Chapter 1
Setting the scene: Towards greater well-being and stronger development in Peru

Peru has experienced significant improvements in growth, well-being and poverty reduction since the introduction of macroeconomic reforms, economic openness and more effective social programmes in the 1990s. However, the country still faces structural challenges if it is to escape the middle-income trap and consolidate its emerging middle class. The quantitative and qualitative analyses conducted as part of this Multi-dimensional Country Review offer a diagnosis of these barriers to sustainable and inclusive development. In particular, this chapter presents the results of the OECD well-being analysis, which paints a comprehensive picture of people's material living conditions and quality of life in Peru. It also summarises the main bottlenecks to inclusive development, studied in more depth in the chapters that follow. These include health, education and skills, the labour market, innovation, transport infrastructure and logistics, governance, and trust in institutions. These dimensions have considerable implications for the levels of productivity, inequalities and labour informality in Peru.

Peru has made extraordinary progress in recent decades, despite a rather volatile economic and political history. The country has gone through periods of economic crises which have significantly eroded its wealth, together with long episodes of political instability and social unrest that left deep marks on the country's institutional framework and in the memories of its people. This history explains to a large extent where Peru stands today and how, despite the recent encouraging progress, significant socio-economic challenges and gaps remain that are holding the country back on its pathway to inclusive and sustainable development.

This first volume of the OECD Multi-dimensional Country Review (MDCR) of Peru diagnoses the main barriers to sustainable and inclusive development (Box 1.1). Promoting equitable, inclusive and sustainable economic growth and improving the well-being of all citizens should be at the core of all national development strategies. Development strategies must take into account the multiplicity of development objectives and the means available for implementing public policy actions. The diagnostic analysis in this first report serves to identify the constraints hampering Peru's further development. The diagnosis focuses specifically on areas in which the country is lagging behind so as to identify actions to improve this performance.

Box 1.1. **The MDCR in the context of the OECD Country Programme with Peru**

In 2014, the OECD and Peru agreed to set out a joint Country Programme to support Peru in its reform agenda and improve its public policies in key priority areas. The Programme will facilitate Peru's adherence to OECD legal instruments, participation in OECD bodies and programmes, and effective implementation of OECD standards and best practices. Over two years (2015-16) the programme is and will be conducting a series of policy reviews and activities in five priority areas: removing barriers to growth, public governance, anti-corruption, human capital and the environment. The programme also includes workshops and capacity-building activities in areas such as tax policy, regulatory policy, and statistics.

This OECD Multi-dimensional Country Review (MDCR) is the first policy review of this Country Programme to be published. It is designed to help Peru formulate development strategies and identify and support the policy reforms needed to achieve further sustainable and inclusive development. This review is composed of three distinct phases:

- This first report aims to identify the main constraints on achieving sustainable and equitable improvements in well-being and economic growth.
- The second phase will further analyse the key constraints identified in this report in order to formulate policy recommendations that can be integrated into the development strategy of Peru.
- The final phase of the MDCR will provide support to the implementation of these recommendations.[1]

For each phase, a report is published and a series of workshops are organised. The MDCR methodology is based on quantitative economic analysis, as well as qualitative approaches including foresight and participatory workshops. Quantitative methods include standard approaches as well as a comparative analysis with a selection of countries, referred to here as the benchmark countries.

This introductory chapter explores well-being in Peru and summarises the key constraints on development. It starts with a review of economic developments of recent decades and summarises the main economic and social challenges in the context of an economy seeking to escape the so-called middle-income trap and reduce the vulnerability of its increasing middle class. It then presents the main results of the OECD well-being analysis, painting a comprehensive picture of people's material living conditions and quality of life. It also outlines the thematic areas which will be examined in greater detail in the chapters that follow. Finally, it concludes by summarising the key constraints for inclusive development in Peru.

Peru's recent progress marks the end of a tortuous path

The two and a half decades from the mid-1960s to the early 1990s represent for Peru a period of particular economic decline vis-à-vis most middle- and high-income countries. A combination of interventionist and protectionist policies and large microeconomic distortions, such as lack of competition in some markets and barriers to setting up formal businesses, undermined incentives to save and invest and led to a deterioration in Peru's economic potential. Private investment was at very low levels, with the ratio of exports to gross domestic product (GDP) falling dramatically and the fiscal budget in a significantly weak position.

The "lost decade" of the 1980s was Peru's worst economic period of the second half of the 20th century. GDP per capita decreased in real terms by more than 20%. Hyperinflation devastatingly eroded savings and wealth, and the country was battered by years of intense economic and social instability. The annual inflation rate was more than 50% throughout the decade, soaring to over 1 000% in both 1988 and 1989, and the annual fiscal deficit averaged more than 8.5% of GDP.[2] This explains in part why today, among the seven largest economies in Latin America (the others being Argentina, Brazil, Chile, Colombia, Mexico and Venezuela), GDP per capita in Peru has the largest gap with respect to OECD economies.

The 1990s represented a period of reforms aimed at modernising the economy, but challenges remained in the macroeconomic framework. These reforms included removing barriers to private investment. Investment and exports grew significantly during this period, and the fiscal deficit and inflation declined. Economic growth reached an average annual rate of almost 4% between 1991 and 1997. However, by the end of that decade, the government's expansionary fiscal policy, along with the creation of a number of tax exemptions, contributed to raising the fiscal deficit. In addition, the failure to implement an inflation targeting regime affected the credibility of the monetary regime. This decade was not without social unrest and terrorism-fuelled conflicts. Coupled with the international financial crisis and capital outflows in 1998, Peru was once again in a difficult position, and in need of deep and urgent structural reforms.

