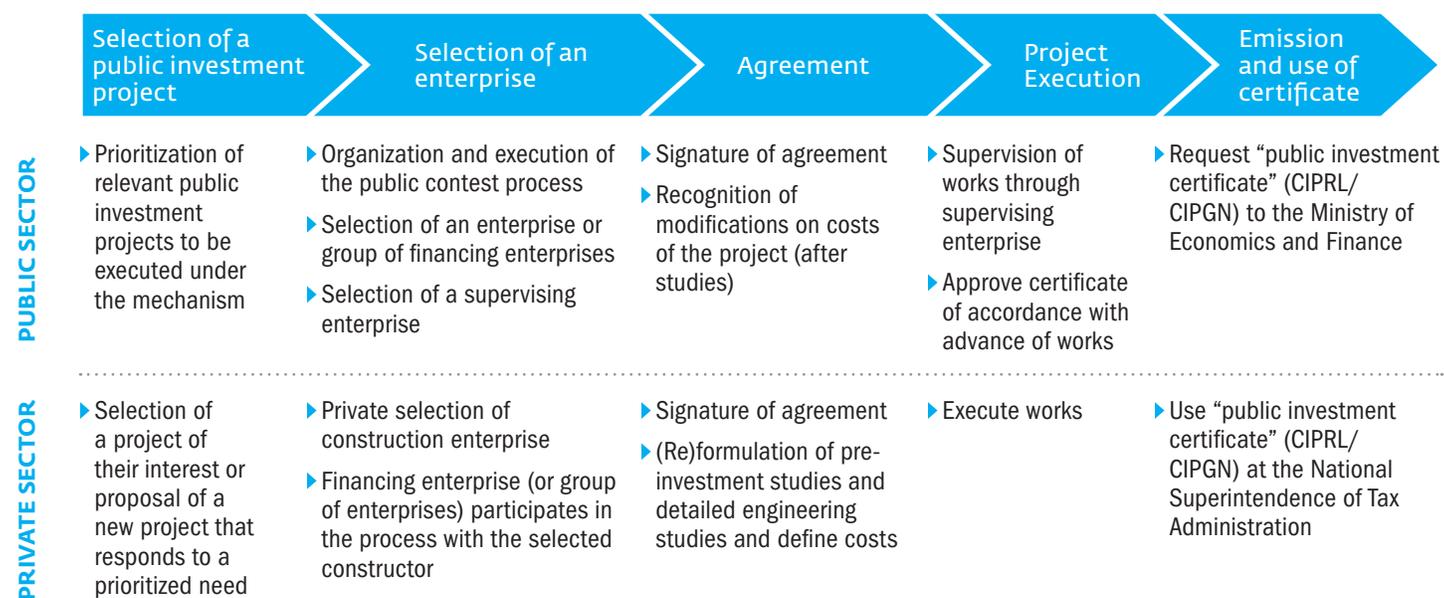


FIGURE 2 Simplified Process of “Works for Taxes” Mechanism

Source: AC Pública. 2017. “Mecanismo de Obras por Impuestos”; AC Pública. 2017. “Ayuda Memoria: Financiamiento de proyectos de inversión pública a través del mecanismo de obras por impuestos.”

Aligning Incentives Between Parties

Works for Taxes is not governed by traditional contracts law. A comparison of the mechanism and contract law (used for public investment) can be seen in Table 1.

Table 1. Works for Taxes Versus Traditional Contracts

WORKS FOR TAXES LAW	TRADITIONAL-CONTRACTS LAW
The contract between financier and constructor is dealt privately (under private law)	Constructor deals directly with the government
Selection of the supervising enterprise is made in parallel, saving time	Public tenders to contract a supervisor are made after the contract with the constructor
Direct award if no bidders	Abandon process if no more bidders and start of a new contest

Source: Salinas, Sergio. 2017. "Obras por impuestos: mecanismo para facilitar el cierre de brechas de servicios en el Perú." Nota de Política 2. Escuela de Gestión Pública, Universidad del Pacífico.

Depending on the magnitude and complexity of a private initiative project, it can have the following schedule:⁶

- Receipt of a declaration of relevance 20 days after sending a letter of interest
- Six months to prepare the pre-investment study
- Two months to select a construction firm (private contest), conducting the public contest for the financing firm and signing of the agreement
- Six months to prepare a detailed engineering study
- 18 months to execute the public work
- Two months for the reception and settlement of the works.

