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On 25 January 2022, the OECD Council decided to open accession discussions with Peru as well as five other countries Argentina, Brazil, Bulgaria, Croatia, and Romania. On 10 June 2022, the Council at Ministerial Level adopted the Roadmap for the Accession Process Peru [C/MIN(2022)22/FINAL], setting out the terms, conditions and process for the accession of Peru. In accordance with this Roadmap, 24 OECD technical committees, composed of expert policy-makers from each of the 38 OECD Members, will conduct an in-depth assessment of Peru's legislation, policies and practices against OECD legal instruments and OECD best policies and practices covering multiple areas of government policy, including economic policy but also labour market and social policy, education, and health.

The overarching objective of the OECD accession process is to promote Peru's convergence with OECD standards, best policies and best practices, resulting in better outcomes for OECD Members as well as for Peru and its citizens. Throughout the accession process, the OECD will work closely with Peru to support the adoption of long-lasting reforms for this purpose.

The Economic Survey of Peru was discussed at a meeting of the Economic and Development Review Committee (EDRC) on 11 July 2023 and is published on the responsibility of the Secretary-General of the OECD. The cut-off date for data used in the Survey is 14 September 2023. This is the first Survey of Peru. Information on other Surveys and how they are prepared is available at <https://www.oecd.org/economy/surveys/>.

Publication of this document, and the analysis and recommendations contained therein, do not prejudice in any way the results of the review of Peru by the Economic Development Review Committee as part of its [process of accession to the OECD](#).

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Basic statistics of Peru, 2022*

(Numbers in parentheses refer to the OECD average)**

LAND, PEOPLE AND ELECTORAL CYCLE				
Population (million)	34.0		Population density per km ²	26.6 (38.8)
Under 15 (%)	26.0	(17.2)	Life expectancy at birth (years, 2021)	72.4 (78.7)
Over 65 (%)	8.4	(18.0)	Men (2021)	70.1 (75.9)
International migrant stock (% of population, 2019)	2.4	(13.2)	Women (2021)	74.7 (81.7)
Latest 5-year average growth (%)	1.5	(0.4)	Latest general election	June-2021
ECONOMY				
Gross domestic product (GDP)			Value added shares (% , 2021, OECD: 2022)	
In current prices (billion USD)	241.8		Agriculture, forestry and fishing	7.9 (2.8)
In current prices (billion PEN)	930.4		Industry including construction	38.1 (28.3)
Latest 5-year average real growth (%)	2.0	(1.6)	Services	54.1 (68.8)
Per capita (thousand USD PPP, 2021, OECD: 2022)	13.8	(57.3)		
GENERAL GOVERNMENT Per cent of GDP				
Expenditure (OECD: 2021)	23.6	(46.2)	Gross financial debt (OECD: 2021)	33.8 (107.4)
Revenue (OECD: 2021)	22.1	(38.7)	Net financial debt (OECD: 2021)	21.0 (68.7)
EXTERNAL ACCOUNTS				
Exchange rate (PEN per USD)	3.85		Main exports (% of total merchandise exports, 2021)	
PPP exchange rate (USA = 1, 2021)	1.87		Crude materials, inedible, except fuels	39.2
In per cent of GDP			Food and live animals	20.0
Exports of goods and services	29.4	(33.5)	Commodities and transactions, n.e.s.	15.0
Imports of goods and services	29.0	(34.9)	Main imports (% of total merchandise imports, 2021)	
Current account balance	-4.1	(-1.0)	Machinery and transport equipment	31.5
			Manufactured goods	17.0
			Chemicals and related products, n.e.s.	16.3
LABOUR MARKET, SKILLS AND INNOVATION				
Employment rate (aged 15 and over, %, 2021, OECD: 2022)	68.3	(57.5)	Unemployment rate, Labour Force Survey (aged 15 and over, %, 2021, OECD: 2022)	5.1 (5.0)
Men (2021, OECD: 2022)	75.4	(65.4)	Youth (aged 15-24, %, 2021, OECD: 2022)	9.5 (10.9)
Women (2021, OECD: 2022)	61.2	(50.1)	Long-term unemployed (1 year and over, %, 2021, OECD: 2022)	0.0 (1.2)
Participation rate (aged 15 and over, %, 2021, OECD: 2022)	71.9	(60.9)	Tertiary educational attainment (aged 25-64, %, 2018, OECD: 2021)	21.9 (39.9)
Average hours worked per year (2014, OECD: 2022)	2,186	(1,736)	Gross domestic expenditure on R&D (% of GDP, 2020)	0.2 (3.0)
ENVIRONMENT				
Total primary energy supply per capita (toe, 2020, OECD: 2021)	0.7	(3.8)	CO ₂ emissions from fuel combustion per capita (tonnes, 2020, OECD: 2021)	1.3 (7.9)
Renewables (% , 2020, OECD: 2021)	28.8	(11.6)	Water abstractions per capita (1 000 m ³ , 2020)	1.7
Exposure to air pollution (more than 10 µg/m ³ of PM 2.5, % of population, 2019)	98.4	(61.7)	Municipal waste per capita (tonnes, 2021, OECD: 2020)	0.2 (0.5)
SOCIETY				
Income inequality (Gini coefficient, 2021, OECD: latest available)	0.402	(0.315)	Education outcomes (PISA score, 2018)	
Poverty gap at USD 6.85 a day (2017 PPP, %, 2021, OECD:2020)	11.6	(5.0)	Reading	401 (485)
			Mathematics	400 (487)
Public and private spending (% of GDP)			Science	404 (487)
Health care (2020, OECD: 2022)	6.3	(9.3)	Share of women in parliament (%)	40.0 (32.5)
Education (% of GNI, 2021)	3.5	(4.4)		

*The year is indicated in parenthesis if it deviates from the year in the main title of this table.

**Where the OECD aggregate is not provided in the source database, a simple OECD average of latest available data is calculated where data exist for at least 80% of member countries.

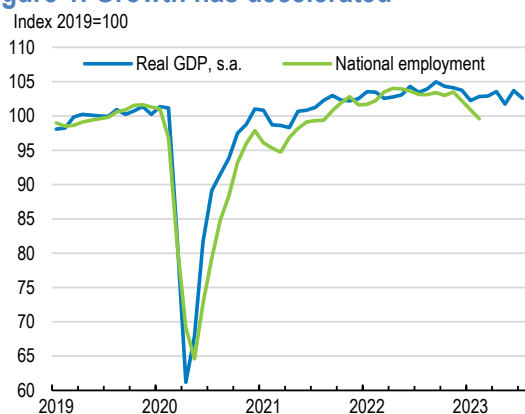
Source: Calculations based on data extracted from databases of the following organisations: OECD, International Energy Agency, International Labour Organisation, International Monetary Fund, United Nations, World Bank.

Executive summary


Growth has slowed

Peru's solid macroeconomic institutions, including fiscal rules, an independent Central Bank and strong financial regulation, have fuelled high economic growth, ensured macroeconomic stability, and substantially reduced poverty over the past two decades. This has allowed the country to mitigate the economic and social impacts of major shocks in recent years. After a significant economic downturn due to the COVID-19 pandemic, the economy bounced back quickly but has since slowed down sharply (Figure 1) amid lower global growth related to Russia's war of aggression against Ukraine, increased political uncertainty, high inflation, tight financial conditions and more recently widespread social unrest and extreme weather conditions. High metal prices have supported the economy.

Figure 1. Growth has decelerated



Source: Central Bank and National Statistics Institute.

StatLink  <https://stat.link/ogmftz>

The impact of these shocks has manifested in inflationary pressures, with rising prices hitting hard many vulnerable families. Thanks to the swift tightening of monetary policy, inflation expectations have started to ease, and headline and core inflation decelerated but remain high. The Central Bank should maintain a restrictive stance to bring inflation sustainably back to target. While employment has recovered to pre-pandemic levels, job quality has further deteriorated, which together with inflationary pressures could result in persistent higher poverty and inequality.

Economic growth is projected at 1.1% this year, and gradually pick up to 2.7% in 2024 (Table 1). High interest rates and inflation and political uncertainty will constrain private consumption and investment. Government efforts to relaunch infrastructure investment and several announced PPP projects will support investment. Tourism and copper production are expected to recover and boost exports. Inflation is expected to continue slowing down and reach the 1-3% target range by early 2024. Risks associated with tighter global financial conditions are mitigated by large currency reserves and low public debt. The financial sector remains resilient amid well-capitalised banks, with large liquidity buffers. Political uncertainty and renewed flare-ups in social unrest remain key risks.

Table 1. Economic growth will gradually pick up

	2022	2023	2024
Gross domestic product	2.7	1.1	2.7
Private consumption	3.5	0.8	2.1
Gross fixed capital formation	0.7	-5.0	1.8
Exports	6.0	13.5	5.7
Imports	4.2	-2.8	2.6
Unemployment rate	4.4	4.7	4.0
Consumer price index (Q4-on-Q4)	8.4	5.2	2.6
Core consumer price index (Q4-on-Q4)	5.7	3.6	2.6
Fiscal balance	-1.7	-2.4	-2.0
Public debt (gross, % of GDP)	33.8	33.6	33.5

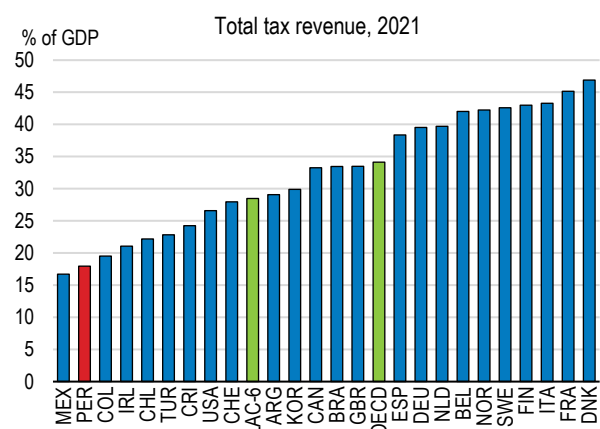
Source: OECD Economic Outlook, update August 2023.

Frequent natural disasters exacerbated by climate change lead to infrastructure damage, exacerbate supply chain disruptions, and contribute to inflation, ultimately reducing medium-term growth. *El Niño*, a natural event that has become more frequent, is expected to be mild this year, but remains a risk as it can rapidly evolve, causing heavy rainfall and economic losses that could jeopardize fiscal consolidation. To combat climate change, Peru has pledged to achieve carbon neutrality by 2050. A forthcoming strategy for the climate transition with concrete milestones and policies is an opportunity to reach this ambitious goal. Meeting emission targets will depend largely on progress in combating deforestation, a key source of emissions, and increasing the use of renewable energy sources.

Prudent fiscal policies and strong commitment to fiscal rules have provided large buffers, that helped the country withstand recent shocks. A recent stimulus programme aims at boosting investment, protecting households from high inflation and supporting a weak economy, while complying with fiscal rules. Going forward, fiscal policy should remain prudent in line with the planned fiscal consolidation and rebuild fiscal buffers to prepare for future shocks, including natural hazards.

To meet increasing demands for social services and infrastructure while maintaining fiscal sustainability, increasing spending efficiency and tax revenues will be necessary. Tax revenues at 17% of GDP are low compared to other countries (Figure 2). Low tax compliance, high informality, significant tax expenditures, an incomplete and outdated cadastre, and a high threshold to start paying personal income taxes contribute to low tax collection. The complexity of multiple corporate tax schemes causes high tax evasion, encourages informality, incentivizes firms to remain small and leads to low productivity.

Figure 2. Tax revenues are low



Note: LAC is a simple average of ARG, BRA, CHL, COL, CRI, MEX.
Source: OECD, Global tax revenue database.

StatLink <https://stat.link/eqc9wx>

Structural reforms are key to boost long-term growth

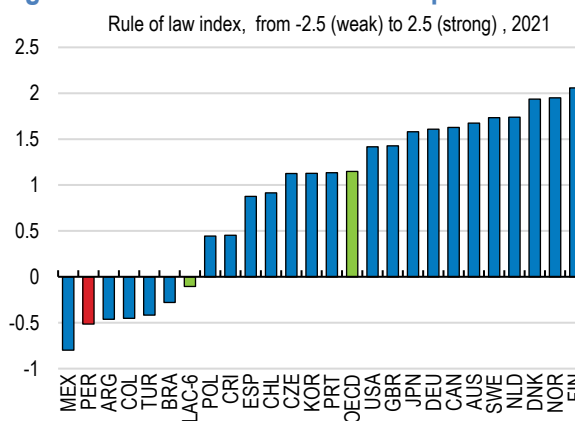
Macroeconomic stability and trade openness have made for strong growth in commodity-exporting sectors. However, economic performance has weakened in the last decade,

and convergence to OECD countries has stalled. To revive and broaden growth and improve living standards for all, there is a need to continue strengthening basic growth enablers.

Peru has a thriving private sector, but low competition due to the dominance of a small number of large business groups is a concern. A general merger control scheme was introduced in 2021 and is a major step in the right direction. Peru's well-regarded competition authority could be further strengthened to enhance enforcement. Weak competition is, at least partly, the result of excessive regulatory compliance costs. The creation of one-stop shops that integrate national and sub-national procedures for starting a business would help in easing regulations for formal firms.

A weak rule of law (Figure 3) leads to an insufficiently stable and predictable business environment, discouraging investment, trade, and entrepreneurship. Strengthening judicial independence and efficiency, including replacing temporary judges with permanent positions that have clear criteria for tenure and career progress, and advancing digitalisation and interoperability of court information systems, could be a cornerstone of a wider reform agenda to improve the rule of law.

Figure 3. The rule of law can be improved



Source: World Bank, Worldwide Governance Indicators.

StatLink <https://stat.link/gsa9lv>

High corruption hampers the government's ability to implement policy, collect revenues, and enforce laws and regulations. A comprehensive strategy is essential for effectively deterring corruption, including strengthening existing preventive integrity measures combining

them with reforms in various areas that discourage, prevent, and sanction corruption. Key areas for reform are justice and civil service. This will not only enhance accountability and effectiveness of the public sector but it will also foster trust in institutions and promote social cohesion.

The State's capacity to implement much-needed public investment and deliver high-quality public services is limited by a fragmented civil service. Overreliance on administrative service contracts results in high turnover, loss of experience, and insufficient deterrence against corruption. A fresh start is needed to effectively implement the 2013 civil service reform that has seen limited progress.

To enhance public service quality and address regional inequalities, restructuring fiscal decentralization is necessary. This includes clearly defining spending responsibilities of national and subnational governments, and gradually grant regions more taxing powers. Enhancing the capabilities, effectiveness, and coordination of public investment planning, particularly at the local level, will play a crucial role in improving the implementation and efficiency of infrastructure investments.

Reducing informality is a key priority

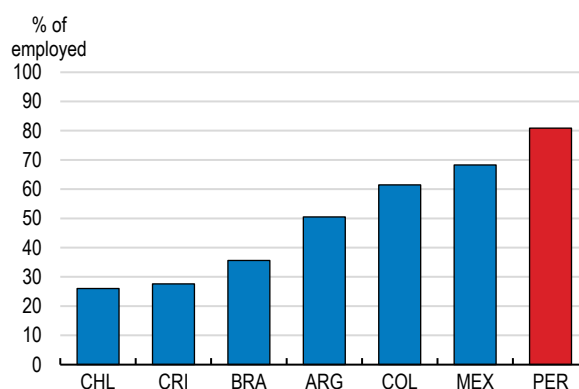
Peru has one of the highest levels of informality in Latin America (Figure 4), with around 80% of workers in informal jobs and limited access to employment protection or social security benefits. High informality left workers unprotected during the COVID-19 pandemic and is a key factor perpetuating inequality and poverty, calling for a comprehensive reform agenda.

Low access to high-quality education and high labour costs of formalisation are key drivers of informality. Weak educational outcomes, high non-wage costs that finance formal-sector social security benefits, strict employment protection regulation, and a relatively high minimum wage whose level is close to the median wage put a high price on formal jobs and generate a vicious circle that perpetuates informality. Improving labour law and tax enforcement, streamlining the tax corporate system and business regulatory environment are also key to reducing informality.


Expanding access to high-quality education is crucial to raise productivity, reduce labour market gender gaps, and promote formality.

Extended COVID-19 related school closures, have worsened pre-existing weak education outcomes and inequalities, given significant disparities in digital preparedness. Widespread access to high-quality early childhood education remains limited, particularly in rural and vulnerable areas. Improving access to high-quality education at all levels will require enhancing teaching quality and school infrastructure, particularly in disadvantaged regions.

Figure 4. Informality is widespread



Note: Informal workers are those not contributing to the pension system. 2021 or latest. Source: IDB SIMS database.

StatLink  <https://stat.link/302oqs>

Reducing informality and expanding social protection will require that a basic level of social protection is available to all Peruvians.

This calls for increasing spending on conditional cash transfers, social pensions and the health system, while a more comprehensive set of benefits supports those who can contribute more. Reducing social contributions for low-income workers will be key to boost formalisation.

To successfully tackle the challenges ahead and implement the required comprehensive structural reform agenda, it is essential to build consensus and foster political stability.

MAIN FINDINGS	KEY RECOMMENDATIONS
Recalibrating macroeconomic policies and reforming taxation	
Headline, core inflation and 12-month ahead inflation expectations are decreasing but remain high and exceed the inflation target.	Keep a tight monetary policy stance to bring inflation sustainably back to target.
Public debt has risen. The economy has recovered from the pandemic-related downturn but has recently slowed down amid social conflicts.	Fiscal policy should support monetary policy to address high inflation. Keep the pace of fiscal consolidation in line with current fiscal plans and rebuild fiscal buffers.
Current tax revenues of 17% of GDP are insufficient for achieving sizeable improvements in social protection and public services such as health and education, and for more inclusive and sustainable growth. Weaknesses in tax collection leads to yearly revenue losses exceeding 5% of GDP.	Strengthen the tax administration and reduce tax evasion through stronger use of information technology and cross-checking of information across different sources.
Complex and multiple corporate tax regimes have contributed to low corporate tax collection, high informality, and low productivity.	Streamline the corporate tax regimes for small businesses by merging the intermediate regimes.
Fiscal decentralisation is incomplete. The system suffers from a lack of clear delineation of spending functions between the national and subnational governments and a distortionary system of financing subnational governments, ultimately leading to deepening regional inequalities.	Clarify spending responsibilities for each level of government. Implement an integral reform of subnational finances including gradually granting more taxing powers at the regional level.
Boosting long-term growth	
Many markets are dominated by a few large firms. Market concentration predates a recently introduced general merger control scheme.	Increase competition enforcement and improve detection of cartels and abuse of dominance.
Barriers to starting a business are largely due to delays and complexities in obtaining municipal operating and construction licenses and permits.	Introduce one-stop shops that integrate municipal and national procedures for starting a business.
High corruption impairs the business environment, rule of law, and state capacity. Few detected irregularities lead to successful prosecution. There has been continuous progress in fighting corruption, including preventive anti-corruption measures, but there is room for further improvement.	Establish a comprehensive strategy for effective corruption deterrence by strengthening preventive anti-corruption measures and implementing complementary reforms in key areas of justice, civil service, public procurement, infrastructure governance, and regulatory transparency.
The justice system lacks in transparency, accessibility, efficacy, and fairness. Large case backlogs and long delays hamper the administration of justice. Judicial corruption is high. Overuse of temporary judge positions creates inefficiencies and conflicts of interest.	Reduce the share of temporary judges by replacing them with career positions.
The civil service is fragmented and over reliant on ad-hoc service contracts with high turnover and low career incentives. A civil service reform has failed to be implemented.	Improve individual and institutional incentives for civil servants to switch to the new regime.
Infrastructure gaps require significant investment. Subnational governments bear the responsibility of implementing most infrastructure projects, but face budget execution challenges and local projects are disconnected from national plans.	Improve the technical quality of national infrastructure planning and coordination and consistency of national plans with local infrastructure project implementation.
Promoting inclusiveness	
Around 80% of workers are in informal jobs. This deprives them from access to many social security benefits, while reducing productivity and tax revenues.	Establish a comprehensive strategy to foster formalisation, including lower non-wage labour costs, particularly for low-income workers, more flexible employment regulation on permanent contracts, better skills, stronger legal enforcement, and improvements in tax administration.
Poverty at 26% is above pre-pandemic levels. The pandemic has highlighted significant gaps in social protection, particularly for informal workers. Income-support programmes are well established but coverage and benefits are low.	Expand coverage and benefits of cash transfer programmes for the poor, based on the existing conditional cash-transfer programme <i>Juntos</i> .
Pension coverage is low.	Expand coverage and benefits of the non-contributory pension scheme.
Access to the health system is highly fragmented. The underfunded public health system provides coverage for the disadvantaged population for free while formal workers' pay contributions for similar quality services.	Improve access to quality healthcare services by integrating the multiple public insurers, with stronger recourse to general taxation revenues.
A large share of teachers does not attain the minimum quality requirements. Disadvantaged schools, from rural areas, struggle to attract qualified teachers.	Continue improving teachers' initial training, recruitment and selection, and promote merit-based promotions and rewards, including incentives for teacher's reallocation to disadvantaged schools.
Strengthening green growth	
Peru has ambitious targets and there are several policies in place. A long-term comprehensive strategy for the green transition is under development.	Update and approve a strategy for the climate transition with concrete milestones and policies to achieve targets and zero net emissions.
NDCs targets are ambitious, but further efforts are needed to meet the targets. There are weak carbon price signals to drive the transition towards wider use of renewable energy sources.	Accelerate progress in decarbonisation through more stringent regulations and more consistent price signals, including carbon taxation, while supporting vulnerable households with targeted and temporary transfers.
Deforestation has risen and reaching current objectives for reducing greenhouse gas emission will require strong declines in deforestation.	Increase resources dedicated to conservation, reforestation, afforestation, and anti-deforestation enforcement activities.

1 Key Policy Insights

Peru's strong macroeconomic and institutional policy frameworks together with structural reforms, including trade liberalisation and opening to foreign investment, have contributed to strong economic growth and steep poverty reduction over the last two decades until 2019. This resulted in the country experiencing one of the strongest macroeconomic performances in Latin America, helping the country mitigate economic and social consequences of recent major shocks. However, Peru still faces high informality, regional disparities, and inadequate access to public services. Convergence to higher living standards has slowed down, making it of utmost importance to boost productivity and investment. The COVID-19 pandemic has worsened structural weaknesses in areas such as health, education, and social protection. To improve living standards for all Peruvians, ambitious structural reforms are necessary. These include improving regulation and competition, strengthening governance and the rule of law, providing universal social protection, and enhancing education outcomes. Although the planned fiscal consolidation ensures debt sustainability, a reform to increase spending efficiency and tax revenues is needed to address long-standing infrastructure and social challenges. A long-term agenda for implementing these reforms would reduce poverty, inequality, and promote income convergence with OECD countries.