Following the macroeconomic instability at the end of the 1990s, Peru adopted key reforms to increase its credibility on both the monetary and fiscal fronts. The adoption of an inflation-targeting regime in 2002 to increase monetary stability, and the fiscal responsibility law of 1999 to strengthen public finances and reduce public debt, helped to boost investment and improve consumer confidence.

Since the beginning of the 21st century, Peru has experienced a period of extraordinary socio-economic progress. Between 2000 and 2014, economic growth reached an annual average rate of 5.3%. During this period, Peru's expansion in GDP was second only to Panama in the Latin American and Caribbean region, and well above the regional average of 3.1%. A sound and stable macroeconomic framework has been one of the main drivers of this expansion, coupled with a period of relative political stability. Favourable external conditions have also been key to this expansion, with high international commodity prices and relatively easy access to international finance. On the social side, the combination of high economic growth with a stronger emphasis on social policies and redistributive programmes have been crucial for reducing poverty rates and inequality, as well as for increasing the overall well-being of Peruvians.

New challenges are arising, such as escaping the middle-income trap and protecting the emerging middle class

Peru's recent period of high GDP growth helped it achieve upper middle-income status in 2008 but this success is not without its challenges. As suggested by recent economic-development literature, countries usually face a period of prolonged slowdown once they reach a certain level of income, in what is referred to as the "middle-income trap" (OECD/CAF/ECLAC, 2014). This phenomenon occurs when a country can no longer rely on its traditional drivers of growth (e.g. low labour costs, and the accumulation of labour as a major source of growth) to make further progress. This middle-income trap can be particularly hampering for the country's immediate growth and social prospects. Peru needs new drivers to sustain further growth. Escaping the trap will require increases in productivity and much greater diversification of the economy (OECD, 2014).

The emergence of Peru's middle class has been another distinctive feature of the recent period of socio-economic progress, but it also brings a whole set of new challenges. Between 2000 and 2012, the middle class jumped from 12.3% to 34.3% of the population (UNDP, 2014). This places greater demands on policies, as those in the middle class demand more and better public services and welfare provision. This is particularly challenging for a country like Peru, where improving public provision would entail raising tax revenues to finance them. However, the poor quality of public services has eroded the state's fiscal legitimacy, making it difficult to increase the fiscal burden. Another challenge is related to the increase in the size of those belonging to the "vulnerable" group, which increased from 33.8% to 40% (UNDP, 2014).[3] Despite the socio-economic progress achieved in recent years, many people in Peru are in an unstable situation in which they could easily slip back into poverty following any turbulence or slowdown in the economy.

In recent years, Peru has proposed a large number of policies to tackle the barriers to inclusive growth, but these need greater co-ordination and implementation to make reform happen. Several ministries and public-sector entities have presented valuable analysis on the current socio-economic challenges and set out objectives for the medium term. These include the *Agenda de Competitividad 2014-2018*, the *National Plan for Productive Diversification*, the *National Strategic Export Plan*, the *National Strategy on Development and Social Inclusion: "Incluir para Crecer"*, and the *Plan Bicentenario: El Perú hacia el 2021*. While these plans aim to tackle the main challenges in Peru, the country will need better co-ordination among public institutions to determine priorities, and a better connection between the budgeting process and these agendas to adopt and implement reforms for inclusive growth.

Peru's combination of good policies and favourable external conditions has led to improved overall well-being and better socio-economic conditions, but despite recent improvements, it cannot rest on its laurels. It still lags behind OECD economies and faces pressing socio-economic challenges. Income and spatial inequalities, informality and low productivity are affecting the prospect of inclusive growth. The country needs to embrace structural reforms to overcome the challenges associated with the middle-income trap, to improve living conditions and to promote greater well-being.

The multi-dimensional review methodology explores development from all perspectives

Development is multi-dimensional in the sense that it implies an aggregate improvement in a set of desirable outcomes, as opposed to progress along a single dimension. The OECD's Multi-dimensional Country Reviews analyse development challenges from a wide variety of perspectives, using a combination of tools: a gap analysis across a dashboard of indicators, detailed cross-country benchmarking with a set of comparator countries selected for Peru, and a visioning exercise.

The MDCR dashboard of indicators covers three broad areas: well-being, drivers of long-term growth, and structural characteristics and development dynamics. The well-being analysis plays a key role in determining not only "how's life in Peru?", but also in assessing development outcomes.

To accurately assess Peru's economic and social strengths and weaknesses, the MCDR goes beyond describing average outcomes and adopts a more analytical approach. The benchmarking exercise is thus based on both a gap analysis and a comparison with 14 comparator countries.[4] The choice of these countries is based on factors such as income per capita, size and structural characteristics of the country as well as the degree to which their successful policies could act as a role model for Peru. The comparator countries were selected in conjunction with the Ministry of Economy and Finance of Peru and include Australia, Brazil, Canada, Chile, Colombia, Costa Rica, Ecuador, Korea, Mexico, Norway, Panama, Portugal, South Africa and Turkey (see Annex 1.A1 for more detail). In addition to these countries, this review compares Peru to the Latin America and Caribbean (LAC) and OECD averages.

In addition to this quantitative dimension, the OECD MDCR methodology includes a series of participatory workshops. These workshops enable the OECD team to connect with diverse perspectives in Peru and to bring together different parts of Peruvian society to reflect on the challenges to inclusive and sustainable development, as well as on the context in which policy responses will be implemented. The participatory workshops serve as a platform for dialogue and ideas between the OECD team and Peruvian stakeholders to enhance understanding of local issues to test recommendations and ensure these are both targeted and pertinent. A multi-stakeholder participatory workshop was organised in Lima in February 2015 to gather perceptions on the main bottlenecks to inclusive development. Participants included actors from the private and public sectors, civil society, and academia (see Annex 1.A2 for the topics discussed in the workshop).