The Private Investment Promotion Agency (ProInversion) is currently conducting a comparative study between Works for Taxes and traditional public works for a sample of 38 projects related to transport, water and sanitation, and other sectors to compare project execution times. Initial results from the study indicate that there are significant time reductions when investing through Works for Taxes (time reductions vary according to sector and project size):

- Transportation projects are concluded between 12 percent and 67 percent faster.
- Sanitation projects are concluded between 27 percent and 52 percent faster.
- Other sectors analyzed indicate projects are concluded between 35 percent and 53 percent faster.

Time reductions are attributable primarily to the detailed engineering studies involved with Works for Taxes projects, as well as to the fact that the contract with the construction firm is held by the private financing firm.

Projects already in the pipeline are often based on low quality studies, and these don't accurately reflect actual costs or completion timeframes. As a result, the law allows the financing company to recalculate and reformulate the project's investment study. This significantly reduces the risk of cost overruns and project delays. So far there have been no documented cases of a poorly executed project under Works for Taxes.⁷ Moreover, private companies put their brand identity at stake when they take on a project. So reputational risk provides an incentive to complete projects efficiently. Private firms also stand to benefit from improved public works and services in the areas where they are located.

The Works for Taxes mechanism benefits multiple stakeholders, including:

- **The government** – Works for Taxes provides government entities with access to financial resources in advance, allowing them to provide quality public works and services within a shorter timeframe. In addition, it liberates human and physical resources for use in other relevant projects.
- **The financing firm** – By providing public works and services, firms can have a direct impact on their communities and can improve relationships with stakeholders. In addition, companies can invest in works that facilitate their operations or bring positive externalities such as greater local competitiveness or crime reduction.
- **The local community** – The improved execution of public works provides local communities with better public infrastructure and services, including roads, bridges, and schools. These in turn can improve the local labor force and raise household revenues. In addition, construction projects generate local employment.

Use of the Mechanism in Peru and Remaining Limitations

Between 2009 and 2017, approximately \$1.25 billion was pledged or invested in 318 Works for Taxes projects, with the participation of 82 private enterprises, six ministries, 14 regional governments, and 114 local governments. Several private companies that have used the mechanism have been

BOX 1. IFC AND THE 2030 WATER RESOURCES GROUP

The International Finance Corporation, or IFC—a sister organization of the World Bank and member of the World Bank Group—is the largest global development institution focused on the private sector in emerging markets.

The 2030 Water Resources Group (WRG) is a unique public-private-civil society collaboration that facilitates trust-based dialogue processes to drive action on water resources reform in water stressed developing countries. This group has been hosted by IFC since 2012. In Peru, the partnership involves more than 70 institutions, including high-level members from the private and public sectors. Promoting Works for Taxes is one of WRG's key water resources initiatives in Peru.⁸

WRG has been working with the Ministry of Agriculture and Irrigation and the Ministry of Housing, Construction and Sanitation to encourage the private sector to participate in this mechanism, and to identify and provide methods to create a more agile and streamlined process.⁹

Thanks to the 2030 WRG promotion and negotiation activities with more than 30 companies, large private companies from different sectors (beverages, construction, mining, etc.) are now involved in generating water infrastructure works with tangible benefits for the communities in the areas in which they operate. Currently, the Ministry of Housing, Construction and Sanitation has awarded three projects and has over 20 potential projects in nine regions that are being negotiated and could benefit thousands of citizens. Furthermore, given the technical support, the ministry has implemented internal actions for a more efficient application of the mechanism.¹⁰

closely linked to the extractive sector. For instance, as of July 2017, ten mining companies had financed 83 projects with a total value of \$280 million, and five banking and insurance companies had financed 84 projects with a total value of over \$260 million.¹¹ There has also been significant participation by mass consumer industries.¹²

A key reason for the Works for Taxes mechanism's success has been the Peruvian government's receptiveness and willingness to connect with the private sector, while regularly improving the processes and regulation of the mechanism based on private-sector feedback.

Furthermore, in the interest of working together and reducing transaction costs, private companies involved in financing public works through this mechanism formed an organization called ALOXI (“Alliance for Works for Taxes” in Spanish).¹³ This organization analyzes lessons learned, as well as best practices that could be used by all parties when coordinating with the government. In addition, a new market for experts to link the government and private firms along the Works for Taxes process has been developed in recent years. International organizations such as IFC have also contributed to improvements of the mechanism (Box 1).

In the wake of mass damage in 2017 from the El Niño phenomenon, Peru's Private Investment Promotion Agency has promoted national reconstruction projects through the Works for Taxes mechanism to rapidly rebuild damaged infrastructure and create public works that can prevent future infrastructural damage and casualties.¹⁴

What limitations remain?

