

## Executive summary

This document is the first report prepared in the context of the Multi-dimensional Country Review (MDCR) of Peru. The MDCR is undertaken to support Peru in achieving a sustainable path of development that continues to improve the well-being of its citizens and provide solid economic growth. The MDCR of Peru is being implemented in three phases, each leading to the production of a report. This first report aims to identify the main constraints on achieving sustainable and equitable improvements in well-being and economic growth. The second report will present in-depth analyses of the key policy areas identified in this first report in order to formulate recommendations for Peru. The final report will provide prioritisation, sequencing and a framework for measuring progress.

Peru has experienced considerable socioeconomic progress and improved well-being in the last two decades due to a combination of sound domestic policies and favourable external conditions. The country has recorded strong economic growth since the beginning of the 21st century, which has been accompanied by a significant reduction in poverty, from around 60% in 2004 to less than 24% in 2013. While inequalities remain large and relate not only to income but also to different dimensions of well-being, they have decreased. Sound macroeconomic policies, economic openness and effective social protection programmes are largely behind this success, which has also been fuelled by favourable external economic conditions.

However, in order to meet the middle-income challenge and strengthen the emerging middle class, Peru must overcome low productivity growth, large inequalities and high and widespread informality. Countries tend to face a prolonged slowdown at a certain level of development, commonly referred to as the middle-income trap. This phenomenon seems to be currently affecting Peru. The current drivers of growth, which are strongly reliant on labour, capital accumulation and on the commodity exporting sector, seem insufficient to sustain further socioeconomic progress. To unlock new drivers of lasting growth and improvements in social outcomes, Peru must find ways to boost productivity growth, and to reduce inequalities and informality. In addition, progress has expanded the size of the middle class, which now accounts for around a third of the population. Many in the middle class remain vulnerable and could slip back into poverty following any economic slowdown. In addition, this emerging middle class brings new and evolving demands, notably with regard to public services such as education, health and transportation.

A number of pathways for tackling these challenges across multiple dimensions emerge from the analysis and require a comprehensive approach. The analysis presented in this first volume of the OECD Multi-Dimensional Review of Peru shows that coherence and co-ordination of policies among a variety of social, economic and institutional dimensions are needed to tackle the constraints to development that the country still faces.

Despite improvements in access to both healthcare and education, the quality of these essential public services remains insufficient to meet the needs of citizens and the economy. Despite remarkable advances in providing health coverage to the most disadvantaged segments of the population, access to and trust in the healthcare system remain low and service quality is poor. Equitable access to quality education and formal jobs is critical for fostering social cohesion and improving economic performance. Secondary school students in Peru performed the lowest of all participating countries in the last 2012 PISA survey, showing that an average 15-year-old student in Peru is behind the average OECD student by the equivalent of 3 years of secondary schooling. There is ample room for more investment in education, and for a stronger focus on quality and performance through a greater emphasis on teaching, on policies at the classroom level and on pre-primary education, among other factors. Additionally, the pertinence of education is low; almost a third of Peruvian formal firms fail to find the workers with the skills they need, compared to close to 15% in OECD countries. This highlights the importance of focusing on a wider range of skills in the curriculum, including soft skills. It also means improving vocational education and training and mechanisms to better match the demand and supply of skills, including retraining workers throughout their working life and anticipating future skills demands.

Informality continues to dominate the world of work, holding back both job quality and productivity. The labour market is largely segmented, with poor working conditions, aggravated by significant inequalities by gender and socio-economic origin. Informality, at close to 60% of workers, is one of the highest in Latin America. Strong inequality defines both informality and working conditions. Young people with low education in rural areas are the worst affected, while higher education significantly reduces the likelihood of working in informality. The entrance into labour markets in Peru is more likely to take place through an informal job than a formal one, while informal workers are more likely to become jobless. Overly complex and burdensome labour regulations, high non-wage costs and the deficiencies in education and active labour market policies are some of the factors behind these poor outcomes.

Better jobs and continued socioeconomic progress require greater productivity and competitiveness. Low total factor productivity (TFP) explains close to 50% of the labour productivity gap between Peru and the United States. Furthermore, close to one half of all workers are employed in Peru's two less productive sectors: retail and restaurants, and agriculture. Peru needs increased economic diversification towards sectors with greater potential productivity gains, which can contribute to more value-added in exports. In that context, broad-based policies are necessary to foster productivity and competitiveness. In particular, more and better research and development, as well as the effective diffusion of new knowledge are required to close the innovation gap. To reduce transport costs, Peru should diversify transport modes and improve "soft" components of logistics, such as customs and the use of information and communications technology in the transport sector. Finally, despite recent improvements to reduce red tape and increase competition, room for improvement remains in areas such as contract enforcement and the administrative burdens for new businesses.

Improvements in the tax structure should complement a sound macroeconomic framework. The credible monetary and fiscal policies implemented in the past decade are key for inclusive development in Peru. Inflation rates and public debt are at low levels, increasing confidence among domestic and international investors. However, a more effective taxation system is needed to finance the existing socioeconomic gaps. The level of taxation at 18% of GDP remains low compared to OECD and Latin American

countries (34% and 21%, respectively), and the taxation system does little to reduce inequalities and promote entrepreneurship and green growth. Major challenges are evident in the imbalance between direct and indirect taxes, the lack of progressivity in the tax system, the large tax expenditures as a proportion of total tax revenues and the low level of environment-related taxes.

Finally, to achieve the policy objectives required to boost inclusive development Peru needs stronger governance and greater state capacity to prioritise and implement. In particular, tackling corruption should both increase the trust citizens have in their government and build state legitimacy. This would boost tax morale and ease the political economy of tax reform. The governance of the judiciary and legislature should improve, while central government requires better co-ordination and enhanced leadership to drive long-term reforms. Much has been done to integrate the private sector in expenditures and investments, but better management of the process is needed to avoid inefficiencies and unexpected fiscal costs. At the sub-national level, the allocation of public resources and commodity revenues needs to be improved to address Peru's significant spatial inequalities, which are close to 20 percentage points higher than the OECD average. Local governments require more capacity to improve their policy making. Environmental regulations can be both powerful and efficiently administered and at the same time require better horizontal and vertical co-ordination of policies to promote green growth.





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