Using this combination of quantitative and qualitative techniques, this report identifies the main constraints for Peru's development. These constraints are summarised at the end of this chapter and discussed in detail in the rest of the report. An overview of well-being outcomes in Peru is presented below.

How's Life in Peru: An overview of well-being

Development is often considered synonymous with economic growth, and yet growth in GDP is only one element of development. If aggregate increases in productivity and material wealth do not produce meaningful gains in the well-being of a country's population, development has failed in both human and economic terms. Economic growth is only a means to an end – the sustainable and equitable improvement of people's lives. To comprehensively assess life within a country, it is necessary to go beyond macroeconomic indicators and monitor well-being across the many different areas that matter for citizens.

Part of the OECD MDCR benchmark analysis examined a range of well-being indicators in Peru. Well-being is multi-dimensional concept and can be difficult to define in isolation as it covers many areas of people's lives. However, the core idea is relatively intuitive: well-being encompasses those aspects of life that people would consider essential to meet one's needs, to pursue one's goals and to feel satisfied with life (Box 1.2).

Box 1.2. **Using the OECD's "How's Life" framework to measure well-being in developing countries**

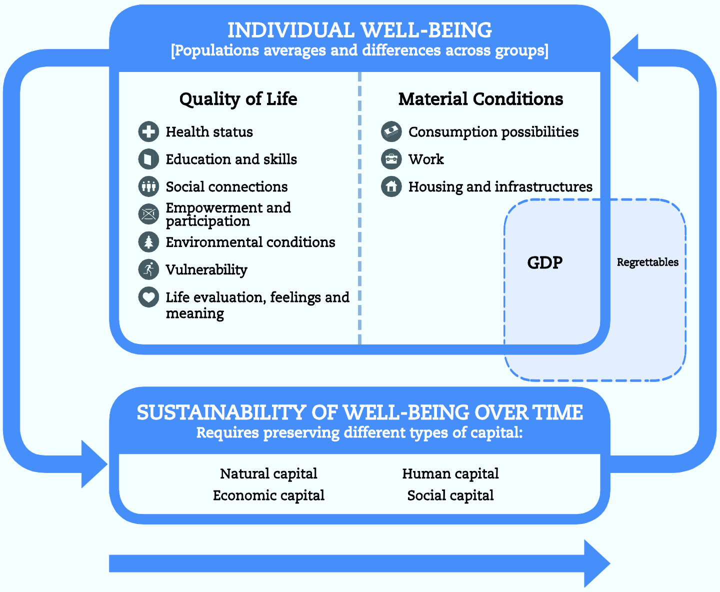
The OECD has developed a framework for measuring well-being in OECD countries based on a number of national initiatives undertaken in several countries and several years of collaboration with experts and representatives from national governments (OECD, 2011). This "How's Life" framework has also been adapted to measure well-being in non-OECD countries, taking into account the literature on measuring development outcomes and embracing the realities of these countries. Its dimensions have been redefined to better match the availabilities of data, the priorities and critical concerns of these countries (Boarini, Kolev and McGregor, 2014).

This adjusted framework, like the original, measures well-being outcomes in two broad pillars. The first pillar, material conditions, comprises the dimensions of consumption possibilities, work, housing conditions and infrastructure. The second pillar, quality of life, comprises health status, education and skills, social connections, empowerment and participation, vulnerability and life evaluations, feelings and meaning, i.e. the main aspects of subjective well-being (Figure 1.1). These ten dimensions are used to measure current well-being; they are complemented with another set of indicators to measure the sustainability of current well-being in the future. The framework emphasises the importance of preserving the natural, human, economic and social resources that are essential for ensuring the well-being of future generations.

The OECD well-being framework is informed by a number of analytical principles. First, it is concerned with the well-being of individuals rather than aggregate economic conditions. Second, it focuses on well-being outputs rather than inputs, recognising that outcomes may be uncorrelated with the resources devoted to achieve them. Third, it emphasises the need to measure the distribution of well-being outcomes to identify inequalities across and within population groups. Finally, it considers both objective and subjective indicators, as people's own evaluations and feelings about their lives matter as much as the objective conditions in which they live (OECD, 2013).

Box 1.2. **Using the OECD's "How's Life" framework to measure well-being in developing countries** (*cont.*)

