

Chapter 1. Peru's path to a high-income economy with better well-being for all citizens

Peru has followed an advantageous path in recent decades. The country has emerged to become an upper middle-income economy but challenges lie ahead if the country is going to avoid getting caught in the development traps. Main bottlenecks are related to productivity, diversification, informality, connectivity and institutional capacities. Overcoming these challenges in the near future remains crucial for taking the economy to the next level and becoming a high-income country with inclusive development and well-being for all.

Peru aspires to become a high-income country where citizens enjoy high levels of well-being. This demands an economy that provides quality formal jobs for citizens with the purchasing power to enjoy consumer goods and generates fiscal revenues to provide high-quality public services. In this vision, Peru would be a highly connected, inclusive and sustainable society, where educated and healthy citizens trust institutions and actively engage in political and civil life. Peru would be well integrated in the region, with innovation and entrepreneurship that fosters a vibrant business environment. In addition, it would have a modern agro-industrial sector and well-managed natural resources. Efforts to improve sustainability will enable citizens to enjoy their country's well-preserved, rich natural heritage and diverse culture.

Peru will need to engage in structural reforms in order for this vision to fully materialise. The policies that led Peru to be part of the upper middle-income countries must be complemented and upgraded if it is to become a “high-income” country and embark on the next chapter of its development. The implementation of sound macroeconomic policies in the 1990s, both at monetary and fiscal levels, helped boost investment and improve consumer confidence, making the Peruvian economy attractive and dynamic. However, further reforms are needed to achieve inclusive growth and improve living conditions for all the Peruvian population.

So far, Peru has experienced considerable socioeconomic progress with improved well-being. The combination of favourable external economic conditions and assertive internal policies has underpinned Peru's strong economic growth since the beginning of the 21st century, reaching an annual average rate of GDP growth of around 5.0% in that period. Significant reductions in poverty rates and the emergence of the middle-class were amongst the most outstanding achievements in the last decade.

Yet, significant economic vulnerabilities remain, namely those associated with the *development traps* (OECD/CAF/ECLAC/EU, 2019). The Peruvian economy is poorly diversified, with a heavy reliance on natural resources that makes it heavily dependent on external macroeconomic conditions. In the past, Peru profited from the boom in commodity prices and a positive global economic landscape. Today, the country must overcome low productivity growth, which is already translating into a prolonged economic slowdown, often known as the *middle-income trap*.

Additionally, socioeconomic gains remain unevenly distributed and the country requires better institutional development. Inequalities are still high, and vulnerabilities are significant for a sizeable share of the population. In fact, many Peruvians still suffer from poor access to quality public services and still work in informal jobs. As a result, many continue to face the risks associated with low levels of social protection. Furthermore, the country requires stronger institutional capacities to improve the effectiveness of public policies and achieve higher state legitimacy, which is critical to strengthen the social contract and bridge the growing divide between citizens and institutions.

On balance, Peru has recorded remarkable socioeconomic progress but significant challenges remain along the path to becoming a sustainable high-income economy with greater well-being for all. Overcoming these challenges requires engaging in sound reforms and implementing structural policies to ignite new engines of inclusive and sustainable economic growth.

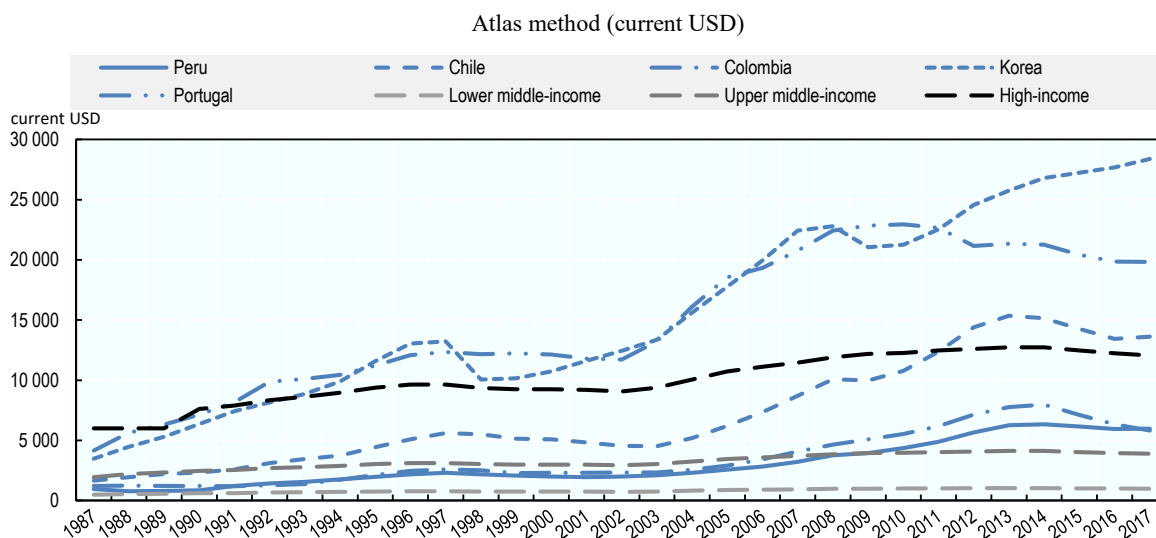
Towards high-income levels and greater well-being...but challenges remain

Overcoming the middle-income trap demands bold policy reform

Peru's convergence with high-income levels has accelerated. From the 1960s to the 1990s convergence was slow, but in the past two decades Peru's growth reached an annual average of around 5%, one of the highest in the Latin America and Caribbean (LAC) region. This has supported a dynamic economy and has resulted in better living conditions for the population.

However, the country faces a period of prolonged slowdown, which has plagued many countries stuck in the “middle-income trap” (Figure 1.1). This phenomenon occurs when a country can no longer rely on its traditional growth drivers to make further progress, as this requires deep, long-term structural reforms that are not easy to achieve or to co-ordinate. In the case of Peru, even if it were to sustain the strong macroeconomic performance of recent years, it would take until 2029 to become a high-income country, supposing more than 80 years as a middle-income country in total.¹ While this is a common phenomenon for most countries in LAC, the performance of some countries worldwide suggests that a more rapid transition from a middle-income to a high-income economy is possible. For instance, this transition took Korea 27 years, Portugal 46 years and Chile 55 years.

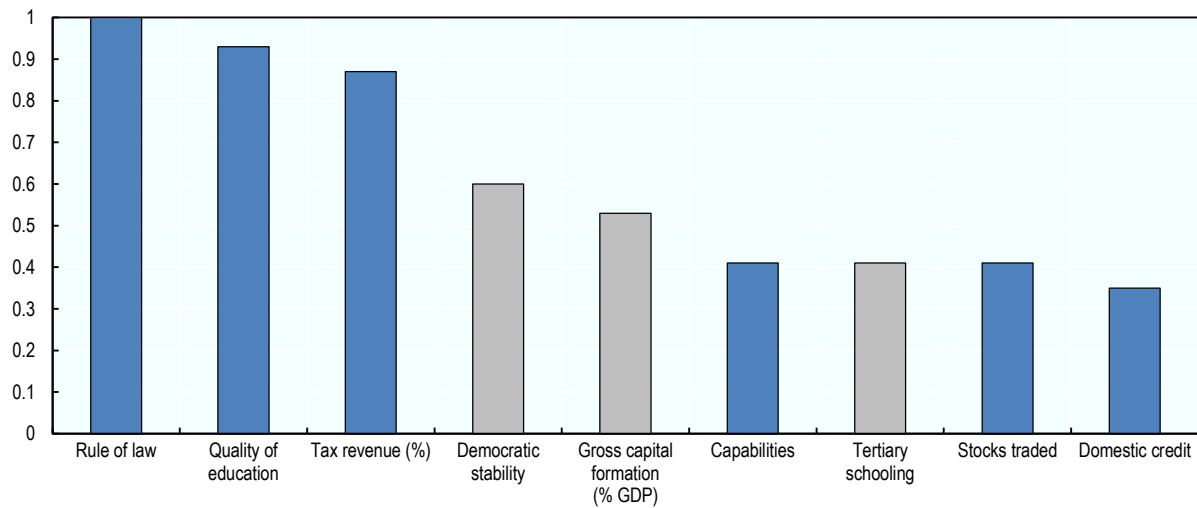
Figure 1.1. GNI per capita



Source: World Development Indicators, with last updated date on 21-09-2018 and World Bank country and lending groups guidelines and analytical classifications.

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Overcoming the middle-income trap requires policy challenges on several fronts that goes beyond income (OECD/CAF/ECLAC/EU, 2019). The priority areas for Peru to focus on are rule of law, quality of education, tax revenues, capabilities and the financial sector (stocks traded and domestic credit as a percentage of GDP) (Figure 1.2). These correspond to the areas where the gaps are larger relative to the average of selected high-income countries before passing to the high-income status (Melguizo et al., 2017).

Figure 1.2. Policy priorities to overcome the middle-income trap

Note: Average of the coefficient of each normalised variable, derived from the linear analysis, based on 1 295 estimates. In blue, the variables in which Peru has the greatest gap with respect to countries that went from middle income to high income. Capabilities refer to productive capabilities based on the economic complexity index, which describes the amount of productive knowledge implied in the country's export structure.

Source: Based on Melguizo, A., S. Nieto-Parra, J.R. Perea y J. Perez (2017), "No sympathy for the devil! Policy priorities to overcome the middle-income trap in Latin America", *OECD Development Centre Working Paper* No. 340.

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The emergence of the middle-class has been a great socio-economic achievement, but comes with new challenges

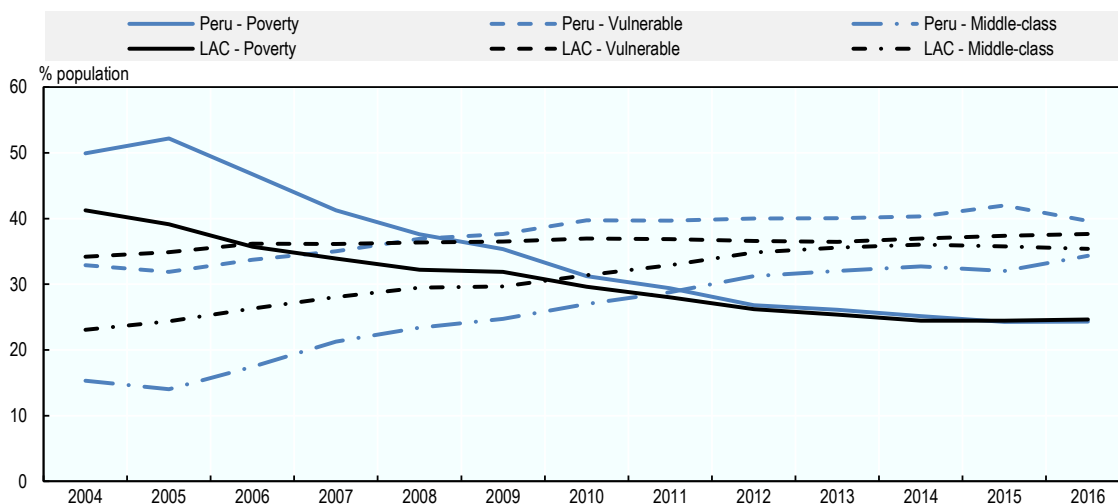
The Peruvian middle-class has significantly expanded over the past decade. In line with the LAC trend, the middle-class in Peru has been growing since the beginning of the 2000s. In 2005, only around 15% of the population was considered part of the middle-class (daily income of USD 13-70/day, 2011 PPP). This percentage already reached 34.3% of the population in 2016, on par with the LAC average of 35.3% (Figure 1.3).

Additionally, Peru's growth has been strongly pro-poor. In the past few decades, the country has been particularly successful in lifting people out of poverty. The poverty rate has almost halved, from 46.7% in 2006 to 24.6% in 2016.

While the middle-class emergence has been one of Peru's greatest socioeconomic achievements, it also brings a whole set of new challenges. In particular, it has created new vulnerabilities, with a vulnerable population (i.e. those who have a daily income of USD 5.5-13, 2011 PPP), which increased from 31.8% to 37.6% between 2005 and 2016. In fact, this vulnerable population represented the largest socio-economic group in the country (World Bank, 2019). This implies that many people in Peru are in an unstable situation where they could easily slip back into poverty following any turbulence or slowdown in the economy, or any setback in the household due to the loss of a job, health problems, etc. Most of the vulnerable population hold precarious jobs in the informal sector, and, therefore, generally have poor job conditions and low levels of social protection.

In addition, the emerging middle class brings new and evolving demands, notably with regard to public services such as education, health and transportation. This is particularly challenging for a country like Peru, where dissatisfaction with public services remains high and tax collection is still a challenge for governments. The vicious cycle of low quality services, dissatisfaction and low willingness to pay taxes (i.e. tax morale) emerges as a relevant development trap for the country, resulting in the erosion of the state's fiscal legitimacy. This makes it difficult to increase tax revenues, which are already low in the country relative to the OECD average: 16.1% vs. 34.3% (OECD et al., 2018).

Figure 1.3. Evolution of socioeconomic groups



Note: Poverty rate (share of the population living with less than USD 5.5, 2011 PPP), middle-class (USD 13-70 a day, 2011 PPP), vulnerable (USD 5.5-13 a day, 2011 PPP).

Source: OCDE/ECLAC/CAF based on World Bank 2019, LAC Equity Lab.

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Well-being in Peru is higher...although large gaps persist

Peru performs relatively well in terms of well-being when compared to the worldwide average. Overall, the OECD well-being framework assesses both material and quality of life standards, providing a comprehensive analysis of people's living conditions. Peru performs reasonably well in the areas of work, health and education and skills, but it underperforms in the areas of environment, empowerment and vulnerability (Figure 1.4). Peru also displays weaknesses in terms of housing and infrastructure.

Peru's scores on consumption indicators are in line with its level of economic development. Gross national income (GNI) per capita captures the gross flow of income to individuals from earnings, self-employment and income from capital. Peru's GNI is USD 12 890 per capita (2017), which is around the expected level for countries with similar GDP per capita. However, Peruvians report their household income is not enough to afford basic needs and the poverty rate is higher than what would be expected for countries with Peru's GDP per capita.

Labour force participation is high in Peru, yet jobs remain a source of vulnerability. The ratio of employment to population is 73.8% among individuals over the age of 15.

Unemployment is relatively lower than the average of countries at this GDP per capita level. However, Peru underperforms significantly in terms of the quality of employment. The share of vulnerable employment² in the Peruvian labour market reaches 49.7%, which is worse than other countries with its GDP per capita.

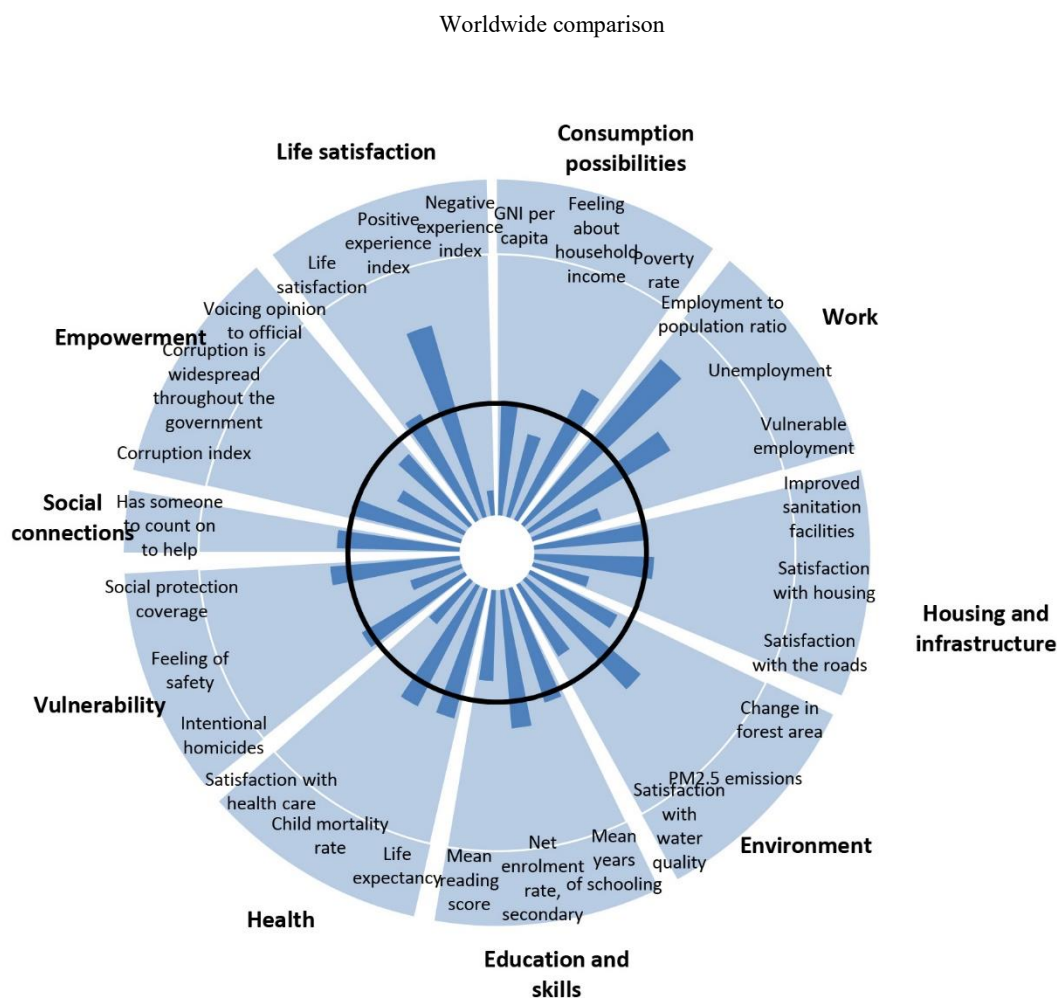
Regarding health, Peru shows relatively good outcomes but underperforms in terms of perception. Peru's results show a relatively high life expectancy and low mortality rate, with respect to the level expected for countries with Peru's level of GDP per capita. Yet, Peruvians report being dissatisfied with the availability of quality healthcare (i.e. indicators are worse than expected).

Education outcomes suggest that the quality of education is still a barrier in Peru despite progress. The country has improved in coverage indicators such as the mean years of schooling, which is slightly higher than the level expected. The net enrolment rate – which includes the total number of students enrolled in a given level of education and with the theoretical age, expressed as a percentage of the total population in that age group – is higher than expected as well. However, in terms of quality of education, the country's results remain low: the mean reading score in the Programme of International Student Assessment (PISA) (398) is still well below the expected level for Peru's GDP per capita. PISA measures the cognitive skills of 15- to 16-year olds in the areas of mathematics, reading and science, assessing their competencies when they reach the end of compulsory education.

Finally, Peru has significant weaknesses in the area of empowerment. Trust in government and institutions is relatively low and participation is similarly limited. The Corruption Perception Index that ranks countries according to the level of perceived corruption, ranks Peru on the expected level for its GDP per capita. Yet, the country underperforms in most of the indicators related to public opinion on institutions and governance. Indeed, 86.8% of the population think corruption is widespread in government according to the Gallup World Poll (2017), an exceptionally high level for a country with Peru's level of per capita income. People voicing an opinion to an official in the last month is below expected levels as well.

In terms of life satisfaction, Peruvians report being satisfied as expected, and report a high positive experience index. In a similar vein, the negative experience index reports to be significantly below than expected.

Figure 1.4. Current and expected well-being outcomes for Peru



Note: This figure is based on running bivariate regressions where the indicator is the dependent variable and GDP per capita is the independent variable. The expected value of each indicator is then computed by taking the coefficient of the bivariate regression and applying it to the actual GDP per capita of the country. The country's observed results are then compared to the expected value for each indicator. The difference between the fitted values and the observed values is standardised by the standard deviation of the indicator. Standardising the size of the gap highlights those dimensions in which the performance of the country stands out. Expected values are calculated using all countries with a population over 1 million.

Source: OECD calculations based on Gallup Organization (2016), *Gallup World Monitor* (database); UNDP (United Nations Development Programme) (2016), *International Human Development Indicators* (database), United Nations Development Programme, <http://hdr.undp.org/en/data>; UIS (UNESCO Institute for Statistics) (2016), *UIS Data Centre* (database), United Nations Educational, Scientific and Cultural Organisation, <http://data.uis.unesco.org>; World Bank (2017), *World Development Indicators* (database), Washington, DC, <http://data.worldbank.org>; OECD PISA 2015 data; Transparency international (2016), *Corruption Perceptions Index*, <http://www.transparency.org/cpi2014/results#myAnchor1>.

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Persistent challenges are jeopardising the broad socioeconomic gains the country has made. At least three crosscutting challenges in Peru exacerbate the need for structural reforms:

- Low levels of productivity, which are a longstanding issue for the Peruvian economy and remain a defining feature of countries bogged down in the middle-income trap. Improving productivity will be at the heart of a sustained growth process and the capacity to compete in global markets and to raise income levels for all.
- High levels of inequality, which is strongly associated with the country's high and persistent levels of informality. These affect social cohesion and equality of opportunities, leaving many people in poverty or in a situation of vulnerability. Inequalities appear at many different levels, from income and regional location, to gender and ethnic groups, among others. Large informality is associated with poor job conditions and with low levels of social protection, leaving many in a vulnerable situation.
- A growing disconnect between society and institutions, with low levels of trust and high dissatisfaction with public services. As it aspires to a better life, the growing middle class, coupled with persistent institutional challenges, is straining the social contract. This has put pressure on the country to transform its institutional architecture.

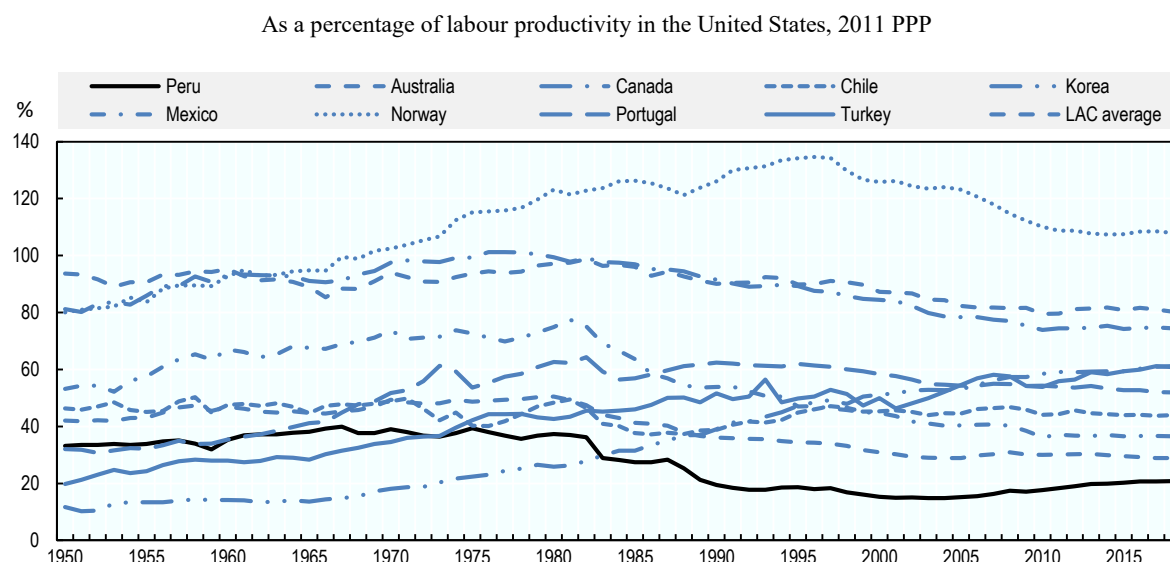
A dynamic economy at a crossroads

A resilient economy with productivity challenges

Peru's economy has been remarkably resilient to global headwinds. Over the last two decades, it has been one of the fastest-growing economies in the region, enjoying macroeconomic stability, a strong mining sector, an open economy, and growing agro-industry and services sectors. The economy recovered from the 2008 global financial crisis and continued to generate one of the highest annual growth rates in LAC. Positive GDP growth continued despite the end of the commodity boom, with an average growth of around 5% in past decade.

However, recent growth has not been enough for Peru to catch up with its peers. Despite an impressive surge in per capita GDP performance over the last decade, Peru has not been able to close the gap with other emerging economies. Since the beginning of the seventies, GDP per capita in Peru diverged from upper middle-income, middle-income and high-income economies on average.

Peru's productivity performance has been poor despite high economic growth. Across Latin America, labour productivity – measured by GDP produced by an hour of labour –, has been declining over the past decade, relative to more advanced economies. Yet, Peru has historically shown a low productivity compared to its peers and to the LAC average. In particular, labour productivity represents only 20% of that in the US, a decline from a level of almost 36% in 1982 (Figure 1.5). This productivity divergence stems from a combination of factors: from low savings and poor use of them, to slower capital accumulation, low efficiency in factor utilisation and limited labour contribution to growth.

Figure 1.5. Labour productivity in Peru and selected benchmark countries, 1980-2018

Note: Labour productivity per person employed in 2017 USD (converted to 2017 price levels with updated 2011 PPPs).

Source: The Conference Board Total Economy Database™ (Adjusted version), March 2018.

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Improving total factor productivity and human capital will be key for promoting labour productivity. Labour productivity, calculated as the output per worker, can be broken down into human capital, physical capital and total factor productivity (TFP). TFP, the portion of output not explained by the amount of inputs used in production, is determined by how efficiently and intensely the inputs are utilised in production. Peru's TFP alone accounts for 49% of the labour productivity gap with the United States; years of schooling accounts for 27% and quality of education accounts for 22% (OECD, 2015). Peru's TFP has grown at an annual rate of less than 2% over the last two decades – even achieving negative rates in the past five years – not enough to close the gap with OECD economies.

The productivity of firms exhibits high heterogeneity compared to other LAC economies and especially to the United States. While in Peru, the ninetieth percentile of most productive firms are 500% more productive than the tenth percentile, in the United States it is approximately 200%, highlighting significant disparities in the allocation of production factors in Peru (Vostroknutova et al., 2015).

To make the economy more efficient and promote productivity and competitiveness, Peru should engage in better connectivity. After controlling for other variables affecting economic growth, there is a significant association between improved logistics and transport infrastructure performance on the one hand and productivity gains and sophistication of exports on the other (OECD/CAF/UN ECLAC, 2013). In particular, Peru has a relatively high share of logistics-intensive and time-sensitive exports, which account for 17% of all exports: 1.38 times higher than the OECD median (OECD, 2015).

Additionally, improving logistics could boost Peru's productivity. The World Bank's Logistics Performance Index (LPI) compares logistics and transport infrastructure performance through six components: customs, infrastructure, ease of arranging shipments,

quality of logistics services, tracking and tracing, and timeliness. The LPI scores countries between 1 and 5. Peru's score in 2016 was 2.89. Countries that improve their score by 1 in the LPI, improve their labour productivity by 35% on average, the productivity gain Peru would enjoy if it achieved the same LPI as Canada (OECD, 2015).

Employment is concentrated in the least productive sectors

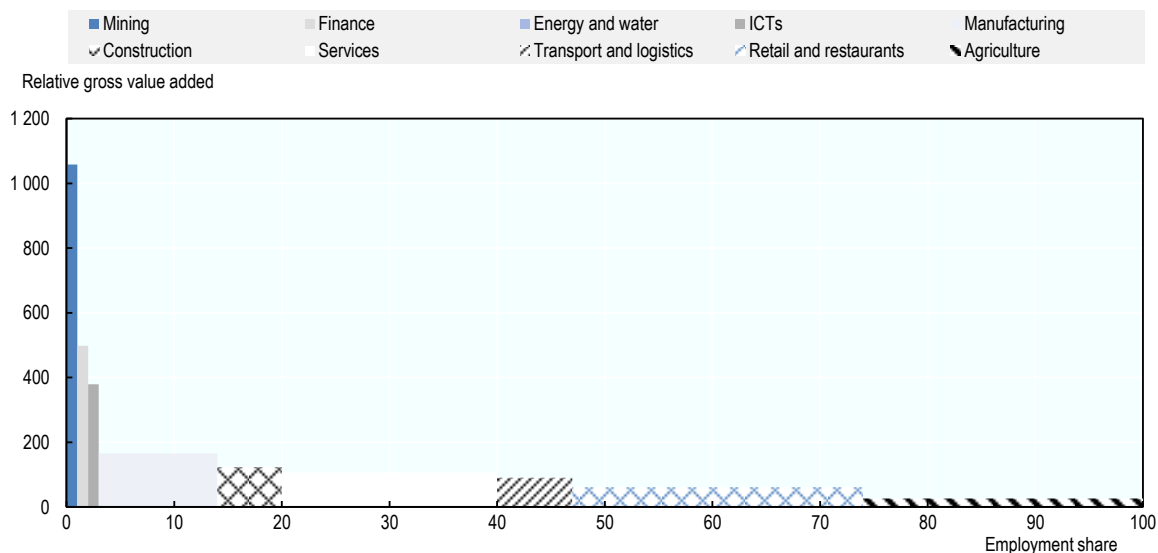
Labour productivity varies widely across economic sectors in Peru. Mining, finance, energy and water, and telecommunications have high labour productivity, while retail and restaurants, and agriculture are particularly low (Figure 1.6). This trend is consistent with the average productivity observed over the past decade. Mining is the most productive sector, with a level of labour productivity of more than seven times the average for Peru, and more than 40 times the level for agriculture.

Most of Peru's jobs are concentrated in the most unproductive sectors. More than half of all workers were in Peru's two most unproductive sectors: retail and restaurants, and agriculture. In contrast, the manufacturing sector accounts for more than twice the average labour productivity in Peru, yet provides only 10.6% of total employment – a share that has decreased from 12% since the start of the century. This picture is even more striking for the most productive sectors. Together, mining, finance, energy and water, and telecommunications represent less than 4% of total employment.

Additionally, the few sectors with high labour productivity create few jobs. The mining sector alone accounts for less than 1.5% of total employment. By contrast, retail and restaurants, and agriculture create close to half of the country's total number of jobs. Yet, they are the least productive sectors in Peru. While these findings seem to imply a misallocation of labour, they also present enormous potential for growth-enhancing structural transformation. The average wage is more than six times higher in the four sectors with the highest labour productivity than in the two sectors with the lowest. The average wage in the mining sector is 12.5 times higher than the average wage in agriculture (Távora et al., 2014), which is less than the 40-fold difference in productivity between those sectors.

Figure 1.6. Labour productivity is concentrated in just a few sectors

Relative value-added as a percentage of workers and employment by economic sector (y axis: 100 = total labour productivity and x-axis: % of employment)



Note: Number of workers is based on Peru's National Households Survey (INEI) of 2013. "Energy and water" is the item with the lowest employment contribution, representing less than 0.5% of total employment.

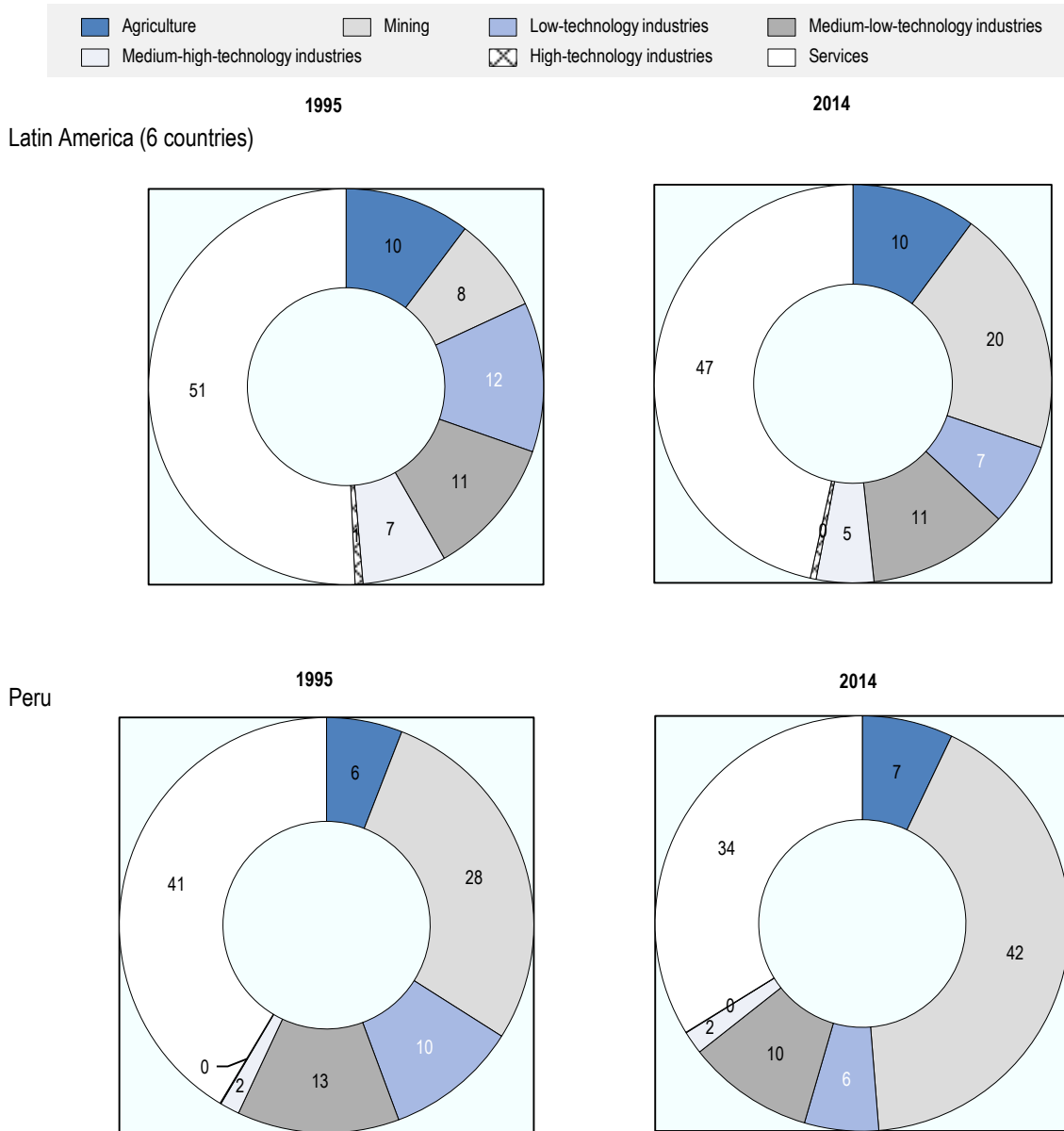
Source: OECD calculations based on data provided by INEI (National Institute of Statistics).

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An open economy with insufficient levels of productive diversification

Peru's integration into international global value chains is low and the country relies heavily on raw materials. The Peruvian economy is overly dependent on commodity exports with limited potential to drive job growth and economic diversification. Commodities still dominate Peru's international trade. Indeed, mining accounted for 42% of total value added in third countries' exports, 14 percentage points more than in 1995 (28%). In contrast, the low, medium and high-technology industries represented altogether 11.7% of the domestic value added in third countries' exports. In Peru, commodities account for 47% of domestic value added, which is slightly lower than the rest of Latin America. In particular, mining as a percentage of domestic value added has been decreasing across the LAC region (Figure 1.7).

Figure 1.7. Domestic value added in third countries' exports by sector of origin in Latin America (6) and Peru, 1995-2014



Note: Data for Australia, Colombia, Ecuador, Korea, and Mexico are from 2013. Latin America (6) is the average of Argentina, Brazil, Chile, Colombia, Costa Rica and Peru.

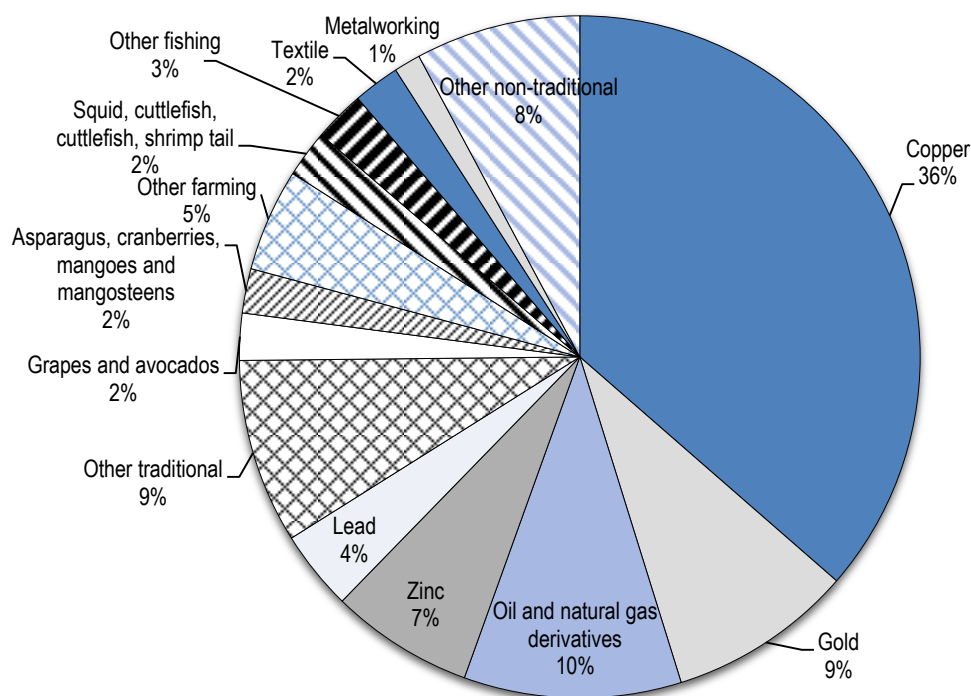
Source: WITS / UN Comtrade, Trade Indicators (database) and Central Bank of Peru (Banco de la Reserva del Perú), <http://www.bcrp.gob.pe/estadisticas.html>.

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Peru remains reliant on its diverse natural resources, making it necessary to improve economic diversification. Peru stands among the top global producers of minerals such as copper, lead, silver, tin and zinc. In addition, Peru contains a significant share of the world's reserves of certain commodities, such as silver, tellurium, cadmium, selenium and copper. Peru's primary mineral production is competitive due to the quality of its resources

(e.g. good mineral grades and its wealth of multiple metals) and the low cost of production inputs. Labour and energy costs account for 15-25% of the total costs of production (McKinsey, 2013). Having an economy that relies so heavily on raw materials makes the economy highly vulnerable to external shocks, and makes the economy highly concentrated in sectors with little added value to global value chains (Figure 1.8).

Figure 1.8. Exports composition, 2017



Source: OECD calculations based on INEI.

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A more inclusive society but vulnerabilities are still widespread

While socio-economic conditions have improved, large challenges remain in the pursuit of a sustainable development pattern that promotes social inclusion and well-being for all. The vulnerable population remains the biggest socioeconomic group in Peru. Despite the emergence of the middle-class coupled with a decrease in poverty rates, vulnerable population (those earning between USD 5.5 and 13 a day) still accounts for 37.6% of the total population. They are usually informal workers with access to low quality public services such as education and health, and social protection systems.

Informality in Peru is high and persistent, with a pervasive impact on the quality of jobs and on social protection

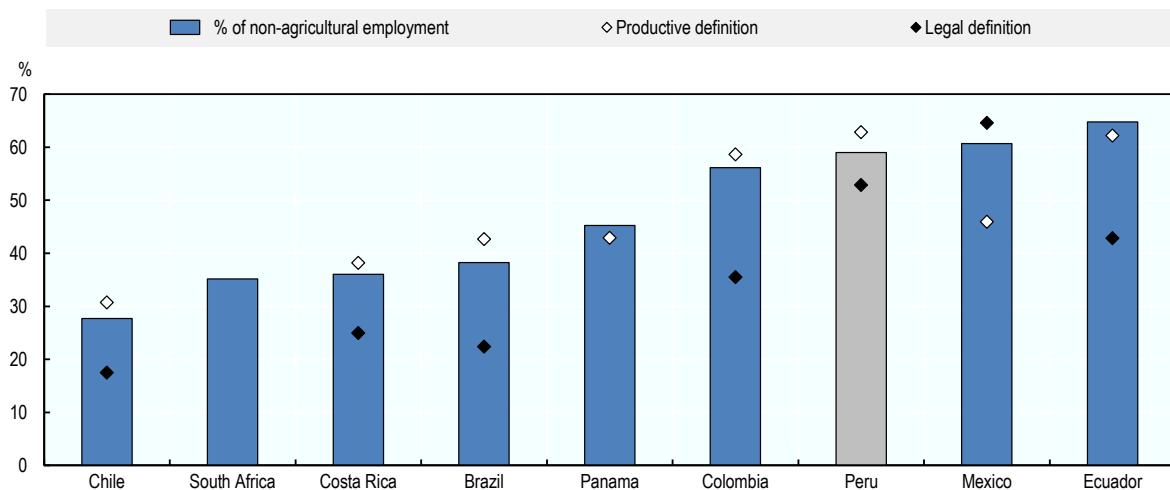
Informality is both a cause and consequence of the low levels of development in Peru. Informality refers to all economic activity happening outside government regulations. The most relevant causes are weak institutional frameworks, high costs associated with formalisation, large size of low-productivity sectors and certain cultural behaviours

common amongst economic agents. Consequences include a pervasive impact on economic efficiency and productivity, tax collection, firm development and poor job conditions, all of which affect the overall performance of a country's development.

Informal employment in Peru remains high and is deeply entrenched. It reached 72% of total employment in 2016 (INEI, 2017). At 68.8% when using the ILO definition applied to non-agricultural employment, it is one of the highest in LAC and among benchmark countries (Figure 1.9). Informal employment has been persistently high in Peru, even throughout the recent period of large economic expansion, when it dropped from 79.9% in 2007 to 72.8% in 2014. Most of this reduction took place in urban areas, while in rural areas informal employment is particularly entrenched.

The incidence of informal employment is unequal across socioeconomic groups. It is higher among young workers (aged 15 to 29) and older workers (age 65+), women, those with lower levels of education and those living in rural areas (OECD, 2015). Among the young, informality is high for all groups and particularly high for those living in poor households. For young people aged 29, approximately eight out of ten workers are informal among those living in extreme poverty households. The rates are seven out of ten among those moderately poor and five out of ten among those living in vulnerable households (OECD/CAF/ECLAC, 2016).

Figure 1.9. Informal employment in Peru and benchmark countries



Note: Non-agricultural employment rates are based on 2015 data for Costa Rica, Ecuador, South Africa and Turkey; 2013 data for Brazil, Colombia, Mexico, Peru and Panama. No data available for Chile for that indicator. Productive definitions are based on 2017 data for Costa Rica; 2016 data for Brazil, Colombia, Ecuador, Mexico, Panama and Peru; 2015 data for Chile. Legal definitions are based on 2017 data for Costa Rica; 2016 data for Colombia, Ecuador, Mexico and Peru; 2015 data for Brazil and Chile. No data available for Panama for that indicator.

Source: CEDLAS and World Bank (2018), *Socio-Economic Database for Latin America and the Caribbean (SEDLAC)* (database) for legal and productive definitions, <http://sedlac.econo.unlp.edu.ar/eng/index.php> and ILO (2018), *ILO Stats*, International Labour Office, Geneva for non-agricultural definition.

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Informality has adverse consequences on social protection and labour conditions for informal workers and the broader population. As informal workers are excluded from national labour laws and social security regulations, they are less likely to have access to

pensions and health insurance systems. They also face more difficult working conditions, in particular lower wages and greater difficulty in finding sufficient work.

Health coverage remains low across Peru, where as many as 31% of Peruvians do not have health insurance coverage. Health insurance is provided through contributory social security (Seguro Social de Salud [EsSalud]) as well as the subsidised Seguro Integral de Salud (SIS). Almost 40% of the population is covered by SIS, while 25% is covered by EsSalud. Other schemes insure 5% of the population. Young adults have the lowest coverage compared to other age groups, with 46% of those aged 18 to 25 having no coverage at all. The various health insurance systems that automatically cover dependents do not cover the beneficiary's children if they are over 18, unless they are disabled or otherwise unable to work.

Likewise, informality challenges pension provision and finance. Peru has one of the lowest rates of affiliation to pension systems in Latin America. Only 40.5% of employed urban workers was affiliated to a pension system in 2013 (ILO, 2014). While this is an improvement over the very low coverage rates of a decade ago (26.7% in 2005), the improvement has been much slower than for health coverage and has slowed down since 2010 (Casalí, Cetrángolo and Goldschmit, 2015). The low coverage of the pension system is largely driven by informality. By definition, informal work remains at the margins of the social protection systems, meaning that workers remain highly vulnerable as they grow older. Formal workers are much more likely to have access to pensions than informal workers. While only 16% of informal workers are affiliated to a pension system, 83% of formal workers are affiliated. Contributions are, in fact, compulsory for dependent formal workers. Since younger workers are more likely to be informal, the affiliation rate is lower for those aged 15 to 29, with 81% having no retirement plan. This figure is better for those 30 and over, although 64% lack affiliation.

Current regulations perpetuate high levels of informality. Despite reforms to labour regulations, firms in Peru continue to struggle with high labour costs. Efforts have been made in reducing enterprises' firing costs but other obstacles remain, limiting firms' capacity to formalise more jobs. Individual dismissals are not allowed unless there is a legal basis or misconduct on the part of the worker; otherwise workers have a right to severance pay consisting of 1.5 times their monthly salary for each year of service up to a maximum of 12 monthly salaries in the case of an indefinite-term relationship. Improvements have been made since neither the notice period for redundancy nor severance pay are very high in Peru, and the firing cost (measured in weeks of wages) was reduced to 17 weeks in 2010 (from 52 weeks in 2005) (OECD, 2015).

Access to education has improved but learning outcomes remain poor

Access to education at all levels in Peru has increased markedly. A variety of indicators show that the "quantity" of education held by the population in Peru has increased in recent years. The average number of years of schooling among 15+ year olds reached 10.1 in 2016, up from 9.5 years in 2005 (INEI, 2015). Adult literacy rates (for 15-year olds and over) have also expanded, from 87.6% in 2004 to a rate of around 94.5% for 2015 (UNESCO/UIS, 2015). But the main improvement has been the number of people participating in education, which has increased substantially at all levels in the last decade.

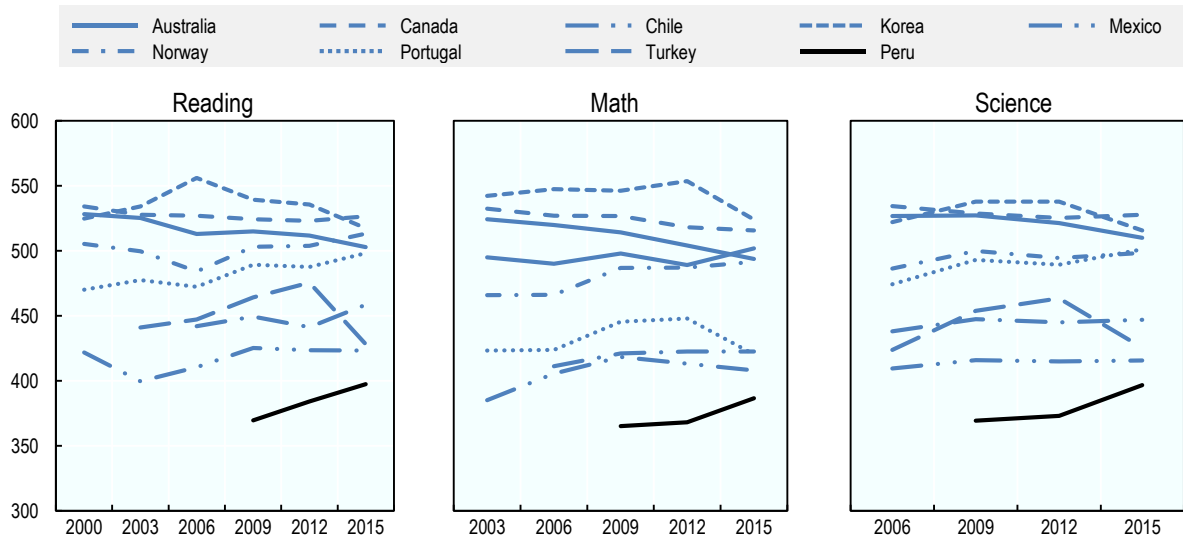
Access to pre-primary, primary and secondary education has improved. In pre-primary, net enrolment rates for those aged three to five reached around 79.2% by 2016, up from around 60% in 2005 (INEI, 2015). Furthermore, access to primary education is high, although it has decreased slightly and students still repeat years and drop out. Net enrolment

rates in primary education were around 91.1% in 2016, similar to the LAC average (91.5%), and slightly below the rate for OECD members of 97% (UNESCO/UIS). Moreover, almost 8 out of 10 students in Peru participate in secondary education, although many leave before completion. Net enrolment rates have increased – from 68.1% in 2004 to around 83% in 2016 – slightly above the levels in the LAC region. However, Peru still remains behind the OECD, where access to secondary education reached around 90% in 2012 (UNESCO/UIS, 2015).

Additionally, access to tertiary education has expanded significantly. This expansion has to a large extent been fuelled by newly created, or expanding, private higher education institutions. Just 45% of students were enrolled in private universities in 2004, but by 2012 that share had reached 66% (INEI, 2015). Despite this increase, only around 20% students aged 22-24 had completed tertiary education in 2013, up from 13.7% in 2005, and around 27% of those aged 25-34 (ESCALE, 2015).

However, the quality of education in Peru still lags behind, despite some recent improvements (OECD, 2016c). Peru improved from 2012 to 2015 in the three categories of the Programme for International Student Assessment (PISA): reading, mathematics, and science. Yet the country still has large room for improvement: it scores on average 380, being the lowest amongst the group of benchmark countries (Figure 1.10). In science, which was the main category assessed in 2015, Peru has the highest level of low achievers (58.4%) amongst benchmark countries. Peru's score in science in PISA 2015 implies that an average 15-year-old student in the country is behind its LAC peer by the equivalent of eight months of secondary schooling, and around three years behind its OECD peers.

Figure 1.10. PISA 2015 scores in reading, maths and science



Note: Based on Table I.2.4a, Table I.4.4a and Table I.5.4a.

Source: OECD (2016), *PISA 2015 Results (Volume I): Excellence and Equity in Education*, PISA, OECD Publishing, Paris, <https://doi.org/10.1787/9789264266490-en>.

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Pertinence of education is also challenging, as shown by the large share of firms that face difficulties to find the workforce they need. In fact, on average between 2005 and 2018

around 4 out of 10 firms claimed that they had difficulties to fill their vacancies (Manpower Talent Survey, 2017). These skills gaps are critical as they represent a barrier to growth but also to labour participation, favouring the concentration of economic activity on low-skilled sectors, and making it difficult to move towards a productive structure of higher value-added and with the capacity to create good quality, formal jobs.

A weak institutional framework undermines the social contract

Lack of trust in institutions has persisted in Peru

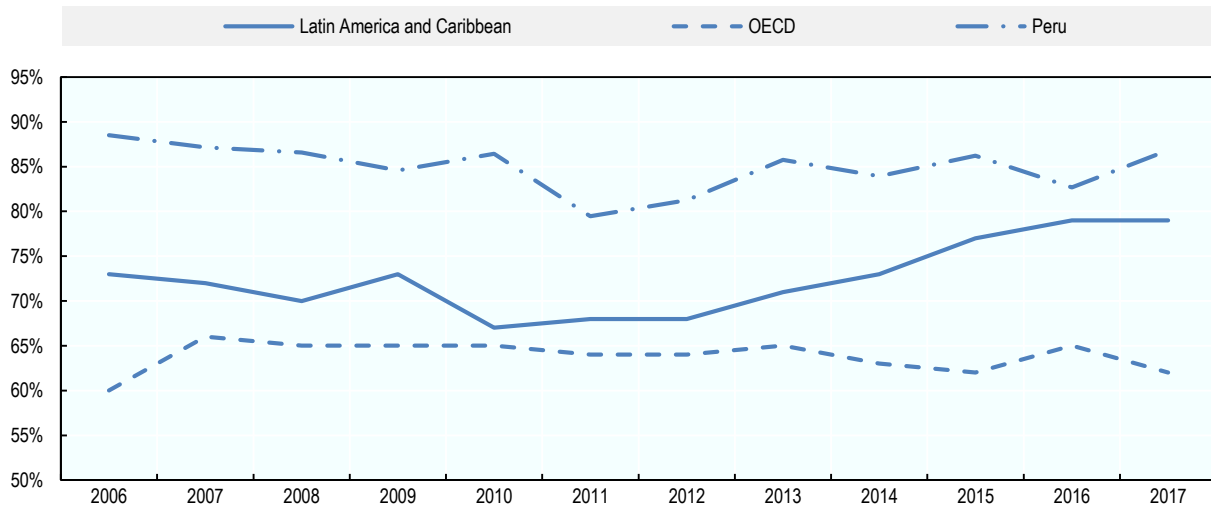
Peru has made progress concerning governance over the last decade. Particularly, the country improved in terms of various governance indicators, namely government effectiveness, regulatory quality, political stability and voice and accountability. Peru has also improved relative to citizens' trust in public institutions. Notably, 82% of people in Peru expressed little or no confidence in the national government in 2017, which was a deterioration from 2007 (77%) and lower than the LAC average of 75% (Latinobarómetro, 2017). On the contrary, confidence in the country's judicial systems and courts improved by 7 percentage points, increasing from 14% to 21.1% over 2006-17, but still remains well below the LAC average in 2016 (34%) (OECD/CAF/ECLAC, 2018).

Significant weaknesses remain and the growing middle-class has come with a rise in social aspirations, leaving social demands unmet in many cases. These dynamics are one of the main explanations to why discontent has remained high even after a period of unprecedented socioeconomic progress (OECD/CAF/ECLAC, 2018). To meet citizens' needs, the state must be able to deliver certain services, improve communication with the population and strengthen administrative aspects.

In Peru, these demands have not been fully met. The population still has negative perceptions of the state and public institutions. Mainly, institutions are perceived as ineffective in achieving their goals, non-transparent in how they act and unaccountable for their results. This undermines social cohesion, hampers collective action to achieve shared objectives, and reduces the well-being of individuals and communities.

In particular, several institutions in Peru suffer from lack of public confidence. Corruption is perceived to be widespread, with 87% of Peruvians believing the entire national government is corrupt (Gallup, 2017). Peru is the third country in Latin America with the highest percentage of people (19%) believing that corruption is the most important problem in the country (Latinobarómetro, 2017). Indeed, and despite a substantial increase in corruption perception throughout the LAC region since 2010, perception of corruption in Peru has been historically higher, compared to LAC and to OECD countries (OECD/CAF/ECLAC, 2018) (Figure 1.11). To face this, building a culture of integrity, transparency and accountability across the public sector can bolster public trust in state institutions and sustain greater socio-economic performance over time (OECD, 2016a).

Figure 1.11. Perception of corruption in government



Source: OECD (2018) based on Gallup (2017), World Poll.

StatLink  <http://dx.doi.org/10.1787/888933995954>

Low confidence in institutions undermines state capacity

Providing good quality public services requires strong fiscal will. Achieving substantial tax collection is both a matter of technical capacity and citizens' willingness to pay. The combination of the two would allow states to invest in the provision of more and better public services, which would result in a growing satisfaction of citizens towards public institutions. Yet achieving this virtuous circle is not straightforward, even less in LAC countries where the level of tax morale is low and has been declining in recent years. Notably, in Peru only 31.7% of the population declares tax evasion as being never justifiable, well below the LAC average of 48.1% (OECD/CAF/ECLAC, 2018).

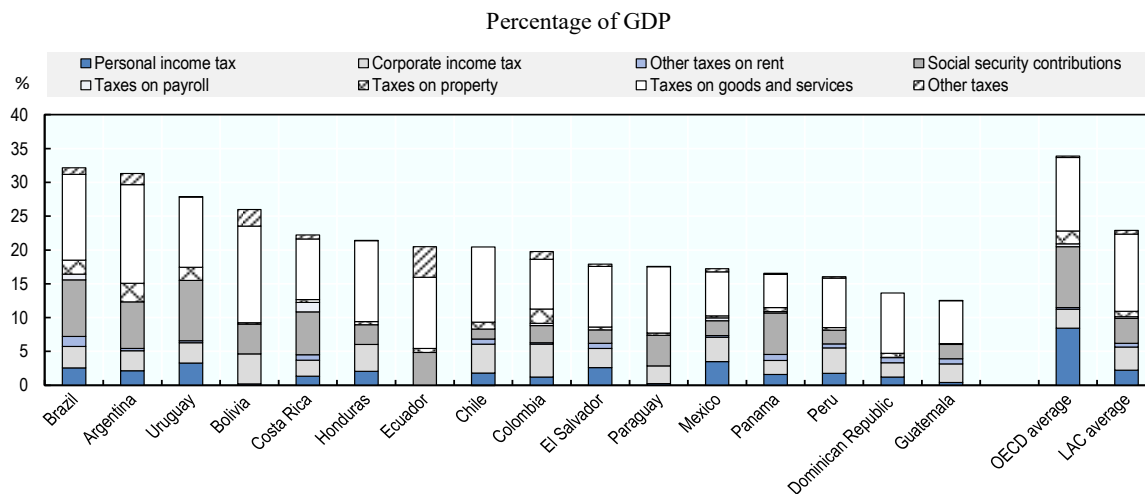
A key challenge for Peru is to improve the technical capacity of levying taxes through a sound tax policy. Tax revenues in Peru are still low compared to benchmark countries (Figure 1.12). Tax revenues represent only 16.1% of Peru's GDP, below the LAC average of 22.7% and well below the OECD average of 34%. The current tax system does not generate sufficient revenues to finance the provision of the services needed to stimulate inclusive and sustainable economic growth.

The fiscal system needs to be improved to turn revenues into a more effective tool for economic and social development. The corporate income tax accounts for 3.8% of the GDP and represent 23% of the total revenue, while the personal income tax accounts for 1.8% and 11% respectively. In contrast, in OECD countries corporate income tax accounts for 8.2% of GDP while personal income tax accounts for 24.8% of GDP. A key feature is that a large share of Peruvian tax revenues are generated through taxes on goods and services, which represent 7.3% of GDP and 46% of total revenues. Within income tax, the personal income tax – which is one of the more redistributive taxes – accounts only for 1.8% of GDP. Overall, Peru's fiscal system relies heavily on indirect taxes and much less on direct taxes, which are usually easier to be levied.

In sum, a more effective fiscal policy needs to be put in place to redistribute income and achieve a more equitable society. Indeed, Peru has one of the fiscal systems in the region that

redistributes the least: the Gini Index barely changes after taxes and transfers (Figure 1.13). Fighting against fiscal evasion and tax erosion would also be crucial in building fiscal capacities and strengthening institutions.

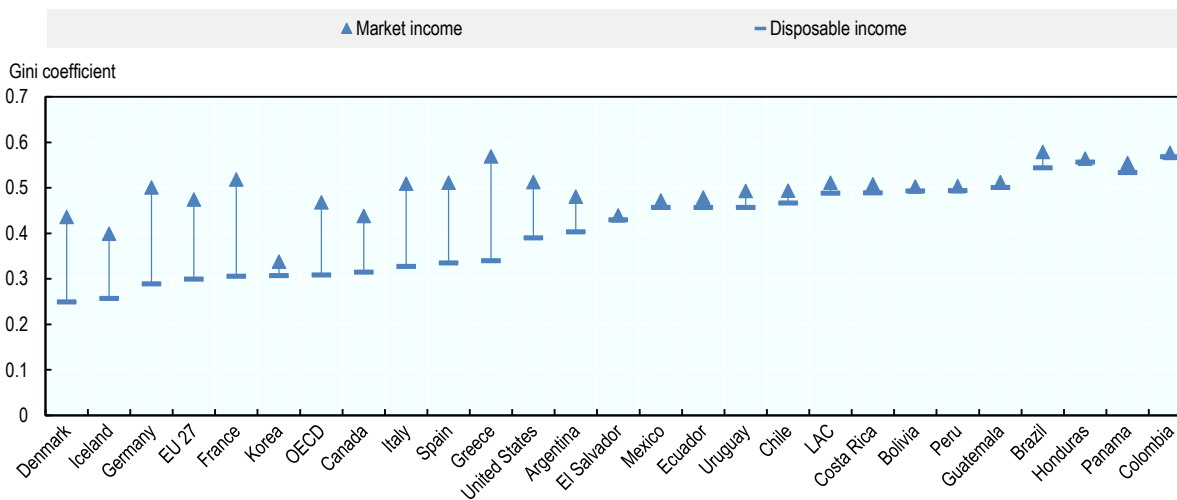
Figure 1.12. Tax-to-GDP ratio composition in Peru and selected benchmark countries



Source: OECD et al. (2019), *Revenue Statistics in Latin America and the Caribbean 2019*, OECD Publishing, Paris, <https://doi.org/10.1787/25666b8d-en-es>.

StatLink  <http://dx.doi.org/10.1787/888933995973>

Figure 1.13. Impact of taxes and transfers on income distribution



Source: OECD/CAF/ECLAC/EU (2019) and Commitment to Equity (CEQ) Institute at Tulane University, New Orleans.

StatLink  <http://dx.doi.org/10.1787/888933995992>

Recent policies have been set up to strengthen the state-society link

Peru faces a number of barriers to both moving towards a more transparent and open government and fighting corruption alongside the private sector and civil society. Peru

lacks a comprehensive strategy on open government data from the central government. Moreover, it does not regularly consult with users regarding data release. Therefore, Peru ranks amongst the LAC countries with the least government support for open data initiatives in 2015 (OECD/CAF/ECLAC, 2018).

Yet, Peru is pursuing an agenda to connect citizens with public institutions and promote more inclusive development. This agenda focuses on citizen safety, the fight against corruption, better delivery of water and sanitation, and a citizen-oriented government service reform. Among other initiatives, the Information Analysis Unit created the Anti-Corruption Observatory of Peru. The government also approved the creation of the Public Prosecutor's office specialised in corruption-related crimes. Additionally, a high-level team was created to facilitate, co-ordinate and prioritise government actions that will enable it to provide its citizens with better services and care.

All government entities have to carry out the Citizen Care Quality Assessment. This new framework also establishes a team that will continually focus on identifying and simplifying obsolete procedures in each sector, as well as reducing administrative burdens. To improve and simplify service delivery, the government wants to further expand the Centres of Better Attention to the Citizen.

The country has promoted, together with Chile, the creation of the LAC Public Integrity Network with the support of the OECD and the Inter-American Development Bank. This network aims at supporting other countries in the region to exchange ideas, experiences and lessons learned. Together, the partners wish to find solutions to common challenges in the implementation of public integrity policies.

The government of Peru recently launched *gob.pe*, a user-friendly version of its Portal of Services to Citizens and Companies that aims to group all state-run procedures related to services for both citizens and firms in one place. Furthermore, the government of Peru has been making the open data portal more accessible and operational. It has also enhanced the Digital Government Secretariat, which proposes national policies and strategies in the field of e-Government. Finally, Peru is developing data and studies nationwide to produce evidence-based policies, which are expected to improve effectiveness and efficiency in public organisations (OECD/CAF/ECLAC, 2018).

Conclusions

Peru has recorded remarkable socioeconomic progress but significant challenges remain to overcome the development traps and to achieve greater well-being for all. Overcoming these challenges requires engaging in sound reforms and implementing structural policies to ignite new engines of inclusive and sustainable development.

Policy priorities to boost competitiveness and well-being go beyond income and require a comprehensive approach for development. Following the multi-dimensional analysis realised in the first volume of this review, boosting productivity and economic diversification, improving transport connectivity and promoting job formalisation are determinant to improve lives of all Peruvians and achieve a higher level of development. In order to implement the policy recommendations for these three areas highlighted in the second volume of this review, specific policy actions are needed in these domains (see Chapter 2).

Notes

¹ OECD calculations following the methodology proposed by Felipe, Abdon and Kumar (2012). Estimations based on the GDP per capita 1990 PPP.

² Vulnerable employment is defined as the sum of the employment status groups of own account workers and contributing family workers. They are less likely to have formal work arrangements, and are therefore more likely to lack decent working conditions, adequate social security and “voice” through effective representation by trade unions and similar organisations. Vulnerable employment is often characterised by inadequate earnings, low productivity and difficult conditions of work that undermine workers’ fundamental rights (Source: World Development Indicators, World Bank).

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