Achieving higher living standards requires ambitious structural reforms

Peru's macroeconomic performance over the past two decades has been among the most robust in Latin America. During the 1980s, the country faced a severe economic crisis characterized by hyperinflation, fiscal imbalances, and mounting external debt (Box 1.1). However, in the 1990s, Peru implemented a comprehensive set of ambitious structural reforms, including liberalizing trade, opening to foreign investment, and developing key sectors such as mining, agriculture, and tourism. These reforms, supported by the adoption of a robust macroeconomic policy framework, including fiscal rules, an independent fiscal institution and Central Bank and a robust financial regulatory framework, played a pivotal role in fostering economic growth and maintaining macroeconomic stability. Peru's participation in several regional and international trade agreements has strengthened trade relations, boosted exports, and enhanced competitiveness in global markets, capitalizing favourable global economic conditions and a commodity supercycle.

Box 1.1. A glance at Peru's economic history

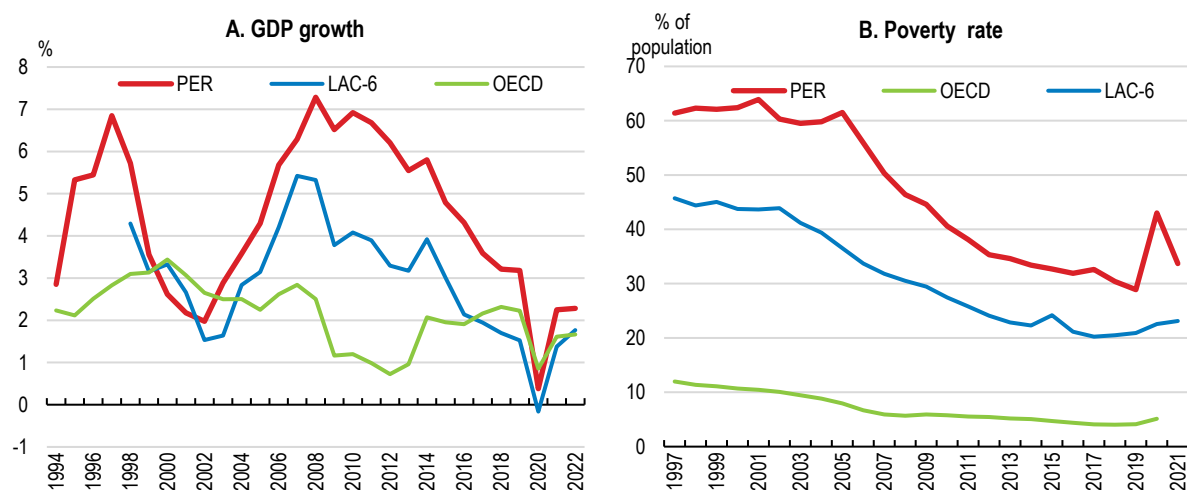
Peru has a long-standing history of economic dependence on commodities, which has led to a series of booms and busts before the broad-ranging macroeconomic and institutional reforms of the 1990s. The country's economy has relied on the export of various commodities such as guano, copper and other minerals such as silver, zinc, and tin. During boom periods, fuelled by high global demand and rising prices, Peru experienced rapid economic growth, leading to infrastructure development and increased investment. However, these periods of prosperity were often followed by abrupt downturns when international commodity prices collapsed or experienced significant fluctuations. Such busts resulted in economic crises, profound recessions, and increased social challenges.

The 1980s in Peru was a particularly intricate period marked by a severe economic crisis, often referred to as the "Lost Decade," characterized by a sharp decline in economic growth, a deterioration of living conditions, widespread poverty, and social unrest. The roots of this crisis can be traced back to the previous decades (1940s-1970s) when Peru accumulated a significant external debt to finance infrastructure projects and implemented import substitution industrialization policies to foster industrial growth. As the country became heavily dependent on foreign loans, the rise in global interest rates in the early 1980s made it increasingly challenging to service the debt. Additionally, a global economic recession led to a decline in international commodity prices, including copper and silver, which reduced export revenues and strained Peru's ability to generate foreign exchange. The combination of these factors, along with inflation reaching hyperinflationary levels due to expansionary fiscal policies, an overvalued currency, and money supply growth, further destabilized the economy. The situation was compounded by political instability, internal conflicts and the surge of terrorist groups led by the Sendero Luminoso and the Tupac Amaru Revolutionary Movement. The crisis persisted into the early 1990s, prompting the need for economic reforms to stabilize the economy, establish a robust macroeconomic framework and institutions, and lay the groundwork for subsequent liberalization measures. These reforms and stabilization measures implemented during this period (described in the previous paragraph) laid the foundation for subsequent economic growth and development (as described below).

As a result, Peru emerged as one of the region's fastest-growing and most stable and resilient economies in Latin America (Figure 1.1, Panel A). With an average annual growth rate of 5.1% between 2000 and 2019, Peru sustained its economic momentum for a long period, driving progress toward higher living standards. Public debt was substantially reduced to 26% of GDP in 2019, sustaining ample access to international capital markets, and large macroeconomic buffers were built. Within its credible inflation targeting framework, Peru achieved an average inflation rate of 2.6% over the two decades until 2019, the lowest among South American countries, while attracting substantial foreign direct investment. The

sustained economic growth, coupled with the implementation of social programmes and improved access to education and healthcare, led to steep poverty reduction (Figure 1.1, Panel B). Most social indicators have seen significant improvements such as life expectancy, which rose from 70 years in 2000 to 76 years in 2019. Peru's experience serves as an example of how a strong macroeconomic framework, accompanied by structural reforms and investment in social programmes can contribute to sustained economic growth, poverty reduction, and improved social indicators.

Figure 1.1. Rapid economic growth was accompanied by notable social progress



Note: Panel A shows 5-year moving average. Panel B shows poverty headcount ratio at USD 6.85 a day (2017 PPP), LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX.

Source: BCRP, WDI- World Bank.

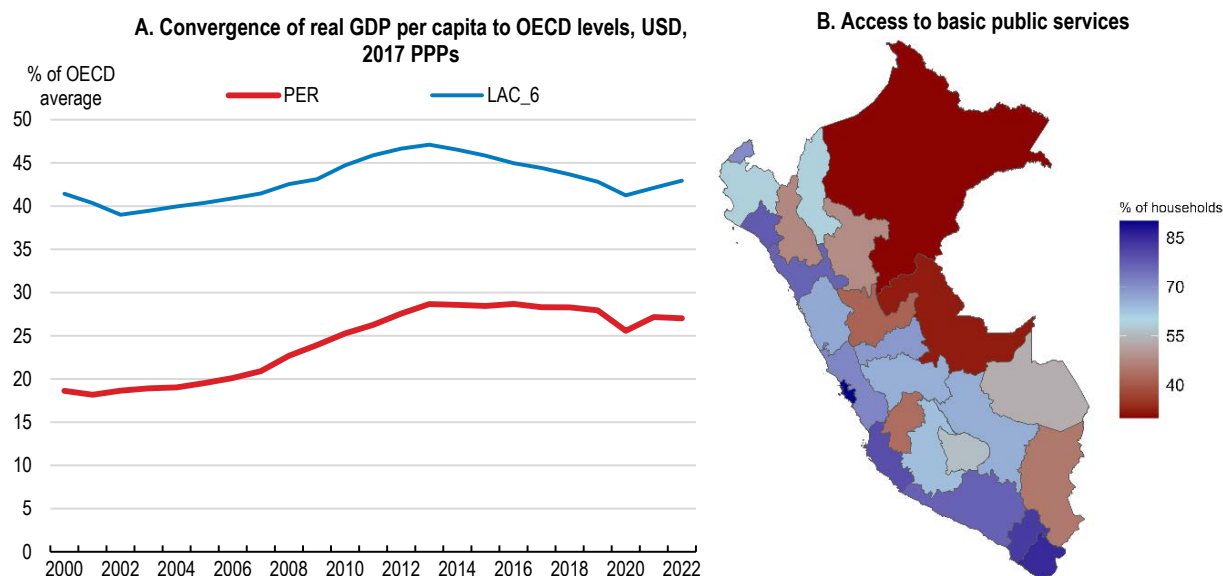
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Despite these remarkable achievements, Peru still faces significant economic and social challenges. Convergence to higher living standards has decelerated after the commodity price boom ended in 2015 (Figure 1.2, Panel A). Since 2020, the Peruvian economy has faced multiple large shocks. The COVID-19 pandemic had a severe impact on both lives and livelihoods, resulting in higher excess mortality and a sharper economic contraction than most countries in the world. The pandemic also caused increases in poverty and widespread learning disruptions. However, thanks to strong policy support, the economy recovered rapidly in 2021, though strong domestic demand and supply chain disruptions pushed inflation above the target range for the first time since 2016. Further inflationary pressures, global supply chain disruptions and fertilizer shortages were caused by Russia's war of aggression against Ukraine in 2022, with rising food and energy prices hitting hard many vulnerable families. Additionally, social unrest related to political uncertainty and severe weather conditions in early 2023 caused significant economic losses, adding to inflationary pressures and economic slowdown.

In its response to these major shocks the government used the fiscal space accumulated over the previous decades to prevent an even more profound impact and aftermath effects, while effective withdrawal of the pandemic stimulus package afterwards serves as additional evidence of Peru's robust macroeconomic framework and the resilience of its economy. However, the pandemic starkly revealed pre-existing structural weaknesses, such as a high share of labour and firm informality, with more than 75% of workers and 90% of firms with less than five workers, without any access to social protection mechanisms or savings or credit, including state-guaranteed, to fall upon. The pandemic exacerbated pre-existing gender disparities in the labour market, disproportionately impacting female workers. There are also stark differences in regional access to basic public services, such as electricity, water and sewerage, and infrastructure deficits, which contributes to high inequalities and leaves many Peruvians vulnerable to


shocks (Figure 1.2, Panel B). Moreover, 1.4 million Venezuelan migrants and refugees live in Peru, many of whom have yet to finalize their migratory regularization process, hold informal jobs. Limited state capacity at the national and subnational levels hampers the delivery of quality public services and infrastructure and impairs the policy response while hampering spending and public investment efficiency. Weak public investment management, lack of coordination between different levels of government, and capacity gaps in the civil service are some of the key drivers. Political upheavals and frequent corruption scandals involving government officials and business leaders are major concerns for citizens and have eroded trust in government (INEI, 2022^[1]). In addition, the country faces significant environmental challenges, as it is highly exposed to climate change and natural hazards.

Figure 1.2. Convergence has been slow and many lack basic public services



Note: LAC_6 shows the average of Argentina, Brazil, Chile, Colombia, Costa Rica and Mexico. Panel B shows % of households with access to electricity, water, and sewerage.

Source: WDI, World bank and INCORE statistics by region.

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To tackle these challenges, it is essential for policymakers to work collaboratively across the political spectrum building consensus to restore confidence, foster political stability and step-up efforts to implement structural reforms aimed at enhancing potential growth and tackling poverty, inequality, and weaknesses in the education, health, and pension systems. However, the ongoing political crisis since 2016, characterized by several presidents and frequent changes in congress and ministries, has created significant political instability and impeded strongly-needed structural reforms to boost economic growth and social protection. Some countries have undergone political reforms aimed at enhancing citizen participation and fostering stability in their political system. These reforms often involve improving representation through electoral reforms and increasing transparency and governance through anti-corruption measures.

As part of the accession process to the OECD, Peru can develop a comprehensive long-term reform agenda to shape the future of its society and economy for years to come. This agenda must be based on clear prioritization and sequencing and all available evidence, both domestically and internationally, and should aim to preserve what has worked well in the past, such as the strong and well-functioning macroeconomic framework that has been a backbone of Peru's economic growth. Policy reforms that raise productivity and investment can generate the income and tax revenues necessary to advance Peru's path towards more widely shared prosperity. Strengthening governance and the rule of law should be a priority to reduce uncertainty and transaction costs for businesses, making it easier for them to operate and grow, and to reduce corruption and restore trust in government.

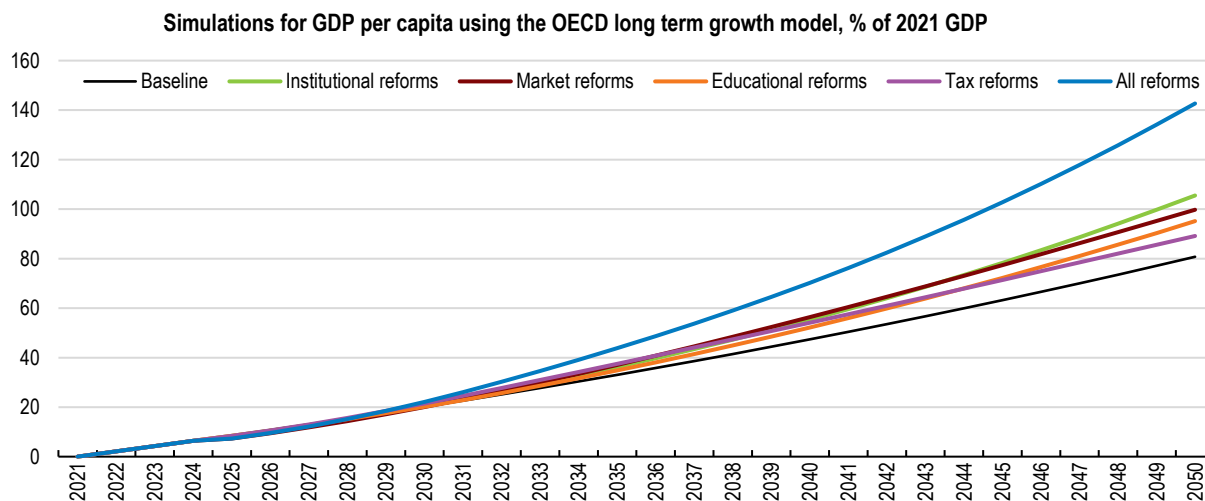
Pressing social needs require reforms to ensure the benefits of growth are broadly shared. The small size of Peru's public sector and its low spending efficiency limit its ability to provide better public services and opportunities for all, and to reduce inequalities. A tax reform to raise revenues will need to be progressive and seek to reduce large regional inequalities. Reducing widespread informality is crucial to ensure universal access to quality social protection. Improvements in pension coverage and benefits are essential, especially after six extraordinary withdrawals of pension funds since 2020. Public education has significant scope for closing access and quality gaps. Seizing new opportunities, such as boosting renewable energy generation, while adapting and mitigating risks to climate change and natural hazards, will make the economy and society more resilient.

Structural reforms can significantly improve living standards. Simulations based on the OECD long-term growth model (Guillemette and Turner, 2018^[2]) suggest that an ambitious reform package that would strengthen Peru's institutional setup, improve domestic regulation and competition, improve education outcomes and reform taxes would be able to almost double GDP per capita by 2050 relative to a no reform scenario which implies maintaining the GDP per capita growth of the last decade (Figure 1.3). While there is considerable uncertainty around such simulations, these are large effects, and would be sufficient to return to a path of income convergence vis-à-vis OECD countries.

Against this background, the main messages of the Survey are:

- The planned fiscal consolidation supports monetary policy to address high inflation and is key to maintaining debt sustainability, but increasing the efficiency of public spending and a comprehensive tax reform to gradually raise public revenues in a progressive way is needed to improve public services, close regional gaps, and provide better opportunities to all Peruvians.
- Raising living standards and long-term growth will hinge on increasing productivity and investment by promoting competition, innovation, and export diversification, enhancing infrastructure, and improving governance and the rule of law. Addressing corruption and improving state capacity at both the national and subnational levels would facilitate the efficient delivery of quality public services.
- To achieve more widely shared prosperity, it is necessary to strengthen incentives for formal job creation by reducing non-wage labour costs, relaxing regulation of permanent employment, gradually expanding access to high-quality education, healthcare and pensions and implementing deep changes to social security schemes. Political stability and consensus will be key to enable the implementation of a comprehensive structural reform agenda.

Figure 1.3. Structural reforms would lift growth and incomes substantially



Note: The “Baseline” projection depicts the trajectory of potential per-capita GDP in Peru according to current estimations of potential growth, without any reform effects. The “Institutional reforms” scenario includes reforms to strengthen institutions and make them more inclusive, through a gradual alignment of the Rule of Law index (Kaufmann, Kraay and Mastruzzi, 2015^[3]) with the current first quartile of OECD countries by 2050, implemented gradually over time. The “Market reforms” scenario implies an improvement in product market regulations to make them more competition-friendly, as measured by the OECD PMR indicator, to the first quartile of OECD countries, and an increase in R&D expenditures to 1% of GDP, all by 2030. The “Education reform” scenario aligns student performance and educational attainments with the OECD average by 2060. The “Tax reform” scenario aligns business taxation with the top decile of OECD countries and the labour tax wedge with Chile’s. Source: OECD calculations based on OECD Long-term growth model (Guillemette and Turner, 2018^[2]).

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The economy is resilient, but there are significant risks

Activity has slowed down and inflation remains high

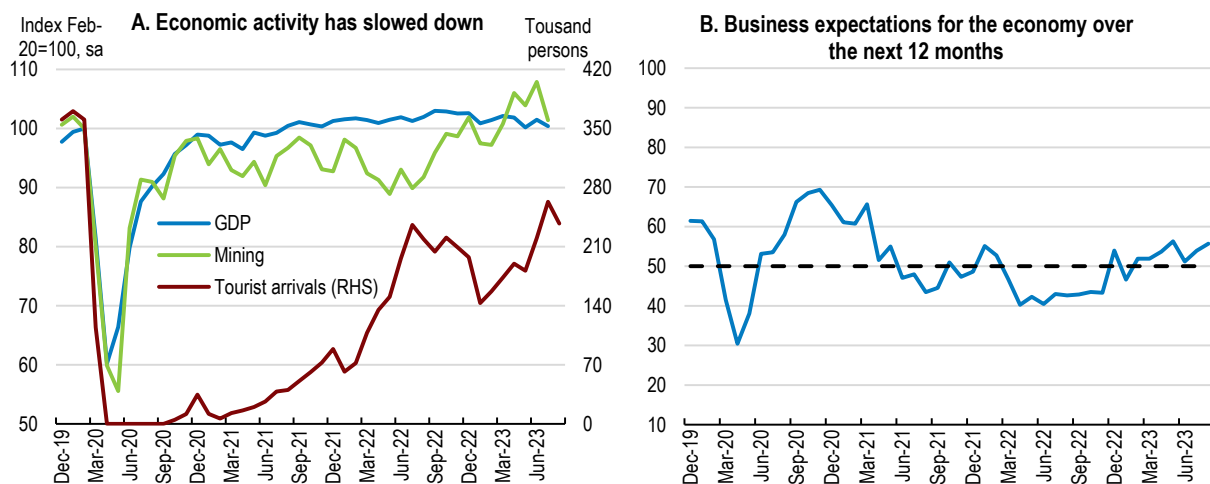
The economy decelerated after a strong bounce back from the COVID-19 pandemic (Figure 1.4). After a deep recession in 2020 when GDP fell by 11% due to the pandemic, the economy recovered strongly, growing by 13.3% in 2021. By the end of 2021, GDP surpassed pre-pandemic levels by 2%. In 2022, the economy grew at a modest 2.7%, below the average of 3.2% between 2016 and 2019. The deceleration was particularly strong in the second half of the year when the economy grew only by 1.7% because of high political uncertainty and inflation and slowing external demand caused by Russia’s war of aggression in Ukraine. The growth rate declined further towards the end of 2022 amid social unrest. Economic activity continued to fall, contracting by 0.4% in the first quarter and 0.5% in the second quarter of 2023 year-on-year.

The meagre growth of 2022 reflects the dissipation of the post-COVID rebound and social protests-related disruptions in the mining industry. Mining conflicts have been at the highest levels since 2017, paralysing construction and production in the sector. Low business confidence led to a decline of private investment. Household purchasing power was eroded by high inflation and rising financing costs, which held back private consumption, while a successful roll-out of the COVID-19 vaccination campaign with 85% of the total population fully vaccinated as of December 2022 and several rounds of private pension and unemployment funds withdrawals supported it. Other factors explaining the growth slowdown are the withdrawal of pandemic-related fiscal stimulus, fertiliser shortages and the erosion of large terms-of-trade gains and slowing external demand amid Russia’s war of aggression against Ukraine.

Social unrest, which lasted from late 2022 to early March 2023, has affected the economy resulting in damaged infrastructure, lower tourism and decreasing mining output. Furthermore, a cyclone in March caused economic losses due to heavy rainfall in the northern region, and El Niño, an extreme weather phenomenon, has negatively affected fisheries and agriculture in the second quarter of the year. The GDP

contraction in the first semester of 2023 is explained by lower growth in private consumption (0.3% y-o-y) and a sharp decline in private investment (-9% y-o-y) in the absence of new mining megaprojects. The tourism sector, which accounted for 4% of GDP in 2019, was hit hard by the protests and has not yet recovered pre-pandemic levels. Agriculture, fishing and construction were also hard-hit in the first half of the year. Mining, which accounts for 10% of GDP, has also been affected, with some copper mines suspending operations in January and February. However, it has bounced back as social unrest and road blockades subsided and the new copper mine, *Quellaveco*, began its commercial operations. This resurgence is evident in the 12% increase the first semester of the year. A significant increase in central government public investment in the first half of 2023 has helped to mitigate the economic slowdown, despite the decline in subnational government investment. The decline in subnational government investment has been lower than in previous first years of government of new regional and municipal authorities.

Figure 1.4. Economic activity slowed down early 2023 amid social conflict and severe weather



Source: INEI, Ministry of Foreign Trade and Tourism and BCRP.

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Inflationary pressures in 2022 were driven by high food and energy prices, exchange rate depreciation and global value chains disruptions, in line with global trends. The war in Ukraine exacerbated inflationary pressures, causing fertilisers shortages that harmed agricultural production and worsened Peru's terms of trade (Figure 1.5). Consequently, the current account deficit widened, reaching 4% of GDP in 2022, surpassing historical levels. In early 2023, road blockades, social protests, heavy rainfall, and avian flu further increased inflationary pressures. However, the annualized inflation rate over shorter periods has decreased since mid-2022. Inflation hits the most vulnerable harder: extremely poor households experienced a price increase 5 percentage points higher than the average household (OECD et al., 2022^[4]). To counteract the impact of rising energy and food prices and a slowing economy, the government has implemented several temporary broad-based and targeted measures since 2022 (Box 1.2).