Figure 1.1. **OECD well-being framework for developing countries**



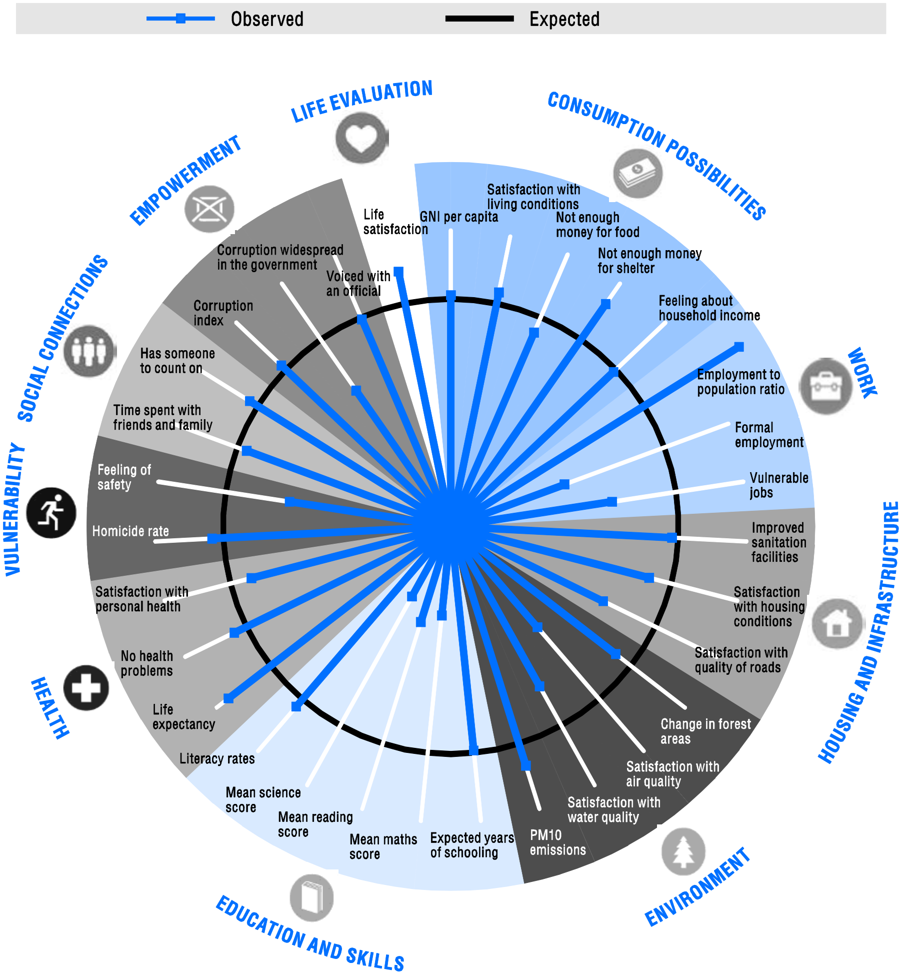
Source: OECD (2011), *How's Life?: Measuring Well-being*, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264121164-en; Boarini, R., A. Kolev and A. McGregor (2014), "Measuring well-being and progress in countries at different stages of development: Towards a more universal conceptual framework", *OECD Development Centre Working Papers*, No. 325, OECD Publishing, Paris, http://dx.doi.org/10.1787/5jxss4hv2d8n-en.

When it comes to well-being, Peru has areas of strengths and weaknesses. Peru performs reasonably well in the areas of consumption possibilities, social connections and life evaluations, but it underperforms in the areas of work, education and skills, and health (Figure 1.2). These latter areas are also characterised by remarkable inequalities across socio-demographic groups. Peru also displays weaknesses in terms of housing and infrastructure, environmental conditions, vulnerability, and empowerment and participation.

Incomes are reasonably good in Peru, but jobs can be precarious and living conditions poor

Given its level of economic development, Peru scores reasonably well for consumption possibilities. Gross national income (GNI) per capita captures the gross flow of income to individuals from earnings, self-employment and income from capital.[5] Peru's GNI is USD 11 280 per capita, which is around the expected level for countries with similar GDP per capita. Satisfaction with living standards is also reasonably high. Two out of three Peruvians say that they are satisfied with their living standards, while 58% report that they can either get by or live comfortably on their household income. Most Peruvians report they can meet their basic needs, with 63% reporting that they have enough money for food, and 84% for shelter.

Figure 1.2. **Current and expected well-being outcomes for Peru: Worldwide comparison**



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.

Sources: OECD calculations based on Gallup Organization (2014), *Gallup World Monitor* (database); UNDP (United Nations Development Programme) (2014), *International Human Development Indicators* (database), United Nations Development Programme, http://hdr.undp.org/en/data; UIS (UNESCO Institute for Statistics) (2013), UIS Data Centre (database), United Nations Educational, Scientific and Cultural Organisation, http://data.uis.unesco.org/ (accessed 15 January 2014); World Bank (2014), *World Development Indicators* (database), Washington, DC, http://data.worldbank.org; OECD PISA 2012 data; Transparency international (2014), Corruption Perceptions Index, http://www.transparency.org/cpi2014/results#myAnchor1

StatLink http://dx.doi.org/10.1787/888933265108

Labour force participation is high in Peru, but the quality of employment is remarkably low. The ratio of employment to population is 73% among individuals over the age of 15. However, Peru underperforms significantly in terms of the quality of employment. The share of informal employment in the Peruvian labour market (i.e. those who do not have the right to a pension or those in a firm with five or fewer employees, a non-professional self-employed, or a zero-income worker) is one of the highest in the world – around 70%, depending on the criteria used to define informality (see Chapter 2 for more details) – and very high for a country at Peru's level of economic development. Similarly, the share of those in vulnerable employment, i.e. unpaid family workers and own-account workers, is above what is expected from a country at Peru's level of economic development.

Access to decent housing and infrastructure is another key dimension of material conditions. Peru provides access to improved sanitation facilities to three-quarters of its population, with 73% of households having access in their house to sanitation facilities such as flush or pour flush toilet (to piped sewer system, septic tank and pit latrine), ventilated improved pit latrine, pit latrine with slab or composting toilet. This value is close to the expect level for Peru based on the experience of countries with similar GDP per capita. However, access to affordable housing and to decent highways and roads is problematic. Only 40% of Peruvians are satisfied with the availability of good and affordable housing and 44% are satisfied with the quality of the roads and highways (Chapter 3). These figures are slightly below what would be predicted in a country with a level of economic development similar to Peru, and highlight the need for more and better use of public finances (Chapter 4).

Key quality of life failings on health status, education and skills, and empowerment and participation are holding Peru back

Peru performs remarkably well in terms of life expectancy, but not so well in other aspects of health status. Good health is a major determinant of quality of life and a core dimension of well-being. In addition to its intrinsic value, it is vital for people's ability to work and participate in social life. Life expectancy at birth in Peru is 77 years (76 years for men and 79 years for women), 1.3 years longer than the world average. In this regard, Peru performs reasonably well given its level of economic development. Despite their relatively high life expectancy, however, one-quarter of Peruvians report being dissatisfied with their health conditions, which is 5 percentage points lower than the world average and below what is expected of a country with Peru's level of economic development.

Education and skills are also a major weakness. In terms of access to education, Peru performs as expected given its GDP per capita. Average years of schooling were 10.1 years in 2013. However, Peru's education outcomes suggest that the quality of its education is a major barrier. While the basic literacy skills of the adult population, i.e. percentage of the population ages 15 and older who can, with understanding, both read and write a short simple statement on their everyday life, are at an acceptable level (90%), the skills of 15-year olds are remarkably poor. Peru ranked at the bottom of the 65 middle and upper-income countries participating in the last round of the Programme for International Student Assessment (PISA). 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.

Social connections in Peru are relatively strong. The ability to count on others in times of need and the amount of time people spend with friends and family are good proxies of the strength of people's close, personal networks. In Peru, 82% of the population says that they have at least one friend or a relative that they can turn to for help in time of need, slightly above the world average. The average time spent socially with friends and family on a typical day is 5.7 hours, slightly below the world average. These measures of social connections are close to the expected level for a country of Peru's level of economic development.

Peru has significant weaknesses in the area of empowerment and participation. Trust in government and institutions is relatively low and participation is similarly limited. According to Transparency International's Corruption Perception Index (Transparency International, 2014), which ranks countries based on how corrupt their public sector is perceived to be by business people and country analysts, Peru ranks just at the midline for countries where data are available. This is in line with its level of economic development. However, the Gallup World Monitor 2015 database suggests that perceived quality of government is remarkably low: 84% of the population think corruption is widespread in government and only 23% believe that elections are honest, levels that are below what would be expected given Peru's GDP per capita. Business people and citizens differ in their perceptions of the trustworthiness of Peruvian institutions, where business people place Peru higher than citizens. This discrepancy is probably due to business-friendly reforms made in the trade sectors, while plenty of room for improvement remains in public services. Turning to participation, just 19% of people have voiced their opinion to a public official, a proxy for citizens' channels of influence in formal institutions (lack of trust and perceptions of corruption are discussed in detail in Chapter 5).

Environmental conditions are close to the expected benchmark levels, but satisfaction with environmental quality is low. Environmental quality has an intrinsic value for individuals and is an important determinant of health and the sustainability of well-being. In objective measures, Peru's environment outcomes are close to what can be expected from a country with similar GDP per capita. For example, there has been a 3.3% reduction in forest area between 1990 and 2011, which is only slightly higher than expected. Similarly, air pollution is also at the expected level for a country with Peru's level of industrialisation. According to the World Bank, Peru's PM10 level (a measure of particulate matters up to 10 micrometres in size that have severe health effects) was 63 micrograms per cubic metre in 2013, which is slightly lower than would be expected. However, Peru does much worse on subjective measures of environmental conditions. Satisfaction with air quality and satisfaction with water quality (at around 40%) are both remarkably low compared to the benchmark outcome (environmental conditions are discussed in detail in Chapter 5).

Personal security is relatively high in Peru, but fear of crime remains widespread. In 2012 there were 9.6 homicides per 100 000 inhabitants, approximately what could be predicted given Peru's GDP per capita and close to the world average of 9.8 per 100 000. In contrast, people's perceived risk of safety is more widespread: in 2014 only 45% of Peruvians reported that they feel safe walking home alone at night, as opposed to 60% for the world average yet similar to 40% for Latin American average. This relatively high level of perceived insecurity could be related to an increase in homicide rates during the last decade, as well as to an increase in crime reporting.

Despite this complex reality, with areas of strong and poor performance, subjective well-being overall in Peru is above average. The way people experience and evaluate their own life outcomes provides essential information that cannot be obtained by objective measures alone. Subjective well-being reflects how people experience a set of circumstances and is as important as the circumstances themselves. It is based on the idea that people are the best judges of how their own lives are going (OECD, 2011). Using the Cantril Ladder, a measure which asks respondents to rate their lives as a whole on a scale of 1 to 10, average life satisfaction in Peru is 5.9, as compared to a world average of 5 and a Latin American average of 6. The high level of subjective well-being relative to the level that could be predicted based on the country's GDP per capita is a feature that Peru shares with most other Latin American countries.

Major bottlenecks to inclusive development

This report takes a holistic approach to determining the major bottlenecks to achieving sustainable and inclusive development in Peru. In particular, it looks at how well Peru is meeting the objectives of sustainable and equitable development and promoting citizens' well-being. It also examines how the underlying dynamics of the country's development process affect these objectives, and how they reinforce Peru's middle-income trap and the fragility of its middle class, hampering the country's prospects for continued progress towards inclusive development. The quantitative and qualitative analyses of well-being outcomes described above are complemented in this review by an in-depth analysis of the dimensions associated with inclusive development in Peru, which are the focus of the remaining chapters of the report. Chapter 2 assesses social challenges, including health, education and the labour market. Chapter 3 covers factors affecting productivity and competitiveness, such as economic diversification and sectoral productivity, innovation, infrastructure, and the business environment. Chapter 4 analyses macroeconomic stability from the monetary, fiscal and financial perspectives, as well as how well the taxation system is used to finance development. Finally, Chapter 5 focuses on governance and state capacity to boost inclusive development.

The analyses presented in this chapter (focused mainly on the general results of the OECD well-being framework) and in the rest of the chapters of this report, show that the major key constraints to sustainable and inclusive development in Peru are:

- Low quality of education, combined with large inequalities in access to education and performance across socio-economic groups.
- Poor levels of skills, which are not aligned with the needs of the labour market.
- Segmented and rigidly regulated labour markets, with unequal working conditions.
- Poor diversification of the economy into sectors that can create both more and better jobs and boost labour productivity and competitiveness.
- Low connectivity of the Peruvian economy due to high transport costs.
- Low levels of research and development spending which are holding back innovation.
- Limited state capacity at regional and national levels, leading to low trust and legitimacy.
- Structural weaknesses in the tax system which undermine progressivity and miss opportunities to fill educational, innovation and infrastructure gaps.

These constraints interact – and further reinforce – with three cross-cutting challenges in Peru which exacerbate the impact on the middle-income trap and the vulnerability of the middle class.

- High levels of informality, which dominate the labour market and stifle productivity. Inefficiencies on the demand and supply sides of the labour market should be tackled to boost inclusive growth.
- High levels of inequality, affecting social cohesion and equality of opportunities, and leaving many people in poverty. Inequalities appear at many different levels, from income, regional location, to gender and ethnic groups, among others.
- Low levels of productivity, which are a longstanding issue for the Peruvian economy. Rectifying these 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.

The second phase of the Peru Multi-dimensional Country Review will complement OECD policy reviews conducted as part of the Country Programme with Peru (Box 1.1). These include a Skills Strategy Review, a Vocational Education and Training Review, an Environmental Performance Review, a Public Governance Review, and a Territorial Review. The second phase of Peru's MDCR will complement these reviews, and take forward the findings outlined in this present report, by focusing on three key areas for boosting inclusive development:

- Tackling informality in the labour market. Several dimensions, such as active labour policies and labour market regulation will be included in the analysis.
- Improving connectivity to foster competitiveness. Transport infrastructure and regulation, and logistics will be analysed as key factors to reduce transport costs in Peru.
- Promoting economic diversification and improving productivity. Better management of natural resources and policies to improve the productive structure of the Peruvian economy will be part of this study.

Notes

1. As in other Latin American economies, this final phase is particularly relevant in Peru given the complexity of both the political economy and the policy-making process to make reform happen (Dayton-Johnson et al., 2011).

2. In 1990, the inflation rate was even higher at over 7 400% year-on-year.

3. The vulnerable group is defined as the group that has 10% or more probability of falling back into poverty, following the definition in López-Calva and Ortiz-Juarez (2014).

4. The gap-based exercise benchmarks Peru against all countries with a population over a million. See note to Figure 1.2 for more detail of how the gaps are calculated.

5. Economy-wide and household level income measures can differ significantly, in terms of both levels and changes, particularly in countries that are relying heavily on natural resources and where a significant part of income from production is transferred abroad. Note that the ideal measure of household living standard is a measure of household net adjusted disposable income but since many developing countries lack such measure the report uses the Gross National Income.

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Annex 1.A1
The cross-country benchmarking exercise in Peru

No two countries face the same combination of development challenges or opportunities and therefore no perfect comparison country exists. The idea of creating a benchmark group is to allow comparative evaluation of Peru's performance over a variety of dimensions. The aim of the comparison is to draw upon a range of policy successes that relate to the multiple challenges and opportunities that Peru faces. The 14 benchmark countries selected have been used in the analysis of Phase I of the MDCR. Throughout the analysis, Peru will also be compared to the Latin America and Caribbean average and the OECD member average.

The 14 countries and a brief summary of their economic structures, strengths and particular relevance to Peru are described below. They were selected according to criteria that included their GDP per capita, the contribution of natural resources (particularly minerals) to GDP and the degree to which their successful economic policies could be relevant to Peru.

Eight of the countries are OECD members: Australia, Canada, Chile, Korea, Mexico, Norway, Portugal, and Turkey. Australia, Canada and Norway are included because of their important natural resource sectors; Portugal and Turkey in part because of their development path; and Korea as an example of a highly successful, export-based Asian economy. In addition to Chile and Mexico, five other Latin American and Caribbean countries are included: Brazil, Colombia, Costa Rica, Ecuador and Panama. Brazil and South Africa, both among the BRICS (Brazil, Russia, India, People's Republic of China and South Africa), are included because of their growing economic power and their mineral resources.

OECD members

Australia

The Australian economy is dominated by the service sector but its economic growth is primarily driven by the mining and agriculture sectors. Mining and mining-related industries contribute around 20% of GDP, with the service sector adding 69% in 2012. The Australian economy has displayed remarkable resilience to international turbulence; for more than 20 years in a row, it has experienced consistent economic growth and no recessions. Strong demand from People's Republic of China, Japan and other East Asian markets for commodities as well as sound macroeconomic policies have been important in maintaining Australia's growth.

Australia ranks very highly in terms of financial market development. According to the World Economic Forum and the Australian Securities Exchange, it has the 9th largest stock exchange in the world in terms of market capitalisation. In 2014, Australia had 32 companies listed in the Forbes 2000.

Canada

The Canadian economy is primarily composed of the service sector that employs around three-quarters of all Canadians. The oil and logging industries are also of considerable importance to the Canadian economy, as is the sizeable manufacturing sector. International trade has an important role in the economy, and this is related to the country's endowment of natural resources; in 2009, 58% of total exports were from agriculture, energy, forestry and mining. Only 4% of Canadians, however, are employed in these areas, and only 4% of GDP is generated by oil and gas revenues.

Canada is estimated to have the world's second largest oil reserves and despite decades of exploitation, its natural resources are not approaching exhaustion. This makes their level of export sophistication – which is higher than Norway's – even more impressive as diversification is often motivated by fear of dwindling resources.

Canada's natural resource endowment varies considerably between regions leading to different economic structures within the country and this contributes to its strong regionalism.

Chile

Chile is regarded as one of South America's most economically stable and prosperous countries. The largest sectors by GDP of the Chilean economy are mining (principally copper), business services, personal services and manufacturing. The Chilean copper industry has been supported both by progressive legislation and the country's good investment climate. Chile currently produces more than one-third of the global copper output. To negate the effects of the volatile international copper market on the Chilean economy, the government created a Copper Stabilisation Fund that collects a direct proportion of revenues when copper prices are high for use when prices fall.

The Chilean service industry has experienced rapid growth as a result of increased access to education and substantial advances in communications and information technology. The government has liberalised the service sector and entered into a number of free trade area agreements. As a result, Chile has been able to expand into the export market for services and specialise in maritime and aeronautical services, tourism, informatics, engineering and construction services, and health and education.

Chile is a highly competitive country, ranked 33 out of 144 countries by the 2014-15 *Global Competitiveness Report* as a result of its strong institutional setup, efficient government, well-functioning markets and a high level of domestic competition and openness to foreign trade.

Korea

Korea is a very successful, high-income market economy and is the ninth largest country in terms of value of international trade in the world. Its economy is largely based on exports of finished goods such as electronics, textiles, ships, automobiles and steel. In total, exports account for more than half of Korea's GDP.

Korea has excellent infrastructure and a sound macroeconomic environment that contribute to its international competitiveness. The country's high-quality education system is one of its particular strengths; in 2014, Korea had the highest gross enrolment rate in tertiary education in the world.

Mexico

Mexico is an export-orientated economy. Its manufacturing industry contributed 17.4% of GDP in 2012 and has benefited from free trade agreements with over 50 countries, including 20 years in the North American Free Trade Alliance (NAFTA). Since 2012, Mexico and Peru have been partners, along with Colombia and Chile, in the Pacific Alliance, which furthers free trade and promotes economic integration.

For its level of development, Mexico's level of business sophistication is relatively high. The country also benefits from a stable macroeconomic environment and a sound banking system. The current Mexican government has passed structural reforms targeting areas including labour, education, competition policy, the financial sector, telecommunications and the energy sector, and it is expected that these reforms will help improve productivity and growth.

Norway

Norway's economy is significantly dominated by the oil-related industries (oil and gas revenue contribute around 25% of GDP) and its citizens enjoy an exceptionally high standard of living relative to other European countries. Successive Norwegian governments have managed the country's natural resource wealth well and used it to further development outcomes, including establishing a strong welfare system. The country has a sovereign wealth fund generated by the exploitation of natural resources. The fund is invested abroad, shielding the economy from fluctuations in oil prices and removing excess liquidity from the economy.

In the last decade, the government has taken initiatives to promote the development of other "mainland industries" that are internationally competitive. These include creating nine "centres of expertise" and forming the Oslo Cancer Cluster. The objective of these initiatives is to encourage the expansion of the high-tech industry and also to encourage small-business growth as a way to create future jobs. Industries like manufacturing have been supported with new knowledge and technology to help reduce their dependence on the oil sector. Investments in education have contributed to Norway's high and growing levels of human capital and this also plays an important role in improving the competitiveness of non-oil sectors.

Portugal

The Portuguese economy was adversely affected by the financial crisis and its ranking on the World Economic Forum's Global Competitiveness Report has fallen notably. Portugal introduced reforms to increase its competitiveness, such as increasing market liberalisation and promoting educational attainment. It implemented labour market reforms, including improving employment protection to protect vulnerable workers. Portugal has also made substantial progress in expanding its tax base, an area Peru must similarly target.

Portugal benefits from an excellent transport infrastructure that includes an extensive network of high-quality roads, motorways and railways, seven major seaports, and three international airports.

Turkey

Turkey has experienced rapid economic growth recently with per capita income nearly tripling in the space of a decade. The country is a major producer and exporter of agricultural products, textiles, motor vehicles and construction material. In the past five years, foreign direct investment has risen from just over USD 1 billion to an average of USD 13 billion. Turkey also has a very successful business sector that is complemented by the country's intensely competitive domestic market.

Turkey benefits from a well-developed transport network, especially with respect to roads and air transport. The country's tourist sector has expanded rapidly, and according to the World Travel and Tourism Council, the sector contributed about 11% of Turkish GDP and supported 8% of jobs in 2012.

The Turkish financial sector displayed notable resilience during the global financial crisis; indeed, it was the only country in the OECD to not give public-sector support to its banking sector. According to the World Bank, the strength of the banking sector can be attributed to fundamental reforms that the country undertook after 2001.

BRICS comparison countries

Brazil

Brazil is the seventh largest economy in the world in both nominal GDP and purchasing power parity terms. Its population boom in the 1950s necessitated the country's green revolution and created a complex agribusiness sector. Brazil has been the world's largest producer of coffee for 150 years, but the relative prominence of the sector has declined as other sectors have developed. Coffee exports made up over half of Brazil's total exports in the 1960s; today, they contribute only around 2%.

The country's principal commodity export is still foodstuffs but metal exports, especially iron ore, are becoming increasingly important. Brazil has a significant supply of mineral resources including nickel, tin, copper and gold and these provide industrial raw materials and contribute to the country's export earnings. Brazil also has a large industrial sector with a variety of advanced manufacturing industries such as chemicals, computers, automobiles and aircraft.

Since 2007, Brazil's performance in the World Bank's Logistic Performance Index has increased markedly as a result of improved traceability and a fall in the cost of shipping goods. Brazil is ranked 57 out of 144 countries in the 2014-2015 *Global Competitiveness Index*. It scores particularly well in relation to innovation and the level of sophistication of its business community.

South Africa

Mining and, to an extent, agriculture have historically played an important role in the development of the South African economy. The country has successfully diversified into higher value-added sectors; by 2013, 70% of national GDP came from the tertiary sector.

South Africa's institutions are of high quality, particularly in relation to things like intellectual property protection, property rights and the efficiency of the legal framework for challenging and settling disputes. South Africa's financial market development is ranked seventh by the 2014-2015 *Global Competitiveness Report*. South Africa also has an efficient market for goods and services and quite high levels of business sophistication and innovation.

Latin American and Caribbean countries

In addition to Chile and Mexico (as OECD economies) and Brazil (as a BRICS country), there four other Latin American and Caribbean countries included in the benchmark group:

Colombia

Colombia has significant supplies of minerals and energy resources including the largest coal reserves in Latin America. In addition, the country has reserves of nickel, gold, silver, emeralds and platinum. Coffee was instrumental to the growth of the Colombian economy and promoted the development of its railways and communications infrastructure.

Colombia has taken measures to attract foreign direct investment including passing laws in many sectors in 1991 and 1992 designed to stimulate investment. The United States is Colombia's biggest investor and is principally involved in the petroleum sector, natural gas, coal mining, and the chemical and manufacturing industries.

Colombia is ranked 66 out of 144 countries in the 2014-2015 *Global Competitiveness Index*, performing particularly well in indicators of macroeconomic performance such as balanced public budget, low levels of public debt and controlled inflation. Colombia also scores well in terms of financial service sophistication and education enrolment. Improved infrastructure, logistics and customs service have contributed to a significant increase in the country's performance in the World Bank Logistic Performance Indicator in 2014.

Costa Rica

Over the past 25 years, Costa Rica has enjoyed steady economic growth as exports have risen and the country has gradually liberalised trade and opened itself to foreign investment.

Costa Rica has strong institutions and a high-quality education system that provides the country with a skilled labour force and contributes to a high rate of technological adoption and business sophistication. Related to these favourable conditions and the stable political environment, Costa Rica has one of the highest per capita rates of foreign direct investment in Latin America.

The Costa Rican economy benefits significantly from tourism; in 2013 the country welcomed more than 2.4 million visitors making it the most visited nation in Central America. Agriculture and electronics exports are also important drivers of the Costa Rican economy.

Ecuador

Ecuador has experienced strong economic growth since 2011, and this growth has translated into a reduction in poverty, reduced inequality and a growing middle class. This growth has been particularly favourable to the poor; between 2000 and 2011, the income of the poorest 40% increased by 8.8% in comparison to the national average of 5.7%.

Public-sector spending and investment as a percentage of national GDP have more than doubled since 2006, and a large amount of the extra resources have been devoted to developing energy, infrastructure, transportation and the social sectors. Ecuador's ranking in the Global Competitiveness Index has increased substantially in recent years as a consequence of infrastructure development, innovation and improved education quality.

Panama

In the last decade, Panama has experienced average annual growth rates of about 8% making it one of the fastest-growing economies in Latin America. Panama's economy is dominated by a successful service industry, particularly focused on banking, commerce and tourism which contribute nearly 80% of GDP.

Panama is ranked as the most competitive economy in Central America according to the 2014-15 *Global Competiveness Report* (it scores second in Latin America behind Chile). The country has impressive transport infrastructure with one of the best ports and airport networks in the survey. This allows it to be a major transport hub in the region. Foreign multinationals have set up corporations in the country, contributing to a high degree of technological adoption and well-developed financial markets.

Panama has implemented a number of policies aimed at tackling poverty and providing improved access to services. These include a conditional cash transfer programme known as *Red de Oportunidades* designed to help very poor mothers. It is estimated that this programme currently assists 357 000 people.

Annex 1.A2 MDCR workshop: Participatory process around inclusive development in Peru

The Ministry of the Economy and Finance and the Ministry of Foreign Affairs hosted the workshop for the MDCR's diagnostic phase, with the theme of "Peru: Vision and challenges". The workshop brought together more than 30 participants from a variety of sectors, notably government ministries, private sector representatives, trade unions, civil society and academia.

The workshop was divided into two sessions. The first session focused on Peru's vision and developmental objectives and participants' normative preferences for the future. Participants were divided into groups and were asked to develop narratives from citizens' perspectives of a Peru in 2030 where all policies had succeeded. Participants then extracted the different categories from their stories, which were subsequently clustered into policy areas.

The participants' general outlook on Peru's future was positive. Delivery of public services surfaced as a major theme, most notably quality and access to healthcare and education, which were perceived as key to economic development. Discussions focused on how to manage and finance public services in the future, with concerns over the impact of privatisation of access. Human rights, workers' rights and most notably gender equality emerged as major themes as participants discussed the treatment of women and opportunities in the labour force. Participants were also concerned about Peru's macroeconomic stability, and reflected on economic diversification, regional development, informality and infrastructure. Finally, the themes of governance, democracy and citizenship were cited broadly, with special focus on the role of institutions and the quality of democracy.

The second session focused on Peru's context. The exercise encouraged participants to consider how changes in Peru's environment and beyond could affect Peruvian development. The exercise provided participants' views on the opportunities and threats presented by technology and globalisation: from solving national challenges such as population ageing and energy supply, to handling increasing vulnerability through integration in competitive global markets. Participants also noted Peru's vulnerability to regional political developments.

The workshops also identified major themes for further research, and provided some insight into the challenges Peru faces in realising its developmental objectives. Most participants agreed that the delivery, quality and access to public services like education and infrastructure are key future challenges, alongside providing decent employment and wages. Peru's capacity to tackle informality, successfully diversify its economy, and build resilient social and judicial institutions will affect its ability to implement meaningful reform. These themes are perceived as key bottlenecks for inclusive development in Peru. They provide the basis for further discussion in Phase II of the MDCR, which will involve the use of scenarios based on the first workshop's thematic outputs.

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