Works for Taxes is considered an overall success in Peru. Yet limitations to the program remain that prevent more firms from participating. One critical challenge is that public officials lack sufficient understanding of how the mechanism works and how it differs from operations affiliated with traditional public works. This, coupled with a fear of potential sanctions imposed by the Comptroller's Office for projects that go awry, have led to a restrictive view of what the law requires. This is aggravated by a lack of confidence in the private sector on the part of some public officials, who tend to delay approval for certificates because of it.¹⁵

Furthermore, public officials are sometimes under political pressure to reduce costs associated with studies that are reformulated by the private sector. As a result, some officials continue to ask financing firms for a “donation,” which implies that officials expect firms to cover some of the costs of the project without recognition.¹⁶

Moreover, the Works for Taxes mechanism is not yet accessible to all public entities, and it does not account for operational costs, just investment costs (the exception is projects in the sanitation sector that allow the mechanism to be used for operational costs for one year). This affects the sustainability of completed public works, as well as the reputation of financing firms.

Furthermore, the law does not recognize the management expenses the firms must confront when negotiating with

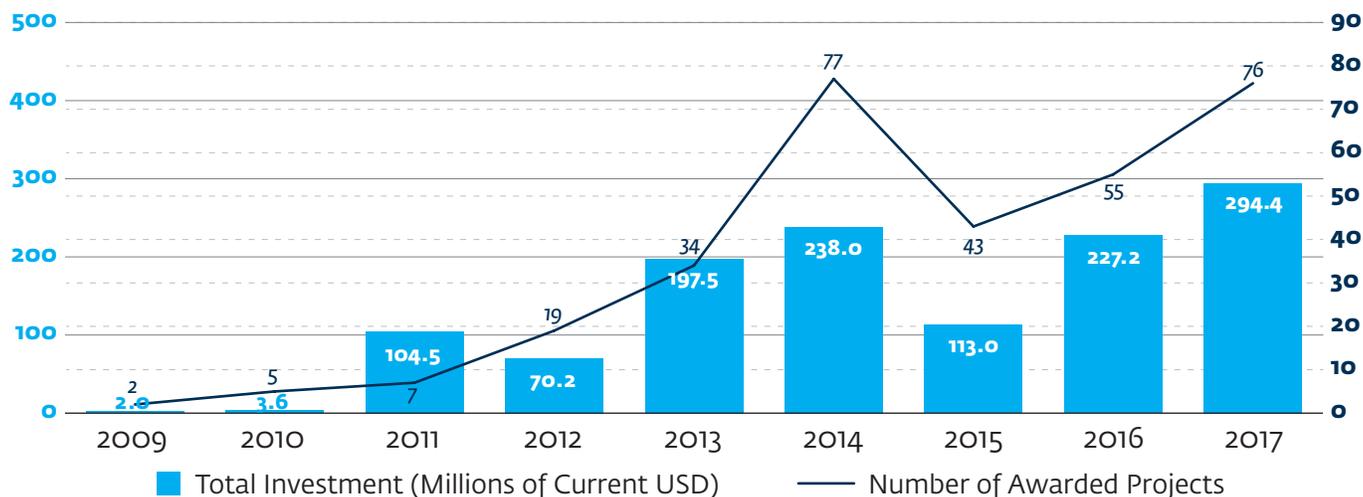


FIGURE 3 Total investment made or pledged through Works for Taxes (2009–2017)

Source: ProInversion

the construction firm, multiple government entities, and the supervisor, all of which are normally commissioned to consultancy firms that manage these relationships and negotiations. As a result, the financing firm may end up paying more than its actual taxes for works that generate no profits.¹⁷

In addition, some parties have expressed concerns that the Works for Taxes mechanism would respond mainly to private interest rather than public interest, in terms of the selection and location of projects.¹⁸ In fact, most projects executed through Works for Taxes are located in the areas of influence of the financing firms, which are not always the areas most in need of development. As the projects are first prioritized by each public entity, this concentration problem should be somewhat mitigated. Yet Peru’s lack of a national infrastructure plan remains a challenge here. Better-quality planning would allow for better prioritization of projects.

So far, only larger firms with an established social responsibility program have been able to afford to participate in the Works for Taxes program, as it remains too costly for smaller firms. This is due primarily to transaction and management costs, as well as the high degree of liquidity needed to disburse large capital amounts to fund major public works projects. It also must be noted that firms that currently use the mechanism are among the biggest tax contributors in Peru, which may also complicate access to liquidity by the government in a country with high tax evasion rates.