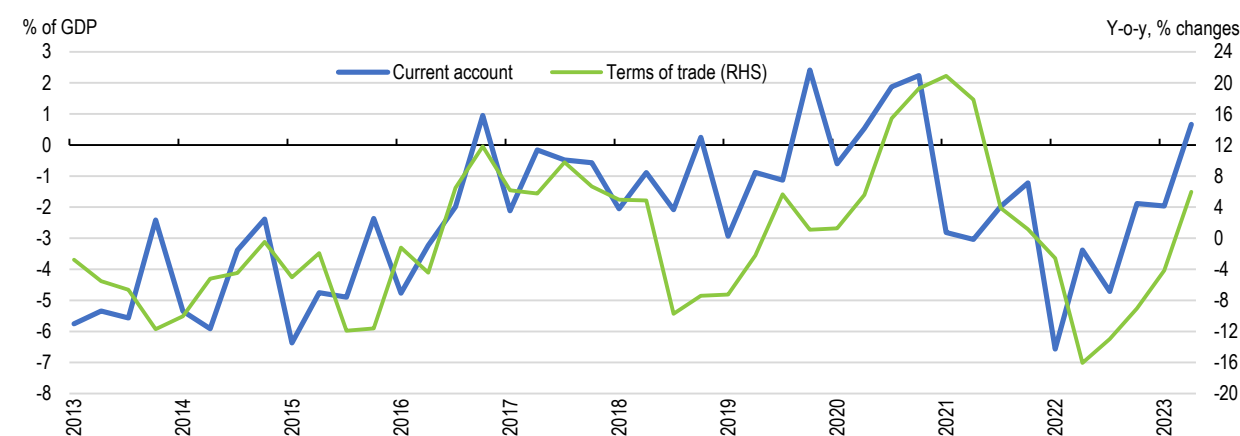
Box 1.2. Measures to mitigate the impact of increasing food and energy prices and the growth slowdown

In 2022, the government implemented various measures to minimize the impact of inflation on consumers. These measures included extending the Fuel Price Stabilisation Fund for fuel products until December 2022 and increasing the value of the Energy Social Inclusion Fund vouchers for purchasing liquefied petroleum gas for domestic use on a temporary basis. Tax measures such as granting a three-

month exemption on gasolines from the Selective consumption tax and exempting essential products from VAT were also implemented. As these measures were phased out, the coverage and benefits of cash transfer programmes were temporarily expanded. Additionally, to address the shortage and high cost of fertilizers, the government procured and delivered nitrogen fertilizers to agricultural producers nationwide.

Recently, the government launched a series of stimulus programmes called *Con Punche Perú*, worth 0.8% of GDP, with the aim to support the economy and contain the impact of high food prices, in the face of external headwinds, and political and social unrest. This is the second stimulus programme, with the first being launched in September 2022 under the name *Impulso Perú*. The *Con Punche Perú*, stimulus programme, launched in December 2022, and its updates in the first half of 2023 (*Con Punche Emergencia-FEN* and *Con Punche Perú 2*), focus on supporting low-income households, by providing temporary and targeted increases in benefits of certain social programs, and prevention of El Niño phenomenon. It also aims at boosting regional economies and revitalise hard-hit sectors such as tourism and agriculture. The bulk of the funding will be directed towards advancing public infrastructure projects such as irrigation, natural gas networks, hospitals, and schools. The programme aims to strengthen the naval industry, promote investment in ports and airports, as well as promoting sustainable public transportation. To support small and medium-sized enterprises (SMEs), the plan allows for delaying the payments of loans and the implementation of state-guaranteed credit programmes for micro and small firms. Authorities are also seeking to remove bureaucratic procedures that hamper private economic activity, particularly in the mining industry. To counter expected budget under-execution by new regional and local authorities, the central government is increasing technical assistance and hiring experienced project managers to improve project execution. The ministry of finance is currently working on further measures to foster public and private investment, such as simplifying processes for obtaining licences, promoting public-private partnerships, and updating the fiscal cadastre. Additionally, the government will extend certain tax exemptions, such as the VAT refund for international tourists and for the imports of goods for the Lima and Callao mass transport electric system project.

Figure 1.5. The current account widened amid deteriorating terms of trade

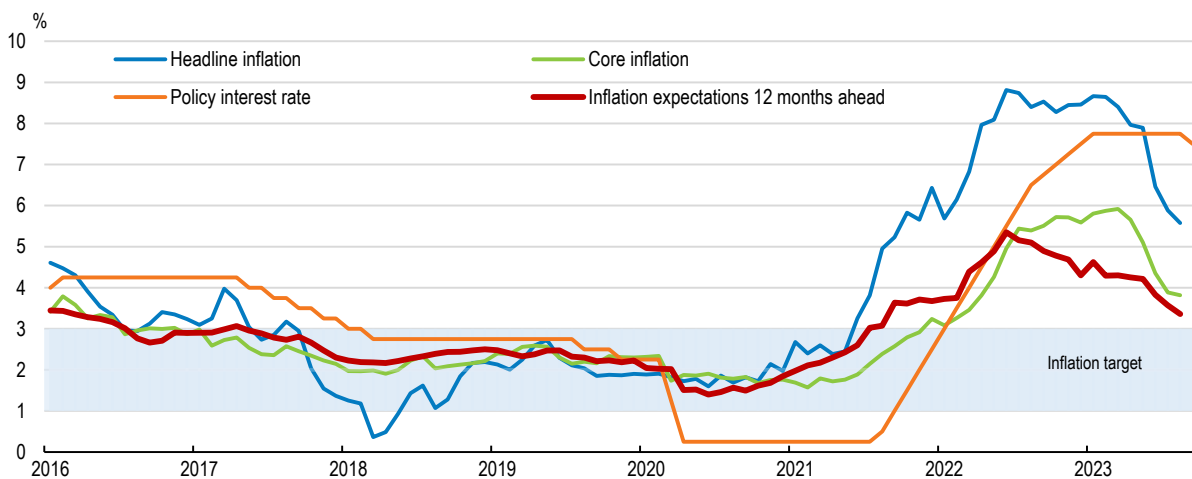


Source: Peru Central Bank.

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To counter inflationary pressures since the pandemic, monetary policy proactively increased interest rates between December 2020 and February 2023, resulting in a total of 725 basis points of rate hikes (Figure 1.6). These rate hikes substantially tightened financial conditions, leading to an increase in the ex-ante real interest rate from -0.1% in December 2019 to almost 2.8% in December 2022. Headline inflation has started to decline from its peak of 8.8% in June 2022 but is still above the target range at 5.6% in August 2023. The monetary authority cut the policy rate by 25 basis points in September 2023 to 7.5% after holding the rate steady for seven months, as inflation expectations eased and economic activity decelerated. Core inflation is also declining to 3.8% in August from its peak of 5.9% in March, with both goods and services prices edging down. Energy prices have declined and domestic factors such as the avian flu and fertiliser shortages are starting to dissipate. Twelve-month ahead inflation expectations are easing, at 3.4% in August, and the output gap remains negative. Looking ahead, policy rates should be kept high to bring inflation back to the target and to firmly anchor inflation expectations. Some modest policy easing can continue, provided inflation pressures firmly ease and inflation expectations return to the target.

Figure 1.6. Headline, core and inflation expectations are declining but remain above target

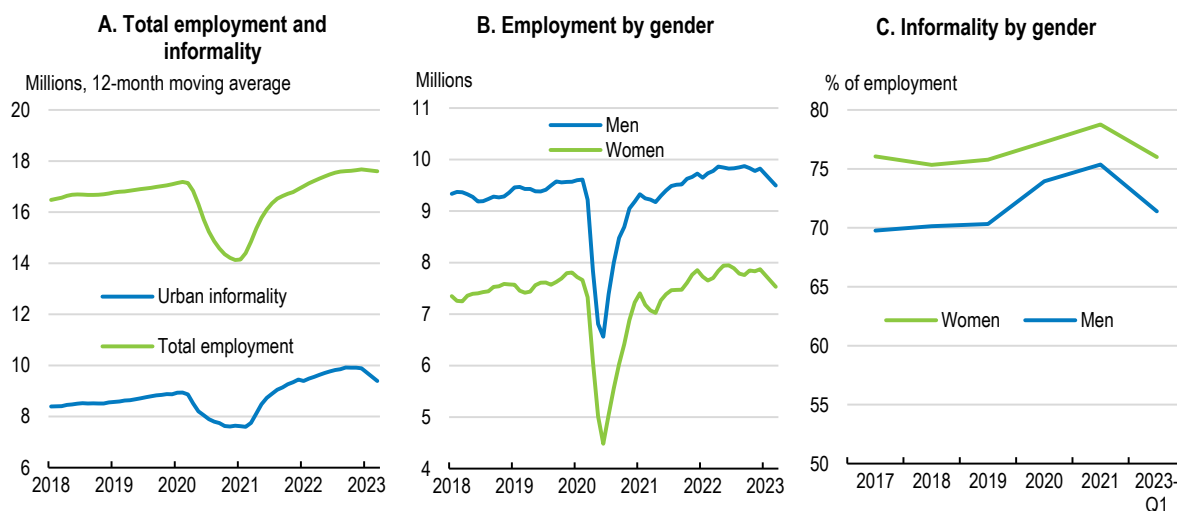


Note: Inflation refers to Metropolitan Lima area.
Source: INEI and BCRP.

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Employment has returned to pre-pandemic levels, but job quality has worsened with informality surpassing pre-pandemic levels (Figure 1.7, Panel A). The unemployment rate fell from 7.4% in 2020 to 4.3% in 2022 but is still above pre-pandemic levels. Employment of the youngest (up to 24 years) and among firms with more than 50 workers has yet to recover. Although female employment has recovered pre-pandemic levels, its growth has been slower compared to men and has been mainly in informal jobs (Figure 1.7, Panels B and C). One reason is that employment in the service sector, a major source of employment (Figure 1.8, Panel A), has not yet returned to pre-pandemic levels, especially for female workers. Another reason is that many women remain still outside the labour market after the large impact of the COVID-19 pandemic, when many female workers left the labour market because of long school closures and to take care of the elderly. Female labour force participation, though higher than in other Latin American countries, amounted to 63.5% in late 2022 compared to 79% for men and is still below the 2019 level of 65.6%. Limited access to quality childcare further restricts women's participation in the labour market. Although informality is prevalent across the workforce and sectors (Figure 1.8, Panel B), female workers are more likely to hold informal jobs, with a 7-percentage point higher informality rate compared to men.

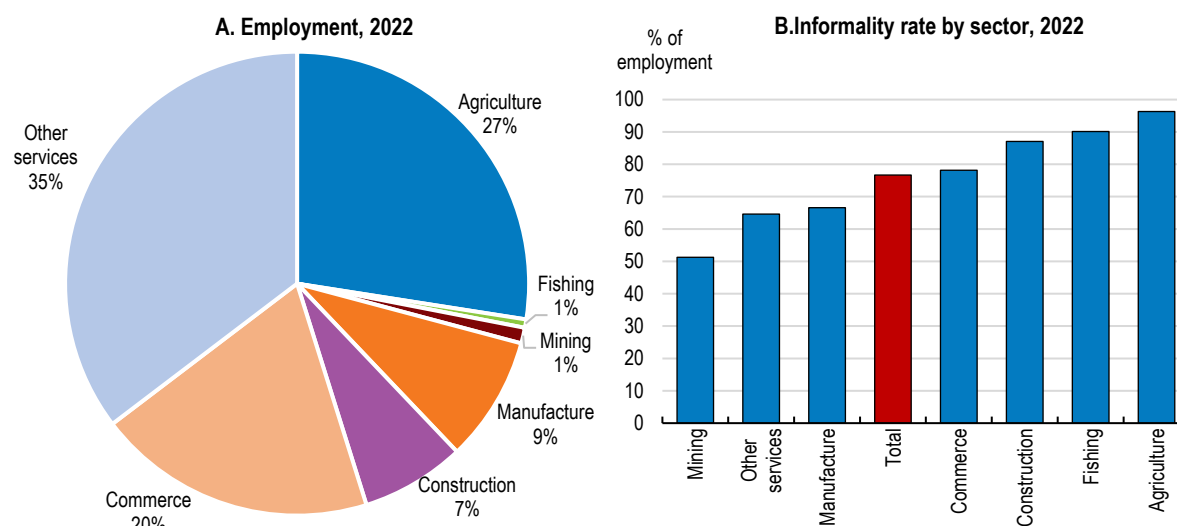
Figure 1.7. Job creation has returned to pre-pandemic levels, but quality has worsened



Source: INEI.

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Figure 1.8. Services account for a large share of employment and informality is prevalent across all sectors



Source: INEI.

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Economic growth will remain weak in an uncertain environment

Economic growth is projected at 1.1% in 2023 and gradually pick up to 2.7% in 2024 (Table 1.1). Political uncertainty, extreme weather events, and high interest rates and inflation are constraining private consumption and investment. Government efforts to relaunch infrastructure investment and several announced PPP projects will support investment. Although public investment at the subnational level is expected to be limited due to high turnover following local elections, national government initiatives to provide training to local authorities will partly mitigate this effect. Inflation is expected to slowly converge within the 1-3% target range by early 2024 allowing for an easing of monetary policy and supporting

household consumption and investment. The recovery of tourism and copper production will drive exports. This together with the improvement in the services account thanks to the normalisation of tourism and lower profit remittances from foreign companies due to lower metal prices will narrow the current account deficit.

Table 1.1. Macroeconomic indicators

National accounts (Percentage changes, volumes, 2015 prices)	2017	2018	2019	2020	2021	2022	2023	2024
Gross domestic product (GDP)	2.5	3.9	2.3	-10.8	13.3	2.7	1.1	2.7
Private consumption	2.8	3.8	3.2	-9.7	12.3	3.5	0.8	2.1
Government consumption	2.9	2.9	3.6	8.5	5.2	-0.9	2.6	1.2
Gross fixed capital formation	1.1	4.8	2.9	-16.5	34.2	0.7	-5.0	1.8
Stockbuilding ¹	-0.3	0.2	-0.5	-1.7	-0.6	0.0	-3.2	0.1
Total domestic demand	2.0	4.0	2.6	-10.6	15.2	2.3	-3.9	2.1
Exports of goods and services	9.1	3.4	0.3	-16.3	19.1	6.0	13.5	5.7
Imports of goods and services	7.1	3.6	1.6	-15.4	26.2	4.2	-2.8	2.6
Net exports ¹	0.5	-0.1	-0.4	-0.2	-2.0	0.4	4.6	0.7
Other indicators (growth rates, unless specified)								
Unemployment rate (% of labour force)	4.3	4.0	4.0	7.7	5.9	4.4	4.7	4.0
Consumer price index	2.8	1.3	2.1	1.8	4.0	7.9	6.8	3.2
Consumer price index Q4-on-Q4	1.4	2.2	1.9	2.0	6.4	8.5	5.2	2.6
Core consumer price index	2.5	2.1	2.4	1.9	2.2	4.7	4.6	2.9
Core consumer price index Q4-on-Q4	2.1	2.2	2.3	1.8	3.2	5.6	3.6	2.6
Current account balance (% of GDP)	-0.8	-1.2	-0.6	1.1	-2.3	-4.1	-1.8	-1.6
Fiscal balance (% of GDP) ²	-3.0	-2.3	-1.6	-8.9	-2.5	-1.7	-2.4	-2.0
Primary balance (% of GDP) ²	-1.8	-1.0	-0.2	-7.3	-1.0	-0.1	-0.8	-0.3
Public sector debt (gross, % of GDP) ²	24.7	25.6	26.6	34.6	35.9	33.8	33.6	33.5

1. Contribution to changes in real GDP.

2. Forecast by the Ministry of Economy and Finance in its Report on Multiannual Macroeconomic Framework 2024-2027.

Source: OECD projections, OECD Economic Outlook Database, INEI, Central Bank, MEF- Informe de actualización de proyecciones macroeconómicas 2023-2026.

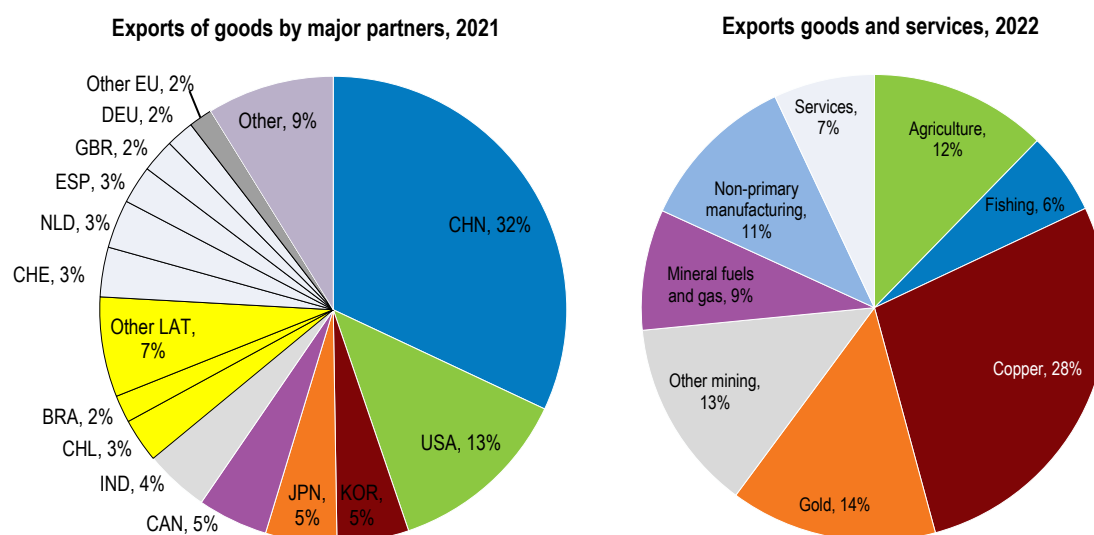
Short to long-term downside risks loom large

At the current juncture, both domestic and external risks are unusually high and tilted to the downside (Table 1.2). Externally, persistent inflationary pressures in advanced economies could require tighter financial conditions. Sudden sentiment changes in global financial markets, possibly related to surprises in the conduct of monetary policy in advanced economies or recent financial volatility, could limit financial inflows and increase financing costs for emerging market economies like Peru. Global geopolitical tensions could lead to further currency depreciation adding to inflationary pressures. A sharper slowdown in China, Peru's main trading partner and the destination for around 30% of exports (Table 1.2; also Figure 1.9), is another risk to growth, and could lead to worse terms of trade, widening the current account, although largely financed by foreign direct investment (Figure 1.10, Panel A). Furthermore, external debt has significantly risen (Figure 1.10, Panel B), albeit from a low level, increasing vulnerability to global financial conditions. Peru's exposure to sharp changes in copper and other mineral prices is another source of vulnerability, although long-term price declines are unlikely given that copper is a key input for the global energy transition towards electricity from renewable resources. These risks are mitigated by large currency reserves (Figure 1.10, Panel C), of around 71% of external debt or 30% of 2022 GDP, a resilient financial sector, ample access to international capital markets, and low public debt. These buffers are complemented by a two-year Flexible Credit Line arrangement with the IMF. Upside risks to growth are sustained higher commodity prices, faster global growth and faster recovery of China's economy than anticipated.


Table 1.2. Potential major medium-term vulnerabilities

Uncertainty	Possible outcome
Natural disasters and environmental risks related to climate change.	Extreme rainfall, droughts, floodings, transmission of viral infections, food and water insecurity, water rationing, infrastructure damage with negative impact on GDP per capita and fiscal sustainability.
Protracted and intensified domestic political uncertainty and social unrest.	Policy uncertainty could trigger reform paralysis, stifle private investment and generate capital outflows.
Abrupt global slowdown or recession and slower economic growth in China.	Lower export prices, falling terms of trade, and lower exports and growth.
Heightened global financial stress.	Capital outflows in a rush towards safety causing further currency depreciation and worsening the outlook for dollar denominated external debt and a sudden increase in risk premia.

Figure 1.9. Mining and China play a significant role for Peru's exports



Source: Central Bank of Peru and Comtrade.

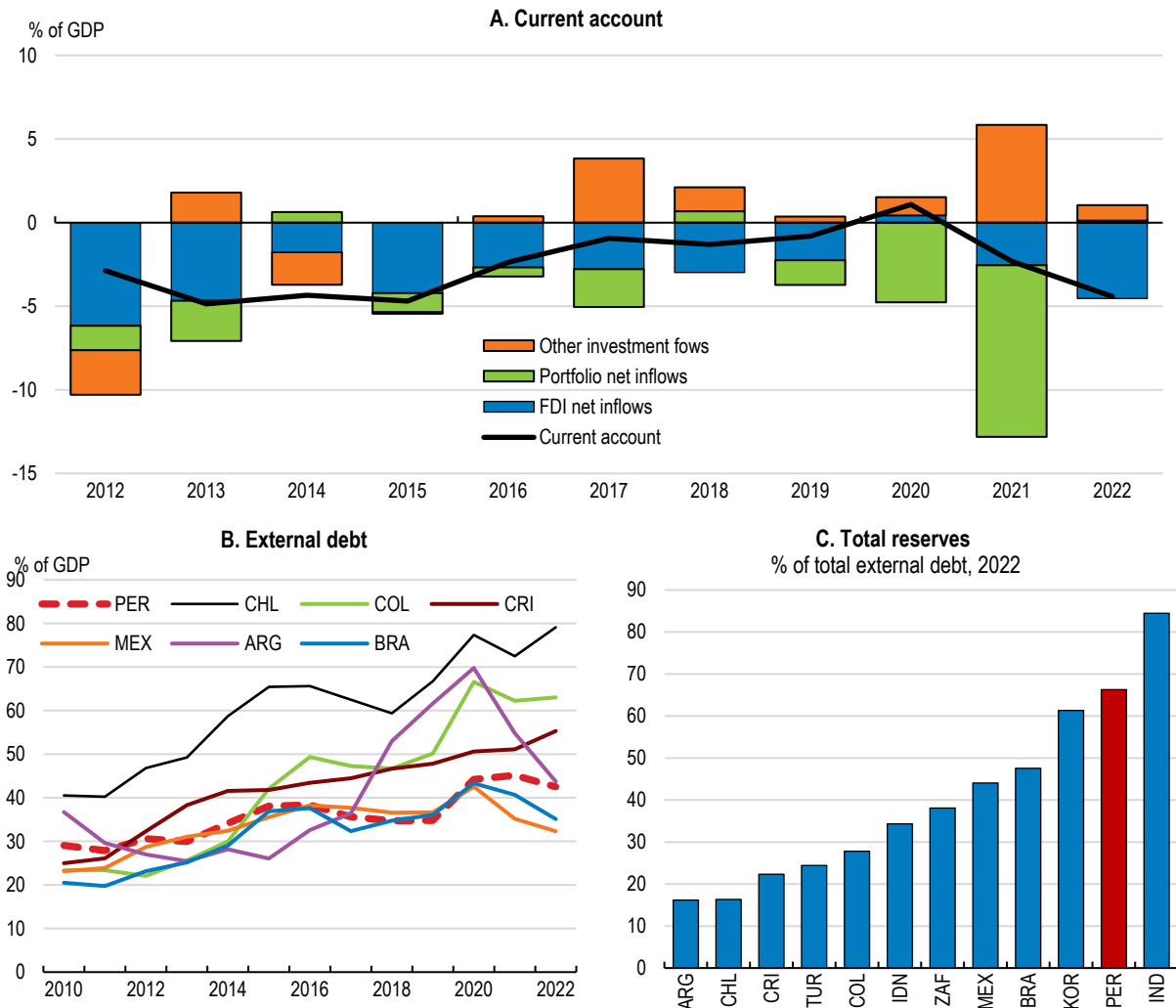
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Peru's long-term domestic vulnerabilities for economic growth include protracted political instability and renewed flare-ups in social unrest. The weak economic outlook, high inflation and political fragmentation increase the risk of further social unrest and political confrontation. The country has been in a political crisis since 2016, with six presidents and frequent changes in congress and ministries. This has led to institutional weakness which could eventually lead to paralysis for much-needed structural reforms to foster economic growth and address deep-rooted social inequities. Persistent political instability can also lead to higher borrowing costs and worsen the debt outlook, as reflected by recent the debt outlook downgrades from Standard and Poors (December 2022) and Moody's (January 2023). On the contrary, political stability could foster the building of consensus around much needed structural reforms, dissipate domestic policy uncertainty and lead to higher economic growth.


Peru is vulnerable to environmental risks, particularly related to climate change and natural disasters due to its diverse geographic conditions and ecosystems. Human activities such as deforestation, illegal mining, land degradation, and pollution have increased exposure to natural disasters such as flooding, landslides, and droughts. Between 2003 and 2021, Peru experienced over 61 000 natural-phenomena emergencies, including earthquakes, droughts, and landslides (MINAM, 2023^[5]). *El Niño*, a frequent extreme weather condition, has increased flooding across the country and remains a key risk to the outlook. It currently looks as if the economic toll will be limited, as this year it is expected to be mild. Climate change also affects the availability of water, which is crucial for agriculture, human consumption, and energy

production, as Peru is highly dependent on glacial meltwater. Low-income and rural households are more widely exposed to natural disasters and the impact of climate change, increasing climate-induced inequality (World Bank, 2023^[6]).

Figure 1.10. Peru has buffers to face adverse external shocks



Source: IMF WEO database, Central Bank of Peru.

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Climate change could lead to the disappearance of many species, increase vulnerability of forests and potentially large economic losses, negatively affecting the well-being of millions of Peruvians. Each degree increase in temperature is estimated to lead to a percentage point loss in the GDP per-capita growth rate each year (Chirinos, 2021^[7]). Climate change will also impact asset valuations and is a significant contingent fiscal risk. For example, in 2017, a moderate *El Niño* subtracted around 1.7 percentage points from that year's economic growth, damaging roads, houses, bridges, farming areas, educational institutions, irrigation canals, rural roads, and health facilities (World Bank, 2022^[8]). Potential water stress could also result in significant GDP losses (CIES, 2021^[9]). Financial regulators should continue working on incorporating climate and natural hazard-related risks into its stress tests and financial stability monitoring tools. The Ministry of Finance should also quantify the fiscal impact and risks associated with climate change in its multiannual projections.

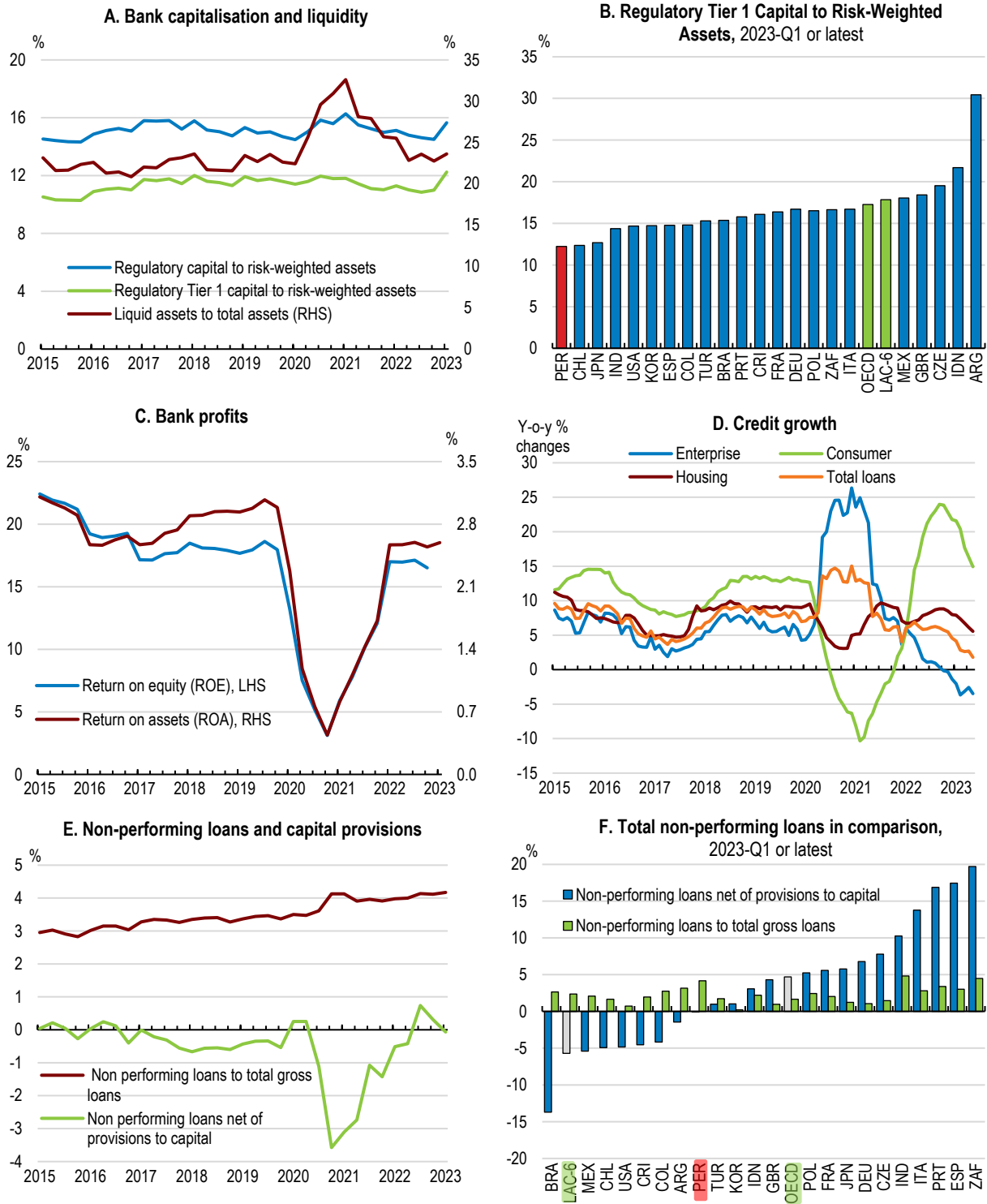
Financial stability risks seem contained

Despite global financial market challenges, including increased risks and volatility, domestic political uncertainty, and lower growth prospects, the Peruvian financial system has proven resilient due to its robust regulatory framework. While some macro-prudential measures were relaxed during the pandemic, higher provisioning and capital requirements have been reintroduced in the past two years to align with international standards such as Basel III. As of February 2023, the Tier 1 capital ratio was 12.9%, surpassing the 6% requirement, although lower compared to other emerging and advanced economies (Figure 1.11, Panels A and B). Bank profits have returned to pre-pandemic levels (Figure 1.11, Panel C) and stress tests indicate the Peruvian financial system can withstand severe scenarios (SBS, 2022^[10]). A new capital structure for banks is in place since January 2023 including capital conservation and systemic risk buffers, in line with Basel III. In an environment of tightening financial conditions, however, the authorities should monitor bank portfolios and lending standards closely. Further steps could be taken to include enhanced supervision of financial groups, and requirements for resolution planning for domestic systemically important banks and financial groups.

Peru's banks are well capitalised and credit risks seem contained. The credit portfolio has rebounded, surpassing pre-pandemic levels. However, following the gradual withdrawal of borrower-based support measures that included extensive government guaranteed loans and flexible loan adjustment terms and monetary tightening, credit growth has decelerated rapidly and turned negative for enterprises (Figure 1.11, Panel D). Factors explaining this trend are low business confidence, rising debt costs and caution in the financial system. Non-performing loans (NPLs) have been increasing and at 4% are historically high, and above OECD average, especially for SMEs (above 8%). But provisioning is robust (Figure 1.11, Panels E and F), with the sector's coverage ratio at 113% of NPLs at mid-2022 (SBS, 2022^[10]). SMEs' NPL rate and late payments by SMEs should not represent a major risk, as SMEs account for 26% of total loans. Rural microfinance institutions continue to have weaknesses including negative utilities, largely related to insufficiently diversified portfolios, and may require continued access to special lending facilities that have thus far contained risks (IMF, 2023^[11]). Nonetheless, spillover risks are negligible, as micro institutions comprise less than 0.5% of total assets of the financial system.

Six extraordinary withdrawals from private pension accounts since 2020, equivalent to half of the pension system's assets and around 10% of GDP, required pension funds to sell long-term assets, reducing the financial market depth and depleting households' pension savings. Chile has gone through a similar experience. The withdrawals were initially intended to provide support to households in the context of the COVID-19 pandemic. They indeed helped limit the contraction in domestic demand, but significantly reduced the value of assets held by pension funds. This, in turn, reduced the capacity of the local market to absorb government debt and finance fiscal deficits, and as a result the government has increased its borrowing from external markets and in foreign currency, worsening the composition of its debt. Local long-term interest rates have increased, and bond maturities issued by banks, firms, and the treasury shortened (BCRP, 2021^[12]). Further withdrawals of pension funds could lead to an abrupt reduction in fixed income and equity asset prices, thus affecting the value of insurance companies, mutual funds, banks and Pension Fund Administrators, affecting the macro-financial stability of the country. Going forward, a comprehensive pension reform is necessary to address the system's long-standing problems of very low coverage and adequacy, but limiting early pension withdrawals to specific cases outlined by law, as discussed in Chapter 3 of this Survey, will be key to enjoy the benefits of deeper financial markets.

Figure 1.11. Financial stability indicators



Note: LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX.
Source: Central Bank, CEIC, BIS.

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The financial sector is exposed to foreign exchange volatility due to a significant share of credit and deposits denominated in dollars, which is larger than in most emerging markets (Figure 1.12), although mitigated by large reserves requirements. Foreign currency loans accounted for 24% of total credit in November of 2022. Peruvian households and firms hold 17% and 142% foreign-exchange credit to deposit ratio. High dollarisation in the corporate sector is concentrated in the large and medium-sized firms (55% and 26%, respectively of total credits). However, they often have access to hedging instruments and the foreign exchange credit risk, which measures the degree of dollar credit granted to non-generators of dollars, amounted to 15% and 12%, respectively. Still, the hedged exposure varies across sectors. For example, the service, electricity, and water supply industries have greater unhedged exposures (IMF, 2023^[11]). Despite substantial deposit dollarisation (35%), banks have adequate foreign exchange liquid reserves to hedge against currency depreciation.

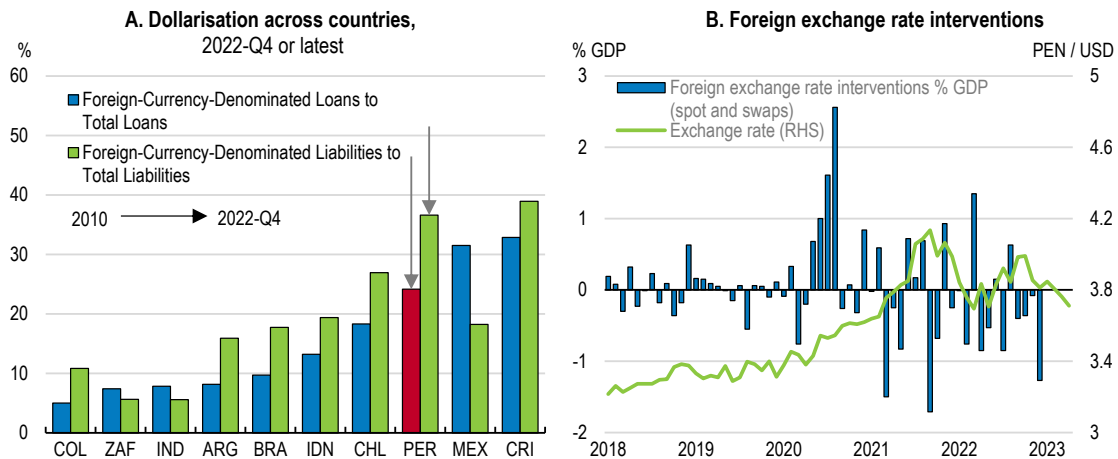
Peru's financial regulators have implemented several de-dollarisation measures since the early 2000s to reduce direct foreign exchange risk in the banking sector (IMF, 2022^[13]), and dollarisation has significantly decreased (Figure 1.12, Panel A). Factors that contributed to the de-dollarisation process include macroeconomic stability, the development of the local currency capital market, including issuance of long-term public and corporate debt denominated in soles, and macroprudential policies, including higher reserve requirements for dollar deposits (Garcia-Escribano, 2011^[14]). In 2013, the Central Bank initiated a de-dollarisation programme that combined reserve requirements based on limits on foreign currency credit balances and new instruments to provide liquidity in domestic currency and a currency hedge to convert dollar into soles loans contributing to accelerate de-dollarisation (BCRP, 2019^[15]). Total credit dollarisation dropped from 41% in December 2014 to 20% in December 2021. Household credit dollarisation declined significantly, with mortgage credit falling from 36% to 9% and vehicle credit dropping from 71% to 13% in the same period.

The lower but persistent dollarisation warrants frequent foreign exchange interventions by the central bank to avoid excessive volatility (Figure 1.12, Panel B), hampers the transmission of monetary policy and implies financial stability risks. Interventions respond to large shocks and the presence of frictions, such as shallow foreign exchange markets or substantial foreign exchange rate mismatches, which could otherwise jeopardize the central bank's goals of maintaining price and financial stability. The percentage of days in which the central bank intervened in the foreign exchange market has decreased since 2016, reaching a minimum of 4% in 2019. In recent years it has increased, reaching 59% in 2022 with swap interventions acquiring more relevance, in terms of volume, than spot interventions. Given the existing currency mismatches and shallow foreign exchange markets, Foreign exchange intervention is broadly appropriate under volatile market conditions, driven by global tight financial conditions, domestic political uncertainty, pension funds withdrawals. These interventions allow to reduce the risks inherent in financial dollarisation without affecting the real exchange rate trend and cementing the financial stability necessary for long-term growth (BCRP, 2021^[16]). More recently, driven by the appreciating trend of Peruvian sol since June 2023, there has been an increased use of exchange rate interventions in the swap market. The exchange rate in Peru is the least volatile in Latin America and is among the most stable among emerging markets.

Gradually limiting interventions in the foreign exchange market to targeted and conditional events would allow economic agents to better internalize exchange rate risks and incentivize the development of local currency markets, reducing currency mismatches and encouraging de-dollarisation. Implementing fewer and more targeted interventions, particularly based on market conditions, and fostering a deeper market would encourage the private sector to develop hedging instruments (IMF, 2023^[11]). Although many economic participants in Peru have natural hedges like dollar invoicing, a deeper forward foreign exchange market would benefit the majority who still require access to hedging options. This would allow the exchange rate to play a larger role as a shock absorber and strengthen the transmission of monetary policy. It would also contribute to export diversification, supporting growth in non-traditional exports (Adler, Magud and Werner, 2017^[17]).

To facilitate the progress of hedging instruments and further de-dollarisation, it is important to develop a deeper foreign exchange and financial derivatives market. This can be achieved by establishing a regulatory framework that ensures the proper functioning of derivative markets and provides clear guidelines for market participants. Additionally, the development of trading platforms, clearinghouses, and settlement systems is crucial to facilitate derivative transactions, which have been increasing since 2014. Authorities can work with financial institutions and other stakeholders to create partnerships and initiatives that promote the development of the financial derivatives market, particularly for small and medium-sized enterprises (SMEs), for whom participation can be more costly. For example, the Brazilian Development Bank provides technical assistance to SMEs on risk management strategies.

Figure 1.12. Financial dollarisation remains large



Source: IMF, FSI; BCRP; Adler, Gustavo, Kyun Suk Chang, Rui C. Mano, and Yuting Shao. 2021. "Foreign Exchange Intervention: A Dataset of Public Data and Proxies," IMF Working Paper Series 21/47, International Monetary Fund, Washington D.C.

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The macroeconomic framework could be further strengthened

Monetary policy in Peru has built up strong credibility with a robust track record in maintaining inflation expectations anchored with an inflation target of 2% and a tolerance range of 1 percentage points. The Central Bank's independence has been critical in ensuring macroeconomic and financial stability since its establishment in the 1990s and has played a critical role during the pandemic recession and the more recent shocks. It supported the recovery by lowering the monetary policy rate and by providing significant liquidity, which was key to safeguarded financial stability and facilitate credit provision. More recently, it has timely increased the monetary policy rate to contain inflationary pressures.

Although the Central Bank's governance generally adheres to international best practices and provides strong legal guarantees for operational autonomy and accountability, its autonomy could be further strengthened. The board of directors consists of seven members. The executive branch appoints four of them, including the president, subject to Congress approval, while the Congress selects three. All board members can only be removed for cause. However, the alignment of the appointment of the president and board directors with the presidential term poses a potential threat to the Bank's autonomy and exposes it to the risk of political interference, even though it has not occurred so far.

A sound fiscal framework, supported by fiscal rules and an independent fiscal institution (Table 1.3), has contributed to strong public finances, low public debt and ample fiscal space. Peru's current fiscal framework, established in 1999 to stabilize the economy and promote growth, is based on fiscal rules governing deficits, public spending, and public debt. These rules were enshrined in the Fiscal Responsibility and Transparency Law, which was updated in 2013 and has since been reinforced with

transparency and accountability measures. A fiscal stabilization fund was created in 1999 allowing to create significant fiscal buffers during the commodity supercycle. A fiscal council was established in 2016 to ensure adherence to the framework. Peru's fiscal framework is considered a model of best practice in fiscal management and has helped establish the country as a leader in economic governance in Latin America.

Table 1.3. Current main elements of the Peruvian fiscal framework

	Instrument	Description
Fiscal rules	Non-financial public sector debt rule.	Public debt may not exceed 30% of GDP. In exceptional cases of financial volatility, and provided that the other rules are complied with, it may temporarily deviate by up to 4 percentage points of GDP.
	Non-financial public sector deficit rule.	The fiscal deficit must not exceed 1.0% of GDP.
	General government non-financial expenditure rule.	The annual growth of general government non-financial expenditure is limited by the annual last 20-year real growth of the economy (15 previous years, current and 4 years of forecast) plus 1 p.p.
	Current general government expenditure rule.	The growth of general government current expenditure, without maintenance, is limited by the annual last 20-year real growth of the economy minus 1p.p. and cannot grow more than non-financial expenditure.
	Rules for regional and local governments.	Total debt stock \leq annual average of total current revenues for the last 4 years; total current revenue \geq non-financial current expenditure.
Macroeconomic management	Escape clauses.	In periods of national emergency or international crisis or when real GDP is declining, rules can be suspended or modified. To that end, the government must submit a bill to the congress that must explicitly contain the path of return to the regular parameters.
	Fiscal Stabilisation Fund.	The fund is funded by remaining resources in the Treasury accounts, after deducting contributions to the Secondary Liquidity Reserve, a share of income from concessions, and a share of privatization proceeds. Resources can be used to finance expenditure when lower revenue is projected, when real GDP is declining or under conditions of a national emergency or international crisis.
Institutional framework, transparency and accountability	Multi-annual Macroeconomic Framework including an explicit contingency assessment and fiscal risk analysis: a document in which the government is required to make public the macroeconomic projections underpinning the public budget for the current year and subsequent years. Update of the Multi-annual Macroeconomic Framework. Statement of Compliance of Fiscal Rules. Monitoring reports. Independent Fiscal Council.	

Source: OECD Secretariat.

The Fiscal Council plays a key and constructive role in supporting Peru's fiscal framework since its inception (IADB, 2019^[18]). The institution's non-binding opinions on the fiscal strategy, compliance with the fiscal rules, the evaluation of budgetary forecasts and emerging fiscal risks are public, timely, and objective. Recent changes have strengthened the Council's independence, such as the recent addition of a requirement for the committee to be made up of five members with demonstrated technical abilities who are appointed by the Ministry of Economy and Finance based on a shortlist proposed by the Fiscal Council. The president of the fiscal council is chosen by the Fiscal Council members. The technical secretariat of the Council is now considered as the equivalent to a public regulatory body allowing it to pay higher wages to technical staff enhancing its technical capacity. However, there is still room for enhancing its operational independence. Consulting the Fiscal Council systematically when modifying fiscal rules and publicly responding to their opinions would promote transparency and accountability, as the deficit rule has been changed, suspended or emended by transitory ceilings frequently. The law requires the government to consult the Fiscal Council when formulating the multi-year macroeconomic framework prior to the approval of Congress. However, this requirement does not extend to subsequent update, for which the Fiscal Council can give its opinion after the publication. Seeking input before the publication of the update would be beneficial for strengthening public finances. Other OECD fiscal council experiences indicate that to further enhance operational independence, the Council could hold more regular hearings before the parliament and undergo external evaluation by local or international experts in line with OECD principles of independent fiscal institutions. With sufficient resources the Fiscal Council could also play a role in monitoring subnational fiscal rules. A good example of this is the AIReF, the Spanish Independent Fiscal

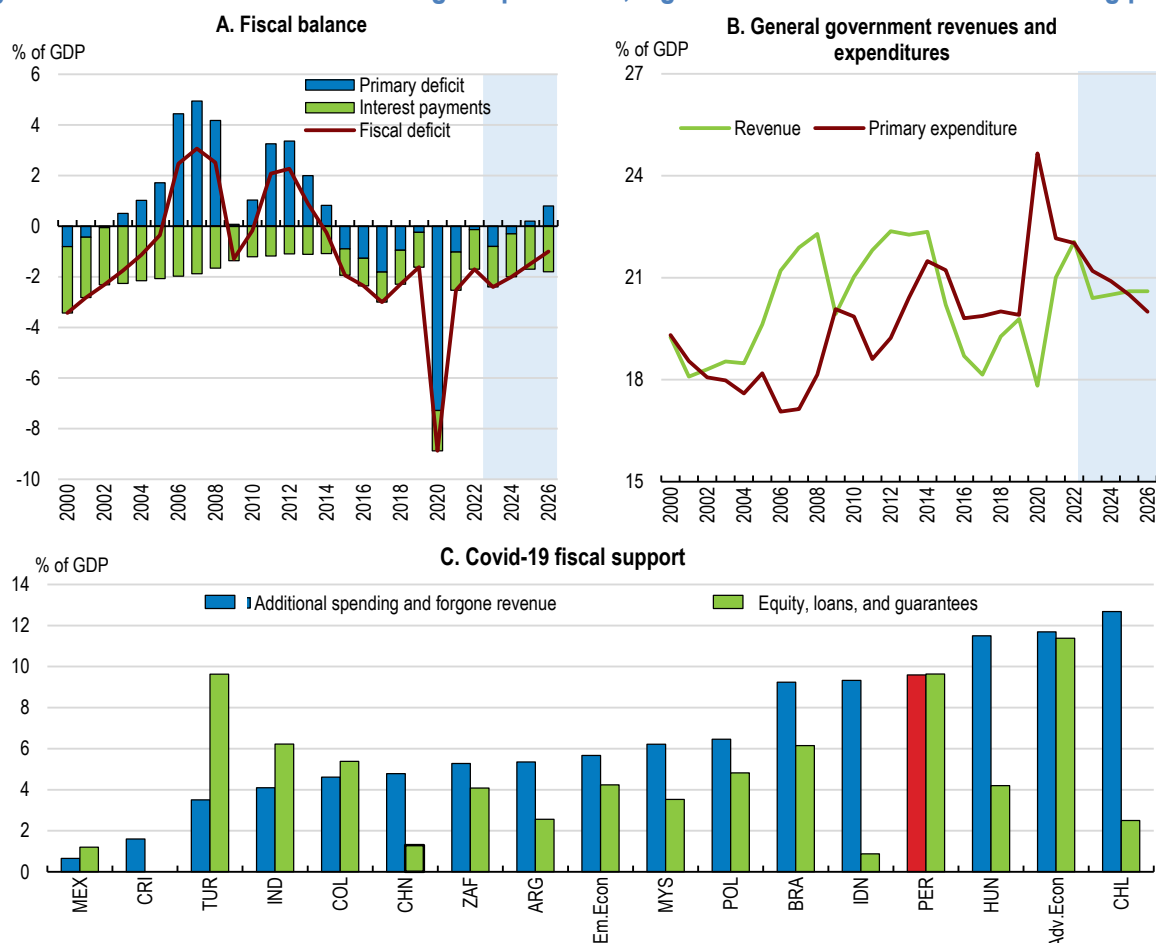
Institution. AIReF is one of just a few IFIs that is charged not only with verifying compliance with general or central government rules, but also with subnational/regional rules. AIReF's assessments of fiscal sustainability have a regional focus, as regions are subject to fiscal deficit targets given high fiscal decentralisation (OECD, 2020_[19]).

Reforms are needed to increase efficiency of public finances

Fiscal policy should remain prudent and rebuild fiscal buffers


The sound fiscal framework enabled the government to provide a bold stimulus of 10% of GDP to support the economy during the COVID-19 pandemic. As pandemic-related spending was withdrawn and revenues increased driven by the recovery and high copper prices, the budget deficit decreased from 8.9% of GDP in 2020 to 2.5% in 2021 and 1.7% in 2022, with debt reaching 33.8% of GDP in 2022. Currently a gradual fiscal consolidation is envisaged to ensure fiscal sustainability in the medium term (Figure 1.13). Fiscal rules, which were reinstated with a transition period in 2022, after a two-year suspension, are expected to bring the debt to GDP ratio under 30% of GDP by 2030 and the fiscal deficit to 1% of GDP by 2026. The fiscal deficit is projected to reach 2.4% of GDP in 2023, in the limit foreseen in the fiscal rule (2.4% of GDP), implying a moderate fiscal impulse aiming to boost the economy, improve social cohesion and mitigate the impact of social protests. During 2024-26, the authorities' fiscal strategy envisions a gradual fiscal consolidation of about ½ percentage points of GDP per year.

Figure 1.13. After bold stimulus during the pandemic, a gradual fiscal consolidation is taking place



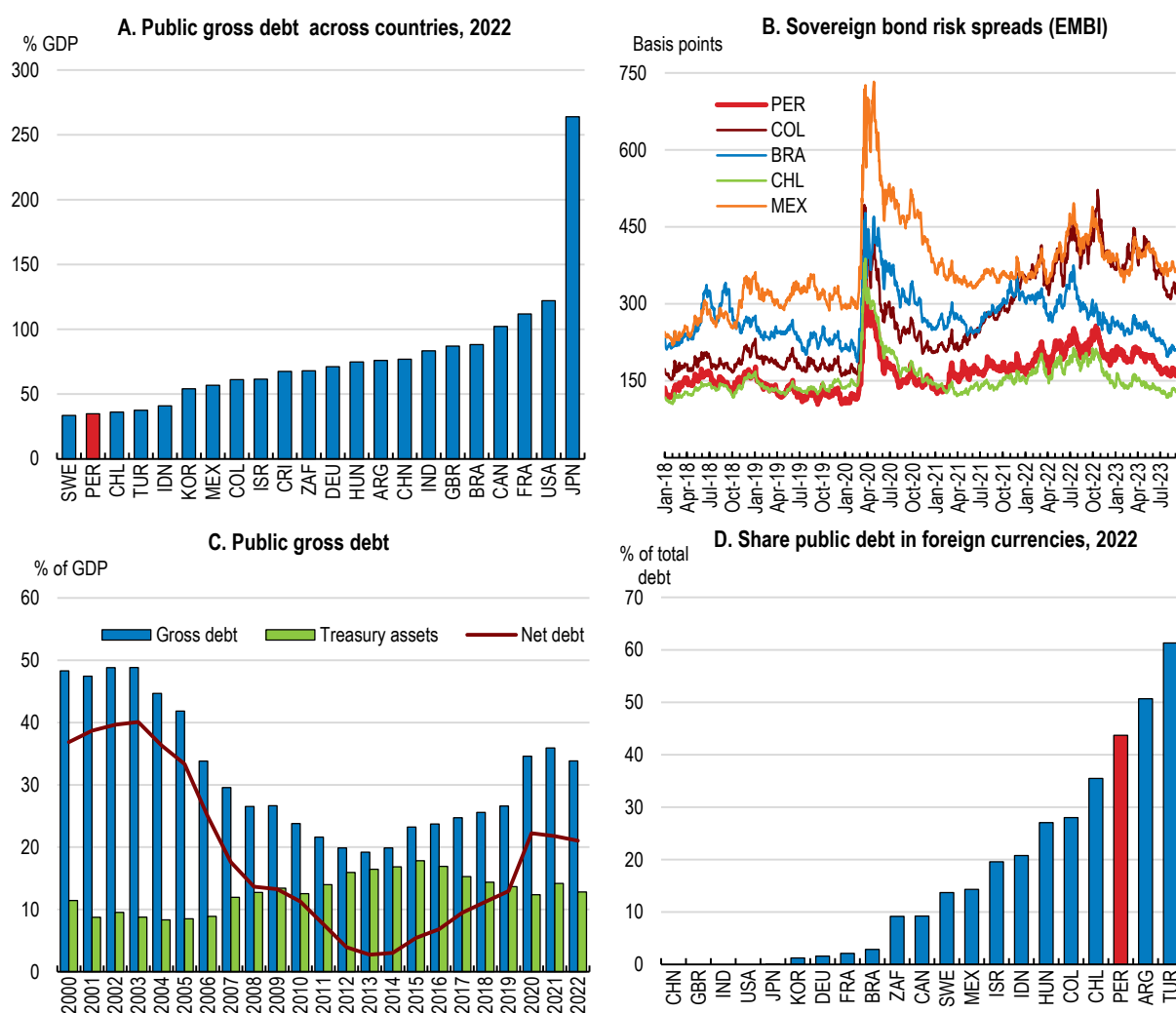
Note: Shaded areas reflect government forecast as reflected in the *Multiannual Macroeconomic Framework report 2024-2027*.

Source: Central Bank of Peru; Ministry of Finance, *Multiannual Macroeconomic Framework 2024-2027* (MMM, 2023_[20]).


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In comparison to other emerging market economies, Peru's public debt remains low (Figure 1.14, Panel A), although tax revenues are also comparatively modest. Peru's public debt has an average maturity of 13 years and market perceptions about Peruvian public bonds remain favourable relative to other countries in the region (Figure 1.14, Panel B), even if funding costs have increased because of tighter monetary policy. However, public debt has been increasing since 2013 (Figure 1.14, Panel C) and is more exposed to exchange rate risks, as Peru's gross public foreign exchange debt has increased to 51.6% of total public debt in 2022 from 31.8% in 2019 (Figure 1.14, Panel D).

Figure 1.14. The public debt outlook remains healthy, but debt composition has worsened



Source: Ministry of Finance; IMF, World Economic Outlook database; BIS.

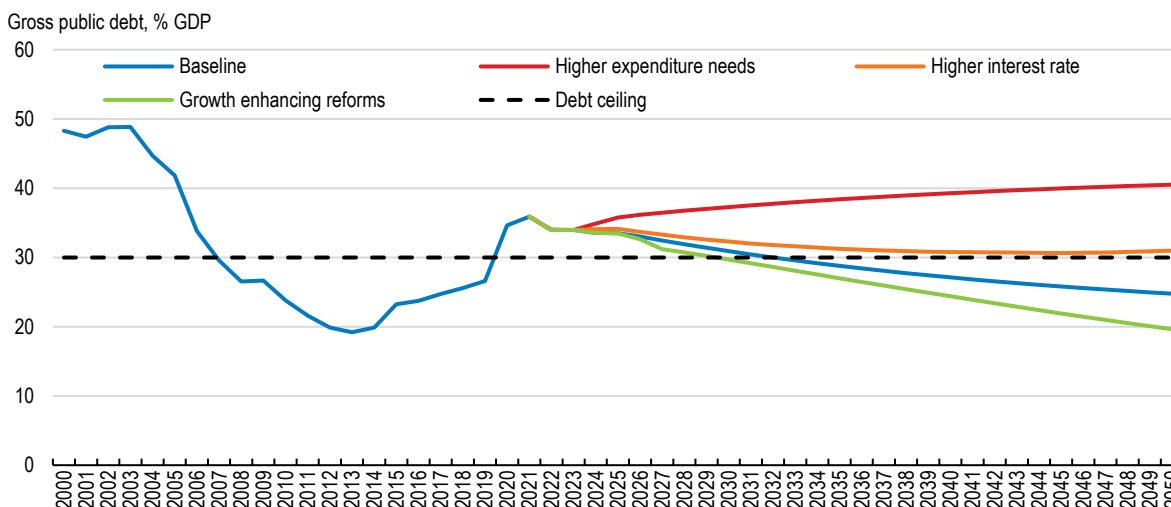
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Rebuilding the fiscal buffers will be key to provide space to fiscal policy during downturns and are necessary to protect Peru against the fiscal impact of natural disasters, commodity price shocks and the realisation of contingent liabilities in the future. The massive spending during the pandemic was financed by drawing on savings in the fiscal stabilisation fund, and new debt issuance, as gross debt rose by 9 percentage points of GDP between 2019 and 2021, to 35.9% of GDP. The size of the stabilization fund was only 0.6% of GDP in 2022, while before *el Niño*, a strong natural event, in 2017, it was at 4.5% of GDP. Contingent liabilities stem mainly from government guarantees in PPP contracts, estimated at 1.8% of GDP in 2021, and guaranteed loans enacted during the pandemic (0.6% of GDP).

One significant fiscal risk is the financial instability of Petroperu, a state-owned oil enterprise that supplies almost 50% of the local fuel market. Petroperu is the sole state-owned enterprise in Peru that does not fall under the jurisdiction of a fund called FONAFE, which exercises ownership rights over all other national state-owned enterprises. FONAFE management is generally aligned to OECD best practices. The government has recently approved a capital contribution of PEN 4 billion and a short-term debt operation of up to USD 500 million (0.2% of GDP) to ensure national energy security, constituting a direct contingent liability. However, long-term balance sheet issues remain a concern. Petroperu also faces challenges related to environmental concerns and governance, with allegations of political interference affecting its operations and management. Authorities should strengthen oversight, implement a strategy to restore the company's viability or divest state participation, and improve transparency, financial management practices, and environmental responsibility, in line with OECD Guidelines on Corporate Governance of State-Owned Enterprises and OECD Principles of Corporate Governance.

Over the medium term, the planned gradual fiscal consolidation is expected to stabilize the public debt-to-GDP ratio below the debt rule of 30% of GDP and preserve debt sustainability (Figure 1.15, blue line). Higher interest rates, possibly related to developments on global financial markets and domestic political uncertainty, would lead to a higher debt trajectory slightly above the debt ceiling of 30% of GDP (orange line). The impact of higher interest rates is relatively limited, as over 80% of public debt is contracted at fixed interest rates with an average duration of 13 years. Permanently rising spending, including due to the possibility of the passage of unfunded spending initiatives by congress, will require deeper reforms to increase revenues and preserve debt sustainability. Otherwise, the gross public debt would exceed 40% of GDP by 2040 (red line). Finally, the package of growth-enhancing structural reforms described in Figure 1.3 would raise growth and hence reduce the debt-to-GDP ratio visibly (green line), with a continuous decline in public debt that would reach 20% of GDP in 2050.

Figure 1.15. Public debt is sustainable in the baseline scenario, but there are risks



Note: The current government fiscal plans scenario assumes GDP growth as in Table 1.1 and 2.9% thereafter. Calculations include ageing related public spending on health and pensions. The higher spending needs scenario assumes additional 1% of GDP while revenue collection is maintained constant as % of GDP. The higher interest rate scenario assumes an additional 0.6 percentage points for the implicit interest rate on gross public debt. Finally, the higher growth scenario assumes an average long-term growth of 3.9% in 2025-2027 and 4.8% as of 2028, in line with the impact of all reforms in Figure 1.3.

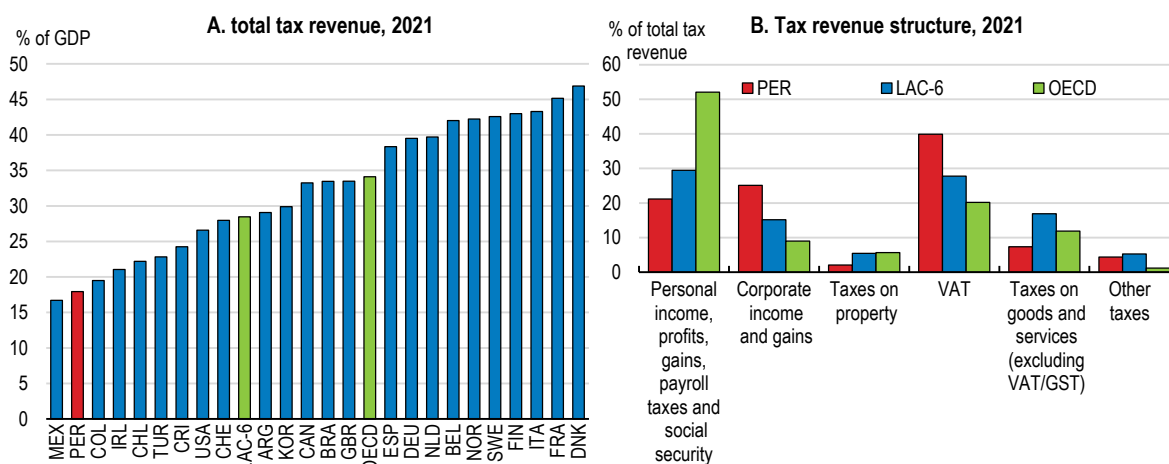
Source: OECD calculations.

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A comprehensive tax reform is needed to address long-standing challenges

The tax system in Peru is characterized by a relatively low tax burden and a narrow tax base. The tax-to-GDP ratio is at 17% well below the OECD average of 34% and the Latin American average of 30% (Figure 1.16, Panel A), and insufficient to meet rising social needs and bolster necessary public investment in infrastructure, education, and health. As in other Latin American countries, the country relies heavily on indirect taxes such as the value-added tax, while higher-income OECD countries depend more on revenues from personal income taxes and social security contributions (Figure 1.16, Panel B). While the reliance on indirect taxes is beneficial from an economic-growth perspective, it leads to a low progressivity of the tax system (OECD et al., 2023^[21]).

Figure 1.16. Tax revenues are low and the composition is tilted to indirect taxes



Note: The tax-to-GDP ratio measures tax revenues (including social security contributions paid to the general government) as a proportion of gross domestic product (GDP). Year 2020 for OECD panel B LAC6 is the simple average of ARG, BRA, CHL, COL, CRI, MEX.

Source: OECD, Global tax revenue database and OECD Revenue Statistics in Latin America and the Caribbean.

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One of the main challenges associated with taxation in Peru is the narrow tax base. A significant number of businesses and individuals do not participate (or participate only partially) in the formal economy and the tax system, resulting in low tax compliance. Despite recent efforts to reduce tax evasion and improve the functioning of the tax administration, tax evasion remains high and costs Peru approximately 5.5% of GDP (Sunat, 2022^[22]; Sunat, 2022^[23]). VAT non-compliance amounts to over 2.6% of GDP, one of the highest shares in Latin America (Figure 1.17). Meanwhile, exemptions and reduced rates in the VAT cost 1% of GDP (Arias, 2021^[24]), with an average VAT rate of 18%. Some goods and services are exempt from VAT, including books, newspapers, and magazines, as well as some agricultural products, the provision or use of services in the country; the first sale of real estate with a value of less than USD 47 000. A temporary reduced VAT rate of 10% for certain restaurants and hotels is in place until December 2024. Raising compliance and limiting the scope for exemptions and reduced rates while compensating the poorest households through the transfer system could increase VAT revenues, while reducing distortions and addressing equity concerns. Moreover, non-compliance with the corporate income tax is higher, reaching 33.1% of potential revenue in 2021 (Sunat, 2022^[22]), exceeding the levels of Colombia, Chile and Mexico.

Greater revenues could be achieved by strengthening and modernizing Peru's tax administration, starting with improvements in human capital, information systems and the use of advanced technologies, and the quality of the taxpayer registry, systematically cross-checking of information across different sources, while also continuing to improve and expanding electronic invoicing (Box 1.3). Full implementation of the 2022

reforms, such as the introduction of a digital tax registry, and leveraging on big data tools seem promising. To continue this progress, it is necessary to incorporate good tax practices into national regulations, particularly those related to combating domestic and international tax avoidance and evasion. For instance, Peru has joined the Inclusive Framework on Base Erosion and Profit Shifting (BEPS) in 2017 and the two-pillar solution to address the tax challenges arising from the digitalisation of the economy in October 2021.

Box 1.3. Strengthening the tax administration using innovative technologies and data collection

Some countries are adopting advanced data and automation techniques to improve their tax administration and taxpayers' registration and identification. The Swedish Tax Agency launched an AI-based risk-evaluation service for business registration applications in May 2021. It categorizes applications using established risk factors and processes them accordingly.

Italy uses data analysis and machine learning to estimate the VAT Gap. Argentina has developed a Simple and Pro-Forma VAT Tax Return and implemented a digital VAT ledger, containing details of a company's incoming and outgoing invoices for each VAT period, to enhance compliance. France employs AI and aerial photographs to detect undeclared constructions.

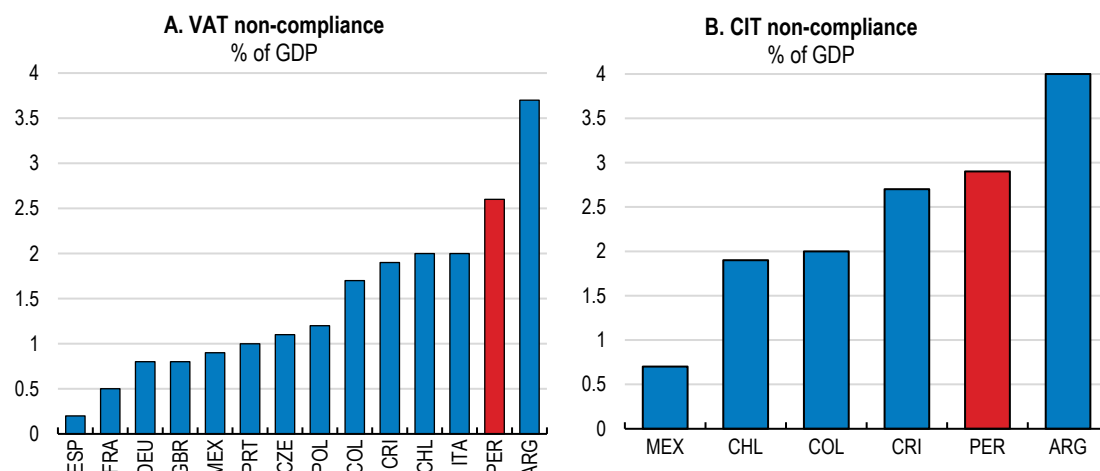
Some countries have improved tax debt management strategies to prevent tax debt. Argentina's SIPER system categorizes taxpayers based on risk factors to enable targeted collection measures and expedited judicial proceedings. Taxpayers are notified of their category and given the opportunity to rectify errors. In the USA, the IRS uses predictive models to streamline case management, predicting taxpayer behaviour and assessing payment likelihood, future compliance risk, and expected payment amounts.

Source: (OECD, 2022^[25]).

Tax expenditures contribute to Peru's low tax collection. Tax expenditures amounted to 2.0% of GDP in 2022 (MMM, 2022^[26]). The largest tax expenditures include exemptions of agricultural products and imports and provision of educational services, VAT exemptions in the Amazon region, exemptions for CTS (a fund that mitigates the risk of employment termination for formal workers). Many of these tax expenditures are badly targeted, benefiting the wealthiest and failing to meet their objectives (Arias, 2021^[24]). Conducting an in-depth evaluation of tax expenditures, retaining only those with positive and cost-effective impact towards well-defined policy objectives while phasing out the rest and replacing them, if needed, by targeted transfers to the most vulnerable population, could generate significant tax revenues. The VAT, personal income and capital gains tax regime could also be revised to eliminate numerous deductions and exemptions that hinder equity and tax collection, including VAT collection mechanisms for digital services (Schatan et al., 2021^[27]; Arias, 2021^[24]).

The existence and complexity of multiple corporate tax regimes in Peru has contributed to lower corporate tax collection, high evasion, high informality, and low productivity. Currently, there are three simplified regimes for small businesses with their own categories and tax burden based on the size of the enterprise (Table 1.4). These special tax regimes cover approximately 1.2 million active taxpayers, or 92% of the total, and bring in tax revenue amounting to barely 0.3% of GDP or 8% of total corporate income tax. While the small enterprises tax regime was designed to simplify and reduce tax compliance costs and allow small firms to formalize, it has created ample opportunities for arbitrage, artificial subdivision of businesses, misreporting, and tax evasion (Ardanaz et al., 2020^[28]; OECD, 2016^[29]). An example of the unintended consequences of Peru's multiple corporate tax regimes is the 2016 reform that introduced the third small enterprises regime (RMT). This reform aimed to introduce progressiveness in taxation and improve incentives for formalization, but in practice, it has led to a migration out of the general regime (Arias, 2021^[24]) (Figure 1.18). The regimes have also relatively high-income thresholds to belong to the regimes. This has resulted in the massification of small, low-productivity firms that concentrate a large amount of employment but have little incentives to grow.

Figure 1.17. High tax non-compliance hampers tax revenue collection



Note: For Peru, year 2021. Panel A: 2017, except CRI and MEX 2016. Panel B: ARG 2005, CHL 2009, CRI 2015, COL and MEX 2016.
Source: OECD Secretariat based on (Cepal, 2020^[30]; Sunat, 2022^[22]; Sunat, 2022^[23]) and (OECD et al., 2022^[31]).


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Table 1.4. Tax regimes for business in Peru

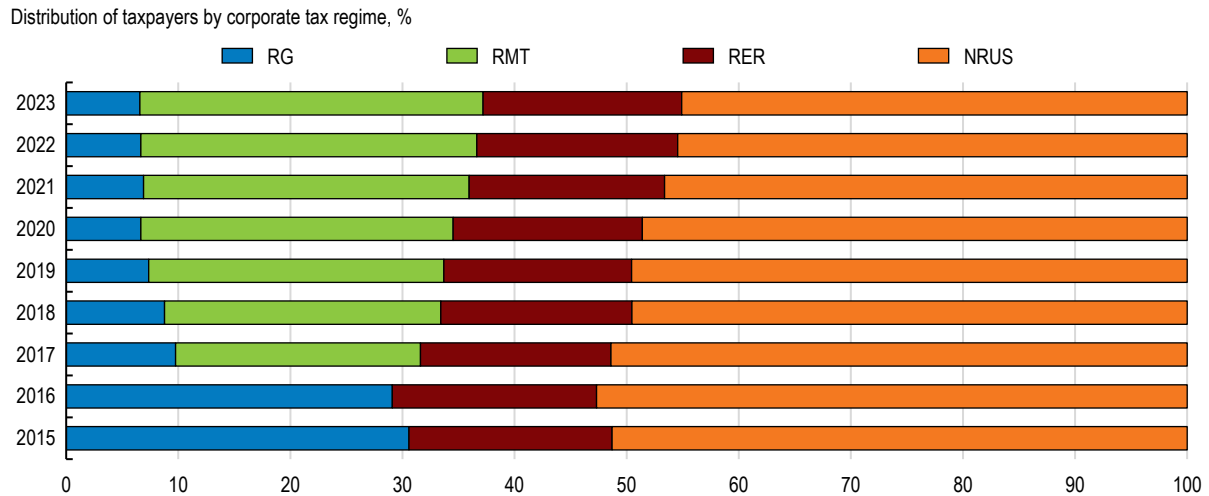
Regime	Coverage	Threshold	Payment	Accounting obligations	Other
New Simplified Single Regime – Nuevo Regimen Unico Simplificado (NRUS).	Natural persons selling merchandise or services to end consumers.	Gross income or purchases below PEN 60 000 or 96 000 annually, equivalent to 2.5 and 4.0 times per capita GDP.	Corporate tax and VAT as a single fee based on sales and purchases. PEN 20 or 50 (USD 5-13) monthly.	None.	Only monthly payment. Issues payment slips only, does not issue invoices for VAT purposes.
Special Income Tax Regime – Regimen Especial del Impuesto a la Renta (RER).	Natural or legal persons dedicated to extractive, industrial, trade, service or agricultural activities.	Annual net income or purchases up to PEN 525 000 (USD 142 000) annually, equivalent to 21.7 per capita GDP.	1.5% paid on net income and VAT.	Purchase and sales registers only.	Monthly declaration. Business costs and expenses, including payroll, not deducted.
Micro and Small Enterprise Tax Regime -Regimen MYPE Tributario (RMT).	Natural or legal persons.	Annual net income below 1 700 UIT (PEN 7.8 million), equivalent to 294.7 per capita GDP.	10% for the first 15 UIT of net income; 29.5% for marginal until 1 700 UIT and VAT.	Purchase and sales registers, accounting journals, ledger, inventories and balance sheets.	Monthly and annual declaration.
General regime (RG).	All.	All.	29.5% on profits and VAT.	Purchase and sales registers, accounting journals, ledger, inventories and balance sheets.	Monthly and annual declaration.

Source: OECD Secretariat based on (Schatan et al., 2019^[32]).

To reduce compliance costs and foster business formality, Peru needs to streamline the regimes for small businesses while preventing larger taxpayers from using the regime to avoid taxes. Tax regimes for small businesses must incentivize informal businesses to enter the formal economy and small formal businesses to grow into the regular tax regime (Mas-Montserrat et al., 2023^[33]). Building on OECD good practice in the design of presumptive tax regimes, Peru could evaluate and redesign their regimes by, possibly, replacing the three regimes by one single (or possibly 2) regimes. The corporate tax system could also be based on net income, which could generate incentives to taxpayers to declare their costs and expenses, improving formalisation incentives. Simplifying the system would also allow for simplified control and

verification and would increase tax collection, in particular if the reform would induce larger businesses to report profits under the general corporate tax regime, without considering positive effects on formalisation, productivity and growth.

Figure 1.18. Multiple tax regimes create distortions in the corporate tax system



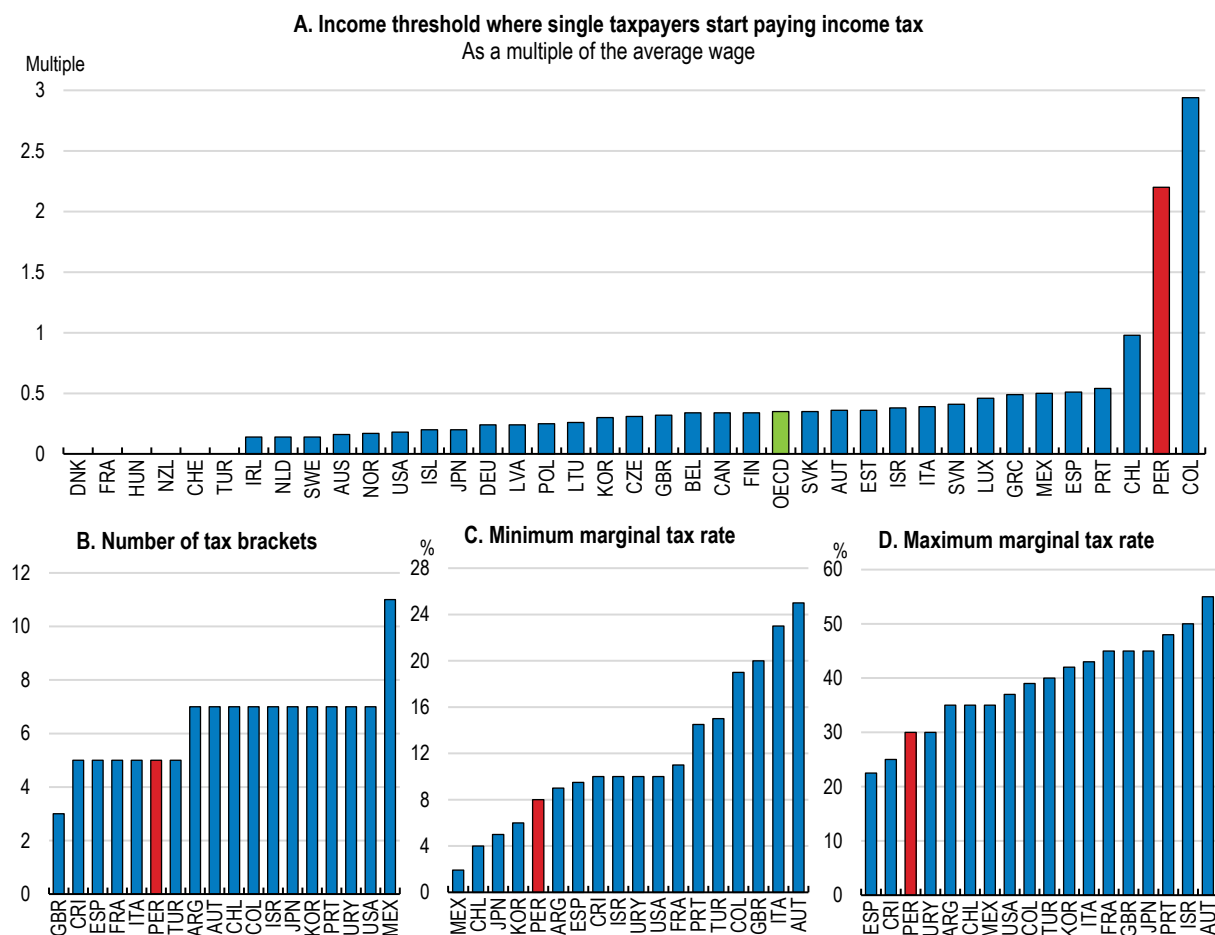
Note: RG is the general regime, NRUS is the regime for micro and self-employed firms, while RMT and RER are the two intermediate schemes for SMEs. See table 1.4 for a description of regimes.
Source: OECD Secretariat based on Sunat data.

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Peru's low tax revenues can also be attributed to the country's very low revenues from personal income taxes compared to OECD countries, a common issue across Latin American countries. Personal income tax revenues in Peru are over four times lower than the OECD average, limiting redistribution (Barreix, Bés and Roca, 2012^[34]; Jaramillo, 2013^[35]; Lustig, 2016^[36]). There is significant potential to bring more people into the personal income tax system without affecting the bottom half of the income distribution. The high tax payment threshold on labour incomes (Figure 1.19) means that only 8% of workers pay personal income tax (World Bank, 2023^[6]), with 78.2% of taxpayers declaring income subject to zero marginal tax and other 14% in the lowest marginal tax bracket in 2017, resulting in an effective tax rate of 5.6% across all taxpayers (IMF, 2020^[37]). The basic personal income tax exemption could be lowered gradually over time, along with a reduction of the entry tax rate to make the system more progressive. Such reform would broaden the tax base and set a more progressive rate schedule.

Low property tax collection is driven by the lack of an updated and complete property registry (Figure 1.20). Evidence suggests that property valuations used to establish tax obligations are up to 200-300% below market valuations (BCRP, 2019^[38]). In 2021, only 15% of all municipalities had complete and updated cadasters (CPC, 2022^[39]). The World Bank has provided technical support to selected municipalities in six cities with the largest tax generation potential to improve their urban cadasters. The government has plans to update and complete the cadastre gradually, with a goal to have an updated cadastre in 100 municipalities by 2023 and complete coverage throughout the country by 2030, but implementation progress has been slow. Further progress on setting up cadastres and a comprehensive review of cadastral values, would enable municipalities to strengthen their property tax collections. Experience in other countries shows that higher recurrent taxes on immovable property are likely to be met with public resistance given their high visibility. To increase their public acceptance, tax increases following a reassessment should be done gradually, and special property tax relief arrangements to reduce affordability constraints for people with low incomes or illiquid assets could also be considered.

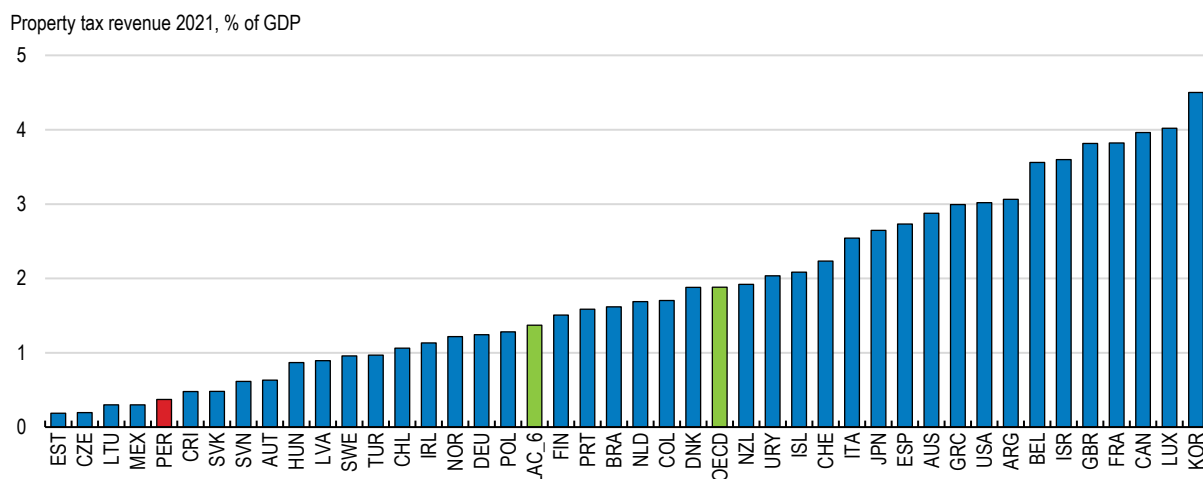
Figure 1.19. Few Peruvians pay personal income taxes



Note: Calculations for Peru are based on a monthly average labour income PEN 1 327.5 at national level in 2021. The threshold to start paying personal income taxes is PEN 34 650 annually.
Source: INEI and OECD, Taxing Wages 2021, available at <https://doi.org/10.1787/83a87978-en>.

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Figure 1.20. Property tax collection is relatively low



Note: LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI and MEX.
Source: OECD Tax Revenue Statistics database.

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Making public spending more effective by reforming subnational finances

Peru's incomplete fiscal decentralisation (Box 1.4.) has contributed to weak public spending and investment efficiency. As identified by the OECD (2016^[40]), the decentralisation system suffers from two main challenges: a lack of clear delineation of spending functions between the national government, regions and municipalities and a distortionary system of financing subnational governments ultimately leading to deepening regional inequalities in terms of economic development, poverty and access to infrastructure, education, and healthcare. The coastal region, which includes the capital, Lima, is the most developed and prosperous area in the country, with a relatively high level of infrastructure, economic growth, and human development indicators. The highlands and the Amazon region, on the other hand, are less developed, with low levels of infrastructure and limited access to basic services (as shown in Figure 1.2, Panel B). The disparities are also reflected in income levels, with the coastal region having the highest GDP per capita. With significant spending needs and large economic disparities, Peru needs to spend wisely to address its human capital, health and infrastructure gaps and enhance its growth potential.

Box 1.4. The origins of the political and fiscal decentralisation in Peru

The country has a two-tier subnational system, with regions and district/provincial municipalities. The decentralisation reform has established politically and administratively autonomous regional governments, elected for a four-year term with a one-term limit for elected heads of local executives. Currently, there are 25 departments at the regional level, while the local level has two sub-levels: 196 provincial municipalities and 1,671 district municipalities. This two-level municipal system is uncommon in OECD countries.

Peru began its process of political and fiscal decentralisation in the early 2000s with the main objectives of increasing the efficiency of the public sector and enhancing democratic decision-making by strengthening regional and local governments. However, the implementation of Peru's fiscal decentralisation process stalled in 2005 when the creation of macro-regions was rejected in a referendum. Under the original decentralisation plan, the 25 regional governments were to be consolidated into 12 macro-regions that would serve as an intermediate level of government. Furthermore, a new revenue sharing mechanism for income tax and value-added tax (VAT) could not be implemented, as it was conditional on the formation of the macro-regions. While there is no ideal degree of decentralisation, there is a broad consensus that the fiscal decentralisation process in Peru is incomplete (World Bank, 2017^[41]; OECD, 2016^[40]; IMF, 2016^[42]; Contraloría General de la República, 2014^[43]).

Source: OECD Secretariat based on (World Bank, 2017^[41]).

In Peru, there is a lack of clear distribution of spending responsibilities among the national, regional and local governments, with inconsistencies and overlaps in the assignment of responsibilities, without formal mechanisms for intergovernmental coordination that reduces accountability (OECD, 2016^[40]). Moreover, regional governments have limited autonomy to allocate the transfers they receive from the central government. They have little power to adjust public services to suit local contexts or coordinate the provision of public goods and services between municipalities in their jurisdictions (World Bank, 2017^[41]). The current transfer system and a high level of local fragmentation provide little incentive to create service delivery platforms or infrastructure projects with economies of scale that serve multiple jurisdictions (Barco, Chávez and Olivas, 2021^[44]) with many municipalities lacking the necessary scale and technical capacity for effective service delivery (World Bank, 2017^[41]). The decentralisation process has also been hindered by the limited competences of subnational governments in terms of planning and implementing public policies and executing spending, particularly in rural areas (OECD, 2016^[40]), as highlighted in Chapter 2 of this survey. Subnational governments often struggle with the necessary technical expertise, and institutional capacity to effectively carry out their responsibilities. This hinders their ability to address the

unique challenges and needs of local communities, especially in rural and remote areas where access to basic services and infrastructure is limited. Enhancing the competences and capabilities of subnational governments is crucial for promoting inclusive development, improving service delivery, and fostering regional economic growth across the country.

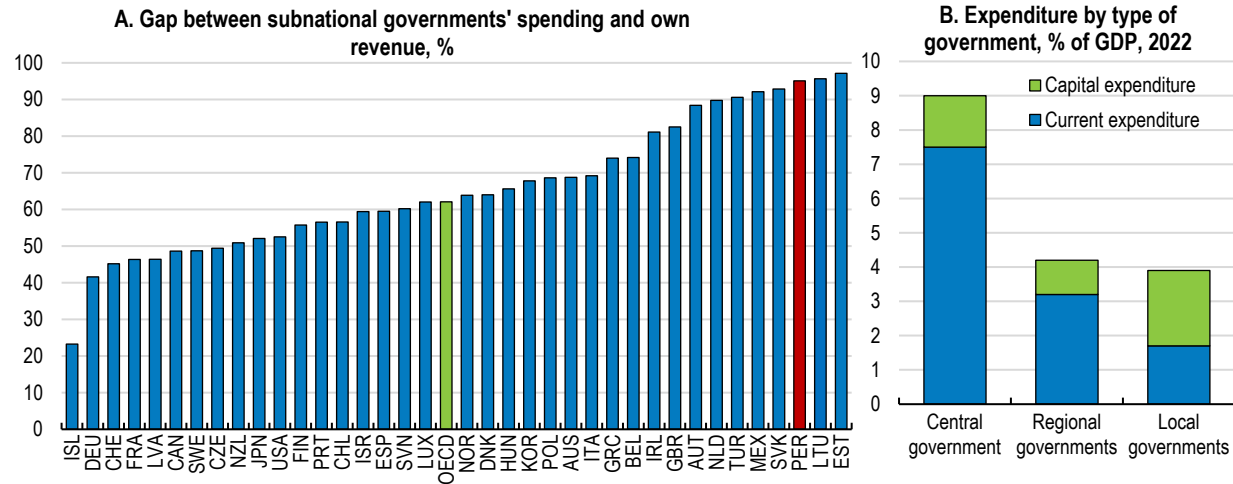
Peru has one of the largest disparities between subnational governments' own resources and expenditures (Figure 1.21, Panel A). Subnational governments are responsible for only 5% of total tax collection (Barco, Chávez and Olivas, 2021^[44]), while they are responsible for 30% of national current spending and 60% of public investment (Figure 1.21, Panel B), with transfers from the central government being the most important source of financing. This leaves the burden of raising tax revenues falling almost exclusively on the central government which reduces incentives for subnational entities to provide good quality services efficiently. Such great disparity between spending and own-revenues may also be deterring own-revenue generation at the subnational level, given the political cost of collecting taxes and the resources needed to administer them. Subnational governments rely primarily on property taxes, including taxes on immovable property and vehicles. However, the collection of these taxes is relatively low, as mentioned in the previous subsection.

Subnational revenues and expenditures vary enormously between regions and municipalities, which leads to high inequalities (OECD, 2016^[40]). Although the central government provides two equalizing transfers to regional and local governments, their small size and distribution formulas limit their ability to equalize. Additionally, resource-revenue sharing transfers from the central government, like royalties, exacerbate imbalances because they are distributed mainly to the producing provinces and regions, rather than based on the need for spending or fiscal capacity. This creates a significant regressive effect, with municipalities with lower financial needs receiving more resources (Figure 1.22) (World Bank, 2017^[41]).

Experience in other OECD countries shows that revenue decentralisation can reduce regional disparities (Blöchliger, Bartolini and Stossberg, 2016^[45]; Kim and Dougherty, 2018^[46]). Peru would benefit from giving regional governments more taxing power, starting with taxes on immovable property, with a long-term view of giving more responsibility for tax setting independence to regional governments on income and value-added taxes. This would improve incentives to collect taxes and use available resources in a more efficient way. Municipalities should better exploit the tax on immovable property, as there is a large potential, with revenues very low in international comparison (Figure 1.20). At the same time, the transfer system should adjust to incentivise tax collection for example by limiting further increases in transfers or by conditioning a share of them to increases in tax collection. The transfer system should consider subnational expenditure needs and fiscal capacity to address fiscal imbalances across regions and local governments. The 2011 Colombian reform could provide some lessons for Peru. One of the main changes introduced by the reform was the modification of the distribution of royalties, aimed to increase resources for low-income regions and municipalities. The new transfer system redistributed tax revenues to subnational governments based on factors such as population, poverty, investment needs, institutional capacity, and compliance with certain goals.

To further improve public spending efficiency, technical inefficiencies in public procurement and civil service could be addressed. Estimates of these inefficiencies account for between 1.2% of GDP (BCRP, 2023^[47]) and 2.5% of GDP (Izquierdo, Pessino and Vuletin, 2018^[48]). Although these spending inefficiencies are relatively low compared to other countries in Latin America, implementing reforms to improve procurement and civil service, as discussed in Chapter 2, could unlock significant potential savings.

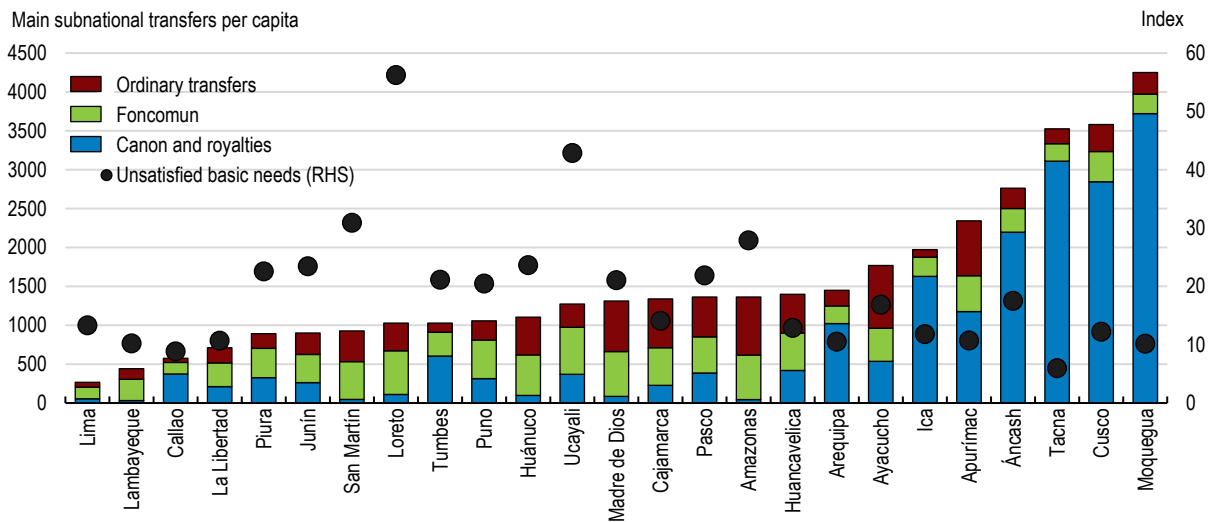
Figure 1.21. Peru has significant imbalances between subnational governments revenues and expenditure



Note: Panel A shows the vertical fiscal gap of subnational governments defined as $[(\% \text{ subnational government expenditure} - \% \text{ subnational government revenue}) / (\% \text{ subnational government expenditure})]$. Year 2018 for OECD countries and 2022 for Peru.
 Source: BCRP, (Barco, Chávez and Olivas, 2021^[44]), OECD (2020), "Subnational Government Structure and Finance", OECD Regional Statistics (database), <http://dx.doi.org/10.1787/data-00531-en>.

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Figure 1.22. Subnational governments financing fails to address regional disparities



Note: Data refers to 2021. Foncomun is a municipal compensation fund with a redistributive criterion in favour of the most remote and depressed areas, prioritising the allocation to the country's rural and marginal urban localities. The components of unsatisfied basic needs are: quality of the house, non-overcrowding of the house, access to sanitary services, school attendance and economic dependency.
 Source: OECD calculations based on Ministry of Finance and INEI data.

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A long-term politically feasible fiscal reform agenda

All the tax reforms discussed in this chapter should be viewed as long-term objectives and direction in which the country should go and not as a short-term agenda. Raising public revenues by around 5.5% of GDP is ambitious and challenging (Table 1.5), and it should be accompanied by increasing the efficiency of public spending and investment. In the short term, improving governance of infrastructure investment will be key to improve implementation capacities and gradually close the infrastructure gap (see Chapter 2). A clear sequencing and gradual implementation of tax reforms will be necessary to make them politically viable. Peru could set up a clear and detailed reform agenda linking the tax reform with the social reforms, discussed in Chapter 3, which would not only raise the necessary revenues but would also benefit particularly those in the bottom half of the income distribution creating support for the reforms.

A key priority would be to merge the intermediate tax regimes for small and medium enterprises. This would boost business formalisation, improve equity, productivity and increase tax collection. The tax base could be gradually broadened by abolishing or phasing out the cost-ineffective tax expenditures. A fiscal cadastre could be gradually implemented across the entire country, alongside a proper property valuation system. In conjunction, authorities could focus on improving the functioning and digitalisation of the tax administration and strengthen enforcement and compliance. Revenues from this reform will increase only gradually, achieving full potential in the medium term. In the medium to long term, the income threshold for paying personal income taxes could be lowered gradually. To maximize potential revenues, these proposed tax reforms must be coupled with improvements in spending efficiency. To maintain fiscal sustainability, it will be crucial to ensure that these reforms effectively generate the expected revenue when committing to permanent increases in spending. In this regard, increasing social spending should proceed only gradually once permanent revenues are available. By implementing these reforms alongside strengthening governance, competition and the business environment (as discussed in chapter 2), the country could enter a virtuous circle of higher tax collection, lower informality, increased productivity and equity.

Table 1.5. Illustrative long-term fiscal impact of recommendations

Recommendation	Estimated impact on fiscal balance
Improved tax administration and tax collection	+2.3% of GDP
Reduce tax expenditures	+1.0% of GDP
Bring more people into the personal income tax system, including by reducing the basic deduction and making rates more progressive	+1.0% of GDP
Update and complete cadastre	+0.9% of GDP
Merge intermediate tax regimes for small and medium enterprises	+0.3% of GDP
Social protection reform package as described in Chapter 3, including:	
- A cash transfer programme for the poor and the unemployed	-1.1% of GDP
- A universal pension benefit	-1.5% of GDP
- Universal coverage of high-quality health services	-1.2% of GDP
Improve education quality through teacher training	-0.6% of GDP
Institutional reforms including civil service, anti-corruption, competition and regulation	-0.3% of GDP
Increase resources dedicated to anti-deforestation enforcement	-0.2% of GDP
Resulting change in fiscal balance	+0.6% of GDP

Note: This exercise aims to illustrate potential measures through which Peru could raise tax revenues and allocate them for specific purposes. It is important to note that these suggestions do not serve as a list recommendations to be implemented. The ultimate determination of spending estimates will depend on the specific type of reform conducted. Estimated fiscal impacts are calculated using departing from the baseline scenarios in Figure 1.3 and Figure 1.15.

Source: OECD estimates.

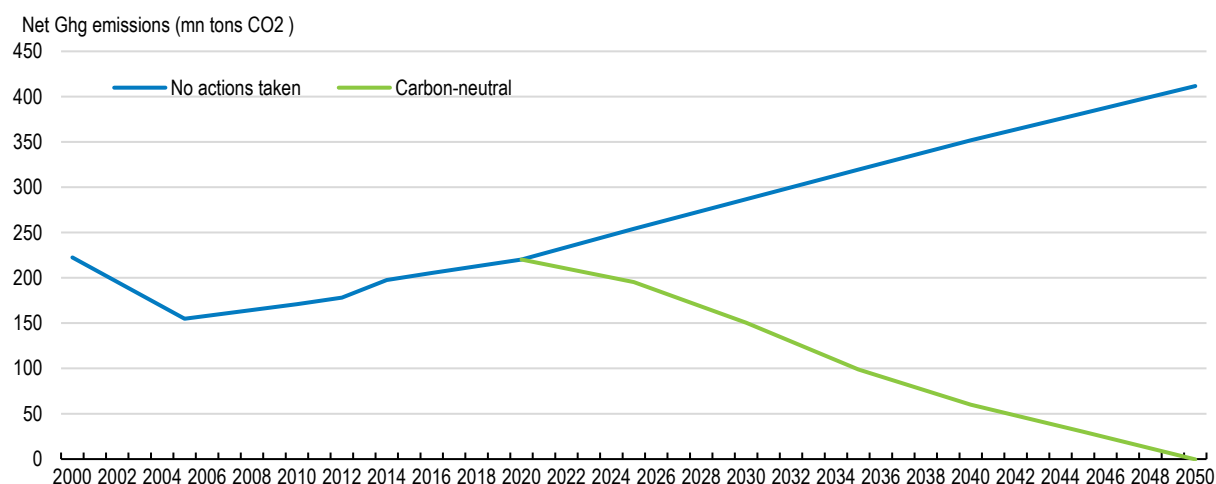
Addressing climate change risks to foster sustainable and inclusive growth

Deep emissions reductions are required for Peru to reach net zero

Peru is highly vulnerable to the impact of climate change as more frequent and severe extreme weather events lead to large economic and social costs, as highlighted in page 24. Peru has been taking significant steps towards meeting commitments set by the 2015 Paris Agreement on Climate Change. It has improved its environmental institutional framework, enabling better implementation, coordination, monitoring, and evaluation of adaptation. In 2018, Peru enshrined its climate change strategy under the Framework Law on Climate Change. It published its National Adaptation Plan in 2021 and declared a national climate emergency in 2022. The government aims at reducing emissions by 40% by 2030 relative to a business-as-usual scenario and under the condition of international support. The unconditional objective is 30% relative to this same business-as-usual scenario. However, this implies a significant increase relative to the emissions in 2015. Peru's National Determined Contribution (NDC) under the Paris Agreement is to achieve net zero CO₂ emissions by 2050. The government is undertaking significant measures to address climate change, including the implementation of 84 adaptation and 64 mitigation initiatives across various sectors, with a particular emphasis on energy and land use changes. Furthermore, the development of the National Strategy on Climate Change up to 2050 is underway, aiming to provide guidance and facilitate comprehensive long-term climate action at all levels of government. The forthcoming long-term strategy to decarbonise the economy by 2050, will be the opportunity to update with concrete milestones, policies and priorities in line with legal targets which would provide more certainty and thereby stimulate emissions reductions and the needed investment in infrastructure. Peru is seeking to engage the private sector under a Green Financing Strategy, with initiatives like Carbon Footprint Peru and the 2021 Green Finance Roadmap, aimed at fulfilling the NDC targets. A Climate Finance Strategy is currently being formulated, seeking to provide guidance for greater mobilisation of resources for enhanced adaptation and mitigation measures. Achieving carbon neutrality will require profound transformations in all sectors of the economy (Figure 1.23).

Given Peru's high vulnerability to more frequent and severe extreme weather events, there is an urgent need to expand on climate adaptation policies to mitigate the potential devastating impacts and safeguard the country's communities, infrastructure, and natural resources. Key adaptation policies could include improving the resilience of critical infrastructure and public services (mainly transport, health and water); advancing resilient urban planning; and building a social protection system that can adapt to shocks. One crucial approach in adaptation is fostering the development of the private insurance sector, which can provide critical financial protection and risk-sharing mechanisms to individuals, businesses, and communities against the escalating risks posed by more frequent and severe extreme weather events. For example, in recent years, Chile has implemented various initiatives to address climate-related risks, including a recently signed earthquake insurance contract for USD 630 million with the World Bank. The insurance would enable Chile to receive payments in the event of certain high-intensity seismic events that cause material damage to the country and its public finances. Chile has also access to the Adaptation Fund that provides financial resources to initiatives that enhance the country's capacity to cope with climate impacts, including investments in infrastructure, research, and risk management. In 2022, Chile launched the Nature Fund, aiming to promote nature conservation, combat climate change, and address desertification challenges in the country.

Figure 1.23. Ambitious actions are needed to be carbon neutral by 2050



Note: Simulations based on a decarbonisation pathway assessment model for Peru by the IADB. The no actions taken scenarios shows an illustrative path of emissions in the case no mitigation actions are implemented beyond those that have been already executed before 2018. A carbon-neutrality scenario presents a transformative process for all sectors, based on measures proposed in the country's 2015 NDC, and traces a path to reach GHG zero net emissions by 2050.

Source: (IADB, 2021^[49]).

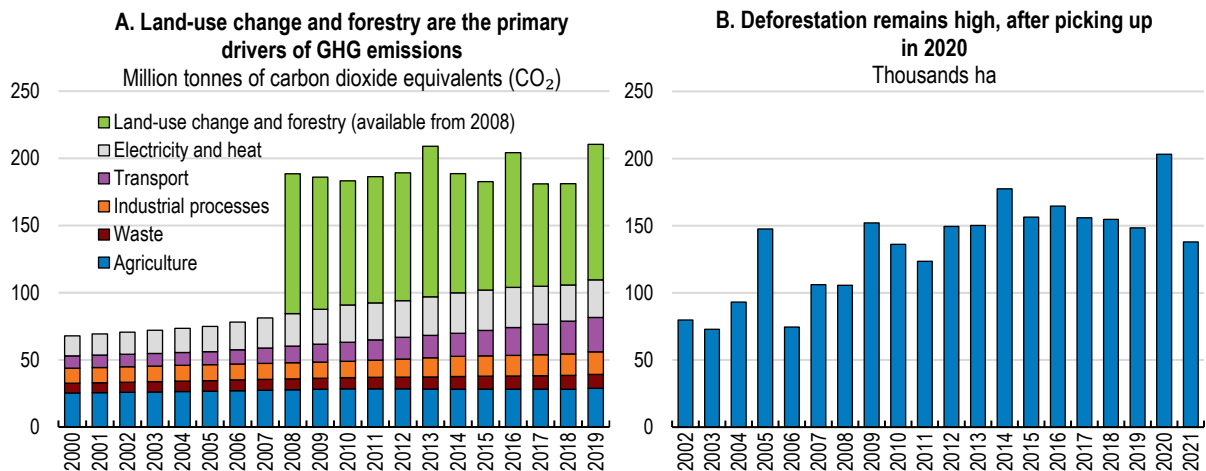
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Further efforts are needed to reverse deforestation

The achievement of emission goals will depend primarily on progress in the fight against deforestation, which is the major contributor to GHG emissions. Land-use change and forestry accounted for 49% of GHG emissions in 2019 due to deforestation (Figure 1.24, Panel A). This is particularly relevant for Peru, as more than 50% of the country is covered by the Amazon rainforest, which contains a wide variety of flora and fauna species. Between 2010 and 2019, 1.5 million hectares were deforested, with 200,000 hectares deforested in 2020, the highest level in the last 20 years (Figure 1.24, Panel B).

Causes of deforestation include the expansion of the agricultural frontier, often for extensive, small-scale low-productivity agriculture, simple land appropriation in the hope of a future land title, road building, and illegal or informal extractive activities (OECD et al., 2022^[4]). Extensive informal small-scale agriculture is one of the main causes of deforestation in the Amazon rainforest as vulnerable farmers invade forests in search of productive soil (IADB, 2021^[49]; World Bank, 2022^[8]). Illegitimate land appropriation, as 50% of the Amazon region has no ownership, and the absence of land-use planning explains a large part of deforestation (De La Torre et al., 2021^[50]). Peru's NDCs propose reducing GHG emissions from the forestry sector, with a focus on mitigating deforestation, with plans to protect 10 million hectares from deforestation by 2030 (MINAM, 2022^[51]). The government has announced several measures under the NDC framework to address deforestation, including allocating land titling to native communities and implementing technical production processes to increase their economic benefits (MINAM, 2018^[52]). However, most of the measures do not have adequate funding (CIES, 2021^[9]). Peru's institutional efforts to curb deforestation have also included financial support for sustainable business projects and an early detection system based on satellite imagery. However, enforcement in remote regions of the Amazon is weak.

Figure 1.24. Land-use change and forestry are the primary drivers of GHG emissions



Source: Ministry of Environment, National Greenhouse Gas inventory; <https://infocarbono.minam.gob.pe/annios-inventarios-nacionales-gei>; Ministry of Environment - National Programme on Forest Conservation for Climate Change Mitigation.

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To curb deforestation, Peru can use nature-based measures that offer a way of addressing climate change risks and restore degraded lands, such as nature-based tourism and silvopastoral systems. Coastal wetland restoration or mangrove rehabilitation could increase carbon storage capacity while mitigating the effects of storms, floodings and droughts (OECD, 2021^[53]). The Amazon rainforest can act as a critical carbon sink. This will require assignment of forest rights and concessions, investments in conservation, reforestation, and afforestation, and the introduction of agroforestry systems. Interesting initiatives such as the preferential credits for investments in agriculture in Brazil could be considered (OECD, 2021^[54]). Combatting illegal and informal mining could lead to better protection of natural areas and curb deforestation. The Peruvian military has been deployed to combat illegal gold mining and other illicit activity in the Amazon, but with limited success due to the military's lack of experience or training in environmental enforcement. Limited state capacity driven by lack of financial and human resources within law enforcement agencies and poor coordination between government agencies curtail such efforts (Global Forest Watch, 2019^[55]). The deployment of the Prior Consultation Law is a welcome step (CIES, 2021^[9]) as involving specific groups in the discussion could help to manage trade-offs, particularly native communities whose livelihoods could be affected by changing forestry or other soil measures (OECD, 2021^[53]). However, it is still essential to strengthen the territorial security of indigenous peoples living in the Amazonian forests by carrying out the titling and demarcation of territories through the implementation of the national property register. Peru could also improve the programme that delivers cash transfers to native populations that protect forests while adopting a Payment for Environment Services scheme, that has successfully helped reduce deforestation in Costa Rica (OECD, 2023^[56]).

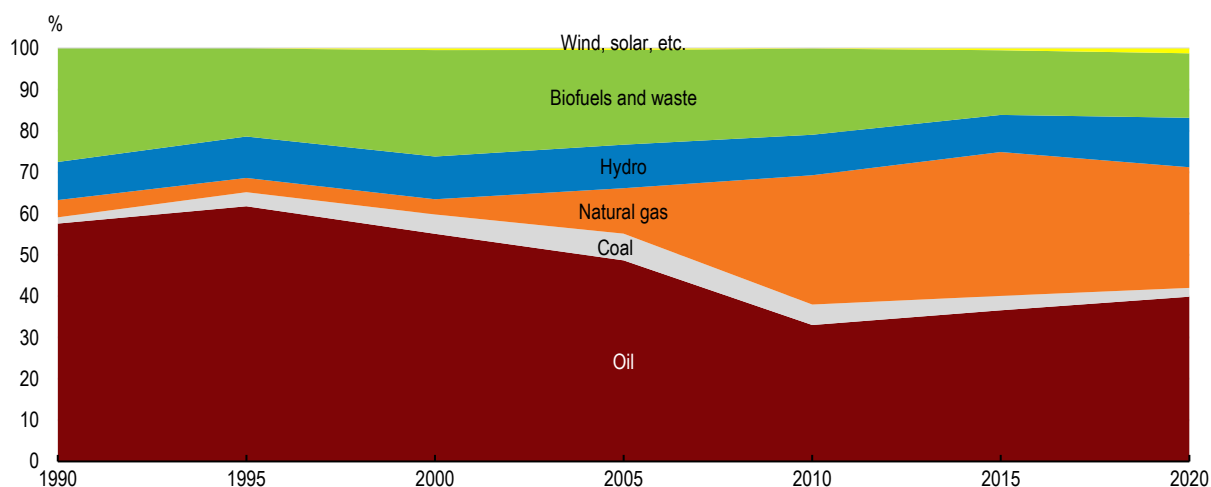
Reducing GHG emissions from energy and transport

Peru's policies to transit to a greener energy matrix are not yet sufficient to achieve the goal of net zero greenhouse gas emissions. Although the energy matrix is more decarbonised than in most OECD countries, the bulk of primary energy comes from fossil fuels (72% vs 77.4% in the OECD average in 2022) and 43% of the final consumption continues to depend on oil, mainly due to public and private transport. Natural gas has been increasing in importance since the discovery of the Camisea natural gas fields in the late 1980s (Figure 1.25). Thermolectric generation of electricity from the Camisea gas provides more than a third of Peru's electricity supply. Hydropower is also an important source of electricity (58%), but while it

is a renewable energy source, it is highly vulnerable to water availability and the impact of climate change (ECLAC, 2014^[57]; OECD, 2021^[53]).

Greater efforts are needed to increase the use of variable renewable energy sources (e.g. solar, wind, tidal or wave power). Currently variable non-conventional renewable energy sources account for 9.1% of total electricity generation. Peru has enormous potential for generating electricity from variable non-conventional renewable energy sources, particularly solar energy, which could lower energy costs in the long term and increase energy efficiency (World Bank, 2022^[8]). Solar potential is among the highest in the world with daily irradiation over 5.5 kilowatt hours per square meter (kWh/m²) and 7kWh/m² in the southern areas (MINAM, 2023^[5]). The legislation sets a 2030 target of producing 20% of all electricity from variable renewable sources (e.g. wind, solar, tidal or wave power). Although some encouraging initiatives are currently in place, such as the use of solar energy to address energy shortages in isolated and rural areas (MINAM, 2018^[52]), renewable energy resource auctions have not been held since 2016. The government has been primarily focused on increasing production from natural gas. Although CO₂ emissions (per unit of energy produced) from natural gas are around 40% lower than coal and around 20% lower than oil, the country needs to increase efforts and promotion for the use of non-conventional renewable energy sources to achieve carbon neutrality.

Figure 1.25. Fossil fuels represent a significant share of the energy generation



Source: World Energy Balances of the IEA.

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Reducing emissions from the transport sector is essential to achieve the net-zero target by 2050, as it is the fastest-growing sector in terms of emissions. The transport sector is also a big contributor to high air pollution levels, with Peru ranking worst in Latin America and 26th in the world according to the 2021 World Air Quality report. The transport sector accounted for 48% of carbon emissions (excluding land use change) and 73% of final oil consumption in 2020. The government plans to turn diesel gas vehicles and public transport into natural gas, which is the lowest carbon-intensive fuel. However, natural gas was responsible for 35% of total CO₂ emissions in 2020 (IEA, 2023^[58]). The government also targets a 5% of the public transport fleet electric by 2030. Progress has been made in this area with pilot exercises using electric buses in Lima. Accelerating electrification of the private and public vehicle fleet has strong potential to reduce emissions from transport and maintenance costs. Progress on establishing a robust network of charging stations will be crucial to support the widespread adoption of electric vehicles by providing convenient and accessible infrastructure. Peru could also benefit from further investment in green hydrogen as its exceptional climate conditions are suitable for competitive production of green hydrogen. Green hydrogen could help to decarbonise hard-to-abate processes in heavy transport and industry, such

as mining and fishing, two key sectors for the Peruvian economy. To prepare for future developments, adopting ISO standards related to hydrogen and establishing a reliable regulatory framework could provide more certainty for investors. This would position the country to be ready when the technology for production becomes more competitive, and demand for hydrogen increases (OECD, 2022^[59]; IEA, 2021^[60]).

To achieve further progress in decarbonising the economy, Peru will need to implement not only more stringent regulations, but also consistent price signals. Peru does not levy an explicit carbon tax. Environmental tax revenues in Peru were only 0.5% of GDP in 2020, well below the 1.6% OECD average and lower than in other countries in the region, with most of these revenues coming from fuel excises. Fuel excise taxes, an implicit form of carbon pricing, covered only 27.6% of emissions in 2021. There were no fossil fuel subsidies in 2021, while in 2018 they covered 0.5% of emissions (OECD, 2022^[61]). Peru has introduced various financing mechanisms to drive decarbonization efforts. These include the issuance of green bonds to fund renewable energy initiatives, a programme that provides resources to projects adhering to environmental and social criteria for the preservation of protected natural areas, and cash transfers targeting households engaged in environmentally-friendly residential projects (OECD et al., 2022^[4]).

Carbon taxes and emissions trading systems (ETSs) could be a crucial element of the overall climate policy mix. They can provide cost-effective means to reduce GHG emissions, incentivise the private sector to invest in climate mitigation actions and modify consumer and firms behaviour towards cleaner energies and transportation modes. Carbon taxes have significant practical advantages over ETSs for developing countries, due to ease of administration, price certainty to promote investment, the potential to raise significant revenues, and coverage of broader emissions sources (Parry, Black and Zhunussova, 2022^[62]). Peru would benefit from levying an explicit carbon tax, like some other Latin American countries such as Argentina, Chile, Colombia, and Mexico. Setting an initial price with a pre-defined trajectory with yearly increases for the next decade would provide certainty to firms and allow them to plan investments and avoid stranded assets, while consumers also adapt. Coverage of the carbon tax could be also increased gradually in a pre-defined strategy (OECD, 2021^[63]; OECD, 2021^[54]). For example, in Colombia, the tax initially applied to 25% of domestic emissions at the low rate of USD 5 per ton of CO₂ while the government has recently considered a gradual increase and an extension to coal. Chile has also set initially a carbon tax of USD 5 per ton of CO₂ and is contemplating raising it as part of the upcoming green fiscal reform in the second half of 2023. The coverage of the type of emissions has also increased gradually in time. The revenues of carbon taxes could be redirected to mitigate the impact on vulnerable households, finance reforestation programmes, and renewable energy-related investments.

Table 1.6. Main findings and recommendations

MAIN FINDINGS	RECOMMENDATIONS (Key recommendations in bold)
Recalibrating macroeconomic policies	
Headline, core inflation and 12-month ahead inflation expectations started decreasing, but remain high and exceed the inflation target.	Keep a tight monetary policy stance to bring inflation sustainably back to target.
The Central Bank's governance adheres to international best practices, but the board's appointment coincides with the presidential term eventually affecting the Bank's autonomy.	Make sure that the mandate of the Central Bank Board members' does not overlap with the government term and carry out staggered renewals.
Public debt has risen. The economy has recovered from the pandemic-related downturn but has recently slowed down amid social conflicts.	Fiscal policy should support monetary policy to address high inflation. Keep the pace of fiscal consolidation in line with current fiscal plans to rebuild fiscal buffers.
Peru has a robust financial regulatory framework that has led to a resilient financial system during recent global financial volatility, tighter financial conditions and domestic political instability.	Continue to monitor bank portfolios and lending standards closely.
Dollarisation remains high, with credit in dollars representing 25% of the total credit and deposits in dollars 30% of total deposits.	Continue to preserve exchange rate flexibility and gradually limit interventions to avoid abrupt changes in the exchange rate. Develop a deeper foreign exchange and financial derivatives market, by enhancing its regulatory framework, developing a strong financial infrastructure and fostering financial education, particularly for SMEs.

Reforming taxation	
Current tax revenues of 17% of GDP are insufficient for achieving sizeable improvements in social protection and public services such as health and education, and for more inclusive and sustainable growth. Weaknesses in tax collection lead to yearly revenue losses exceeding 5% of GDP.	Strengthen tax administration and reduce tax evasion through stronger use of information technology and cross-checking of information across different sources.
Tax expenditures contribute to Peru's low tax collection.	Conduct a thorough evaluation of tax expenditures, retaining only those with positive and cost-effective impact on well-defined policy objectives.
Low revenues from personal income taxes are driven by few people paying, limiting redistribution. There is large room to increase progressivity.	Lower the income threshold where taxpayers start paying income taxes, eliminating exemptions, and strengthening rate progressivity.
Low property tax collection is driven by the lack of an updated and complete cadastre and property valuation system.	Accelerate the update of the cadastre and extend it to all municipalities while developing property valuation rules and mechanisms that are implemented in a consistent manner across the country.
Complex and multiple corporate tax regimes have contributed to lower corporate tax collection, high informality, and low productivity.	Streamline the corporate tax regimes for small businesses by merging the intermediate regimes.
Fiscal decentralisation is incomplete. The system suffers from a distortionary system of financing subnational governments and a lack of clear delineation of spending responsibilities between national and subnational governments, ultimately leading to deepening regional inequalities.	Clarify spending responsibilities for each level of government. Implement an integral reform of subnational finances including gradually granting more taxing powers at the regional level. Improve the functioning and equity enhancing features of subnational transfers by setting up and applying clear and measurable formulae for the allocation of transfers and giving greater weight to social indicators and investment needs and higher incentives to provide better services.
Making growth more sustainable and greener	
Peru's vulnerability to climate change and natural hazards makes it highly susceptible to potential impacts on economic growth, fiscal accounts, and financial stability.	Incorporate climate and natural hazard-related risks in stress tests and financial stability monitoring. Integrate climate change fiscal impact assessment into multiannual projections.
Peru has ambitious targets and there are several policies in place. A long-term comprehensive strategy for the green transition is under development.	Update and approve a strategy for the climate transition with concrete milestones and policies to achieve targets and zero net emissions.
NDCs targets are ambitious, but further efforts are needed to meet the targets. There are weak carbon price signals to drive the transition towards wider use of renewable energy sources.	Accelerate progress in decarbonisation through more stringent regulations and more consistent price signals, including carbon taxation, while supporting vulnerable households with targeted and temporary transfers.
The bulk (70%) of primary energy use comes from fossil fuels.	Increase and diversify the use of renewable energy sources.
Deforestation has risen and reaching current objectives for reducing greenhouse gas emission will require strong declines in deforestation.	Assign forest rights and concessions and develop a land ownership registry. Increase resources dedicated to conservation, reforestation, afforestation, and anti-deforestation enforcement activities.

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2 Boosting long-term growth

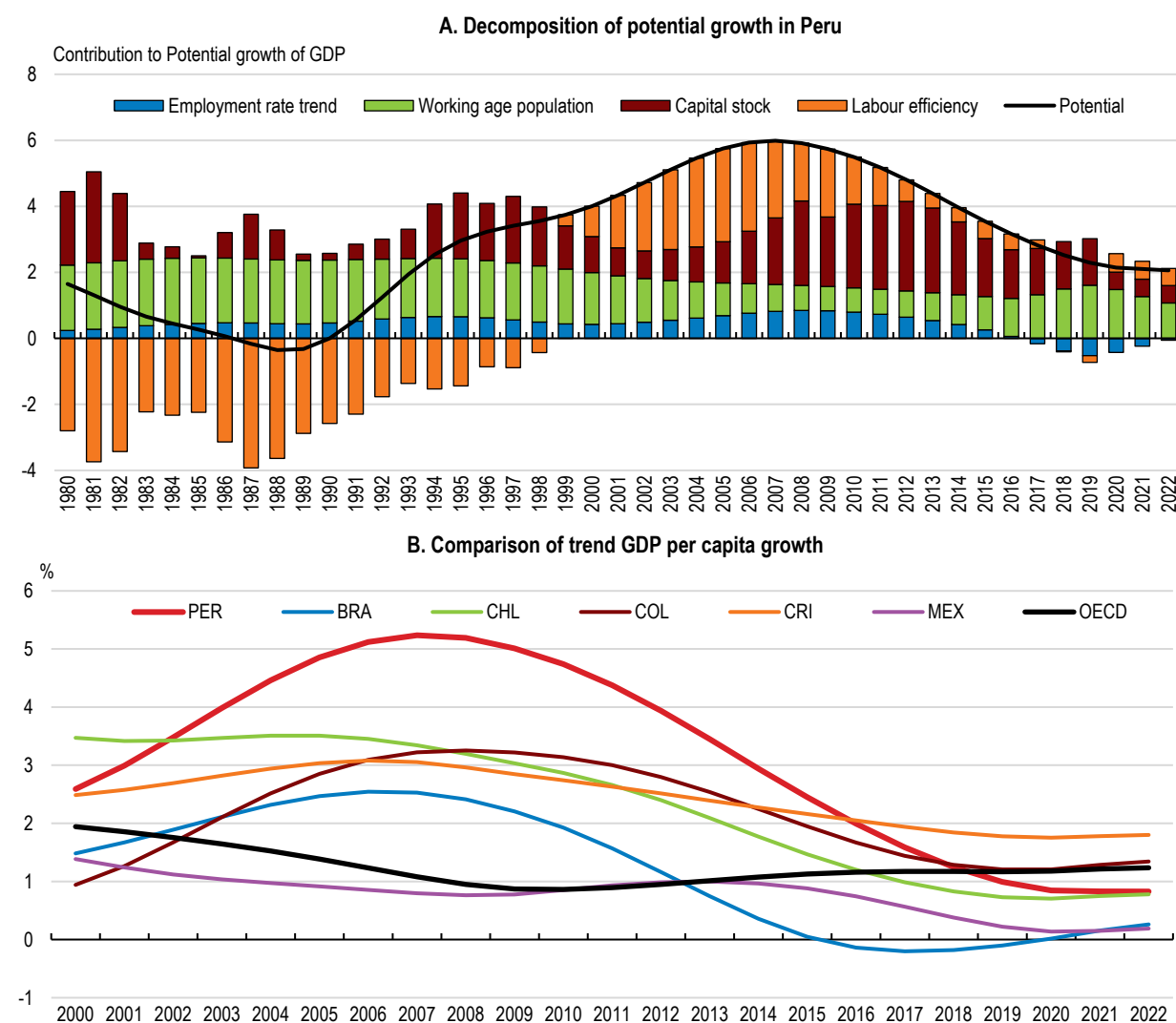
Michael Koelle

After two decades of strong economic performance driven mainly by commodity exports, growth has significantly decelerated. A fresh push for productivity and investment growth will need to be sustained by a broad-based, innovative, and competitive business economy. This requires structural reforms to make markets more competitive and innovative, strengthening the rule of law and the implementation capacity of the state. Strengthening competition enforcement, fighting corruption, modernising the civil service, and increasing judicial independence and efficiency are priority areas for improving the business environment and public infrastructure. Implementing these reforms would put Peru on a sustainable growth path to raise living standards for all.

Introduction: Peru's long-term growth challenges

Peru has experienced significant economic growth over the past few decades and has been one of the fastest-growing economies in Latin America. Between 2002 and 2019, the economy grew around 5.1% each year, on average, and GDP per capita more than doubled. This facilitated a convergence of living standards towards regional and OECD averages. After a “lost decade” in the 1980s (Figure 2.1) – with hyperinflation, default on mounting foreign debt, a financial crisis and a deep recession – investment and productivity recovered thanks to economic stabilisation and structural reforms, and an increasing focus on institution-building with the return to democracy in 2001. Sound macroeconomic policies, openness to foreign investment and trade, and some of the richest mineral deposits in the world put Peru in a position to benefit greatly from the global commodities boom of the late 2000s. Growth was then driven largely by mining investment, but also spilled over to other sectors such as construction and services. Peru joined the group of upper-middle income countries in 2008 (OECD, 2015^[1]).

Figure 2.1. Growth surged with the commodity boom, then decelerated



Note: Potential and trend GDP were obtained with a Hodrick-Prescott (HP) filter.

Source: Feenstra, Robert C., Robert Inklaar and Marcel P. Timmer (2015), "The Next Generation of the Penn World Table" *American Economic Review*, 105(10), 3150-3182, available for download at www.ggdc.net/pwt; and OECD calculations; BCRP and OECD Economic Outlook database.

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However, Peru's growth decelerated after 2014 with the end of the commodities super-cycle. GDP growth dropped to about 2.5% per year, and growth of GDP per capita to 0.8%, below both the regional and the OECD average. This led to a gradual erosion of the earlier achievements in bringing standards of living closer to more advanced economies (as discussed in Chapter 1). Just before the pandemic, in 2019, per-capita GDP in Peru, adjusted for price differences (PPP), amounted to less than 30% of the average OECD country. The pandemic, which led to a larger drop in activity in Peru than in most other countries, caused a further setback in income convergence, and hit the poorest very hard (Chapter 3).

Boosting long-term growth in a sustainable way is essential to achieve lasting improvements in living standards and in reducing poverty and informality. This requires a revitalisation of productivity and investment growth under less favourable global economic conditions than in the 2000s. The prolonged low growth episode further shows that the previous drivers of growth – an expanding labour force, capital accumulation, and the commodity exporting sector – have become insufficient to sustain further socioeconomic progress (OECD, 2015^[1]). Growing the economy towards high income levels will require boosting productivity through more competition, innovation, and a better allocation of resources; and restarting public and private investment in increasingly diversified and higher value-added sectors.

Peru's dual economy, fuelled by high rates of informality, constitutes a drag on growth. Few large firms with high labour productivity coexist with a large low-productivity informal sector composed mostly of small firms that employ about 75% of all workers (see Chapter 3). Both the size of the informal sector, and the productivity differences between large and small firms, are particularly high in Peru, dampening aggregate productivity (World Bank, 2022^[2]). At the same time the high cost of formality, which is caused by a mix of overly strict regulations and a lack of effective enforcement, incentivises informal firms to stay small and unproductive (Ulyssea, 2018^[3]). This creates a vicious cycle in which pervasive informality becomes the norm.

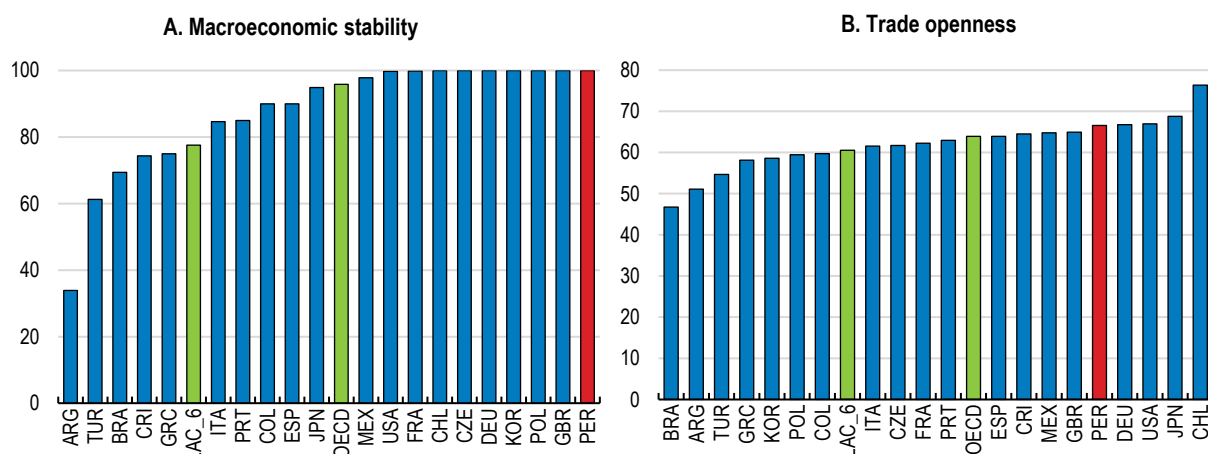
Moving towards a high-income economy based on knowledge and innovation sustained by a broad base of productive and formal firms requires a new set of enabling conditions. Previous rounds of reforms largely focused on a small number of public institutions that became “islands of efficiency” (Guerra Garcia, 1999^[4]) to guarantee favourable framework conditions – such as macroeconomic stability, access to capital, and regulatory predictability – to the relatively small formal economy especially in the commodity sector. However, a business environment that sustains the development and productivity growth of a much broader and diverse share of the economy requires significantly wider reforms.

The next section sets out priority areas for reform based on an analysis of Peru's business environment. The remainder of the Chapter then discusses in turn these areas and presents detailed recommendations for reforms: promoting competitive and innovative markets, strengthening the rule of law, and improving state capacity for public investment and service delivery.

An analysis of Peru's business environment

Peru is highly regarded internationally for its macroeconomic stability and trade openness (Figure 2.2). This reflects its solid economic institutions with their strong reputation for sustainable and prudent fiscal policy, an independent central bank, and a sound financial regulation framework and well-regarded financial supervision authority. These arrangements have kept debt low and have contributed to the accumulation of substantial foreign currency reserves which underpin the country's commitment to free capital flows. Moreover, Peru has put in place strong protections for private investment, including regulatory and fiscal stability agreements with investors.

Figure 2.2. Peru stands out for macroeconomic stability and trade openness

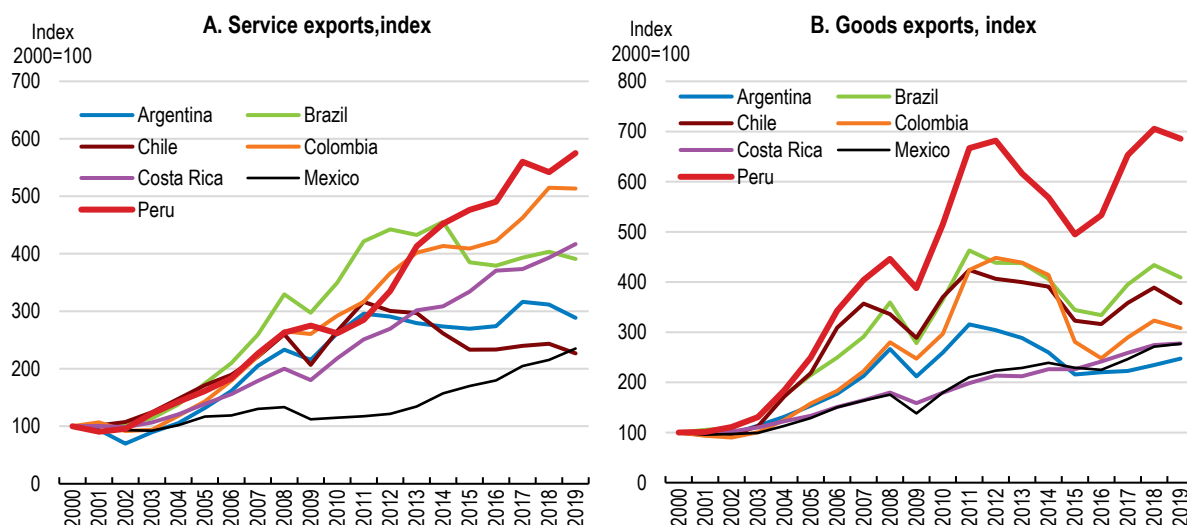


Note: LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX. Data refer to 2019.
Source: World Economic Forum, Global Competitiveness Index 4.0.

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Peru has pursued a policy of systematic economic opening including trade liberalisation. Tariffs are among the lowest in the region, similar to Chile. Peru is an integral member of various regional trade alliances such as the Pacific Alliance, the Andean Community, and APEC and a signatory to 24 bilateral and multilateral free trade agreements. Exports of goods and services have grown faster in Peru than in any other peer country in the region in the last two decades (Figure 2.3). This has brought trade penetration to 47% of GDP in 2019, which is about the LAC average, but above other South American countries including Argentina, Brazil and Colombia that are at similarly long distances from global economic centres. However, although expanding into non-traditional agricultural trade has met with success, exports are highly concentrated in commodities, mostly to China (see Chapter 1), calling for a gradual diversification of exports and an upgrading of Peru's position in global value chains.

Figure 2.3. Goods and services export growth is highest in the region

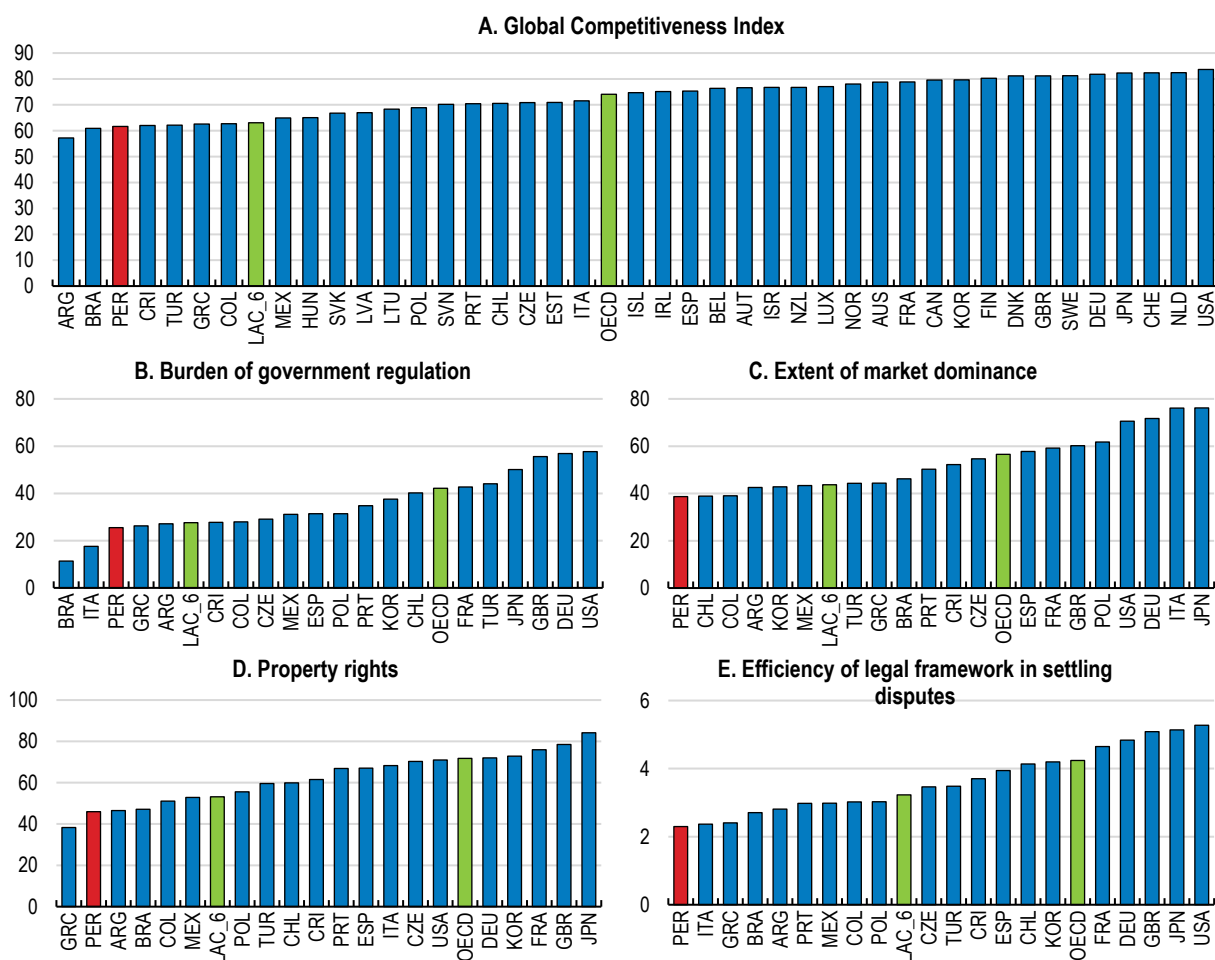


Note: Index of BOP exports in goods and services, respectively, in current US dollars.
Source: (Arnold et al., 2023^[5]); WITS.


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Despite these clear strengths that have underpinned Peru's strong growth until recently, the overall competitiveness of its economy lags behind OECD countries, including peer countries in the region such as Chile, Colombia, Costa Rica and Mexico (Figure 2.4, Panel A). Among the different factors that drag down the business environment, two areas stand out. First, burdensome regulations and low competition reduce market dynamism, discourage investment, and limit innovation and creative destruction, the bedrock of productivity growth (Figure 2.4, Panels B and C). Perceptions of a high burden of government regulation likely reflect a combination of factors: excessive regulatory compliance costs, poor regulatory quality, and weak and uneven enforcement. High market dominance reflects high concentration in many industries.

Figure 2.4. Restrictive regulations, limited competition, and weak institutions harm the business environment



Note: Panel A shows the overall business environment index (the Global Competitiveness Index) and Panels B-E show selected sub-indicators. Indicators are based a mix of data sources, including the Executive Opinion Survey, and are scaled 0 (worst) to 100 (best). Data refer to 2019. LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX. Source: World Economic Forum, Global Competitiveness Index 4.0.

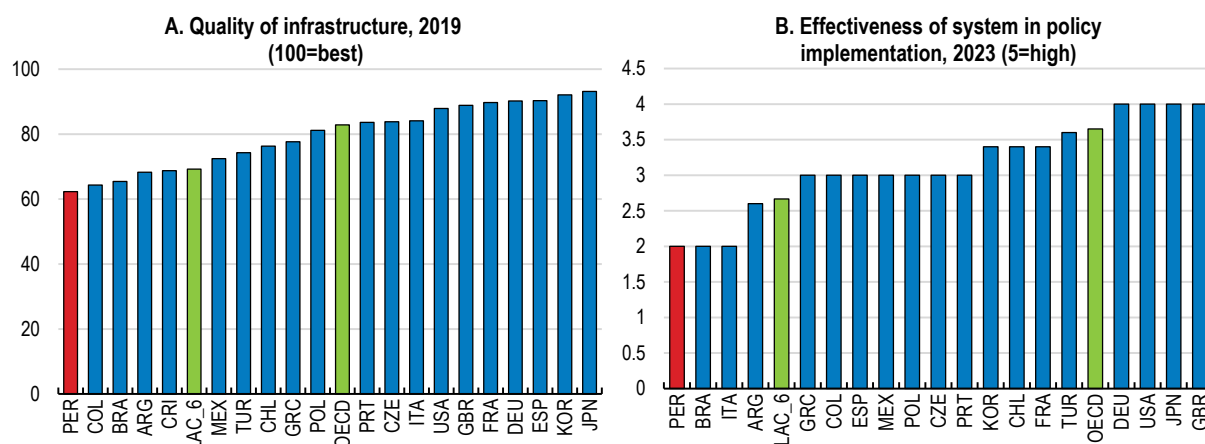
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Second, the weakness of the rule of law reduces the attractiveness of Peru's business environment. A strong rule of law is supposed to not only protect private parties from arbitrary action and infringement of property rights by the state, but also to ensure a level playing field for economic interactions between private parties. It provides for security of property rights and contract enforcement (Acemoglu, Johnson and Robinson, 2001^[6]; Johnson, McMillan and Woodruff, 2002^[7]), necessary incentives for private sector

investment and innovation. However, in Peru, high corruption and an unpredictable and inefficient judicial system result in weak *de facto* property rights, as perceived by the business community (Figure 2.4, Panel D). The poor efficiency of the legal framework in settling disputes (Figure 2.4, Panel E) limits businesses' willingness to bear the risk of, for example, contracting with unknown business partners, or hiring formal workers given high legal uncertainty about the interpretation of strict employment protection regulations. Such risks arguably constitute a larger deterrent on potential market entrants due to their lack of information, experience, and contacts to navigate the Peruvian business environment, thus contributing