Use of the Mechanism in Other Countries

Peru’s Works for Taxes program has the potential to benefit other countries facing low governance standards, insufficient fixed capital investment, and significant infrastructure and services gaps. For example, Colombia has been exploring replicating the mechanism to build public works related to the peace agreement signed in 2016 with the Revolutionary Armed Forces of Colombia.¹⁹ Public works would include rebuilding shattered villages and clearing mines, among other reconstruction efforts. As a result, teams from Peru have made visits to Colombia to provide training to individuals in both the public and private sectors.²⁰

Colombia enacted a law to launch Works for Taxes in November 2017. Within a month, 28 firms related to food, beverages, insurance, banking, tax auditing, cement, basic sanitation, legal services, mining, and oil have expressed interest in participating.²¹ The government plans to prioritize investments in water, sanitation, energy, health, education, and roads.²²

Based on Peru’s experience, it is clear that there are crucial elements to consider before launching Works for Taxes programs in other countries.²³ Developing a system for prioritizing public investment projects, identifying infrastructural gaps, and subsequently defining which projects to develop are all critical, as is evaluating a project based on a cost effectiveness analysis.²⁴ In addition, a government could also offer private companies additional incentives to invest in remote areas or in areas of greatest

public interest, thereby preventing concentration in just a few areas.

For Works for Taxes programs to work, it is also essential to make public officials aware of the mechanism's benefits, as well as how it differs from other forms of public investment. In addition, the government should provide a straightforward system to resolve disputes by assigning an entity to mediate administrative conflicts. And simplifying and standardizing projects could help reduce or prevent such conflicts.

Finally, as Peru has demonstrated, it is critical for the government to keep open lines of communication between the public and private sectors, as this creates opportunities to provide and receive feedback about how to enhance the mechanism's regulation and adapt it to country-specific needs.

Conclusion

A key aspect of the success of Works for Taxes in Peru has been the alignment of the incentives of all parties involved, in order to provide the highest quality public works. As a result, all parties have been driven to provide the best quality product to protect their respective reputations. Since the construction firm is selected privately by the financing firm, which risks its own reputation, the financing firm has the incentive to strictly monitor the costs and quality of the project.

This particular form of private participation in public investment can benefit other countries with similar characteristics, provided that the government is open to private sector feedback. In addition, multilateral development organizations can play a significant role by gathering lessons learned and best practices, and by promoting more efficient ways to implement the mechanism.

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PREVIOUS EM COMPASS NOTES ABOUT PRIVATE INVESTMENT IN INFRASTRUCTURE

Please see also these EM Compass Notes about trends in private Investment in Infrastructure: *Crowding-In Capital Attracts Institutional Investors to Emerging Market Infrastructure Through Co-Lending Platform* (Note 53); *Queen Alia International Airport – The Role of IFC in Facilitating Private Investment in a Large Airport Project* (Note 35); *Creating Markets in Turkey's Power Sector* (Note 33); *Private Provision of Infrastructure— Opportunities for Emerging Markets* (Note 26); *Energy Storage Business Solutions for Emerging Markets* (Note 23); *Attracting Private Investment Through Power Sector Reforms* (Note 21); *Mitigating Private Infrastructure Project Risks* (Note 20); *Seven Sisters: Accelerating Solar Power Investments* (Note 18); *How to Scale Solar Power Generation in Emerging Markets* (Note 17); *How To Make Infrastructure Climate Resilient* (Note 14); *Infrastructure Financing Trends* (Note 5); *Infrastructure Finance* (Note 4).

¹ Peru has a mining code that provisions for the sharing of natural resource profits between the regional and local governments where the mining company operates (Canon Minero), provided that these revenues are used for public investment projects. With the commodity prices boom, these profits grew significantly while physical and technical capacity remained low in subnational governments. Hence, low municipal and regional government capacity to manage, formulate, and execute public investment projects that meet standards and procedures set by the National Public Investment System has resulted in large unused amounts of revenues.

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⁴ AFIN (Asociación para el Fomento de la Infraestructura Nacional). 2015. "Un plan para salir de la pobreza: Plan Nacional de Infraestructura 2016-2025."

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- ¹³ See <https://aloxi.org.pe/>
- ¹⁴ El Comercio. 2017. “Obras por impuestos se usará en 140 proyectos de reconstrucción”. <https://elcomercio.pe/economia/obras-impuestos-usara-140-proyectos-reconstruccion-422716>
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- ¹⁷ Escaffi, 2017.
- ¹⁸ Presidencia de la República de Colombia. 2017. “Empresarios podrán pagar impuestos con obras en zonas afectadas por el conflicto.” <http://es.presidencia.gov.co/noticia/171122-El-Presidente-Hoy-Empresarios-podran-pagar-impuestos-con-obras-en-zonas-afectadas-por-el-conflicto>
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- ²¹ El Colombiano. 2017. “Nuevas obras por impuestos, el canje de la paz.” www.elcolombiano.com/colombia/nuevas-obras-por-impuestos-el-canje-de-la-paz-FA7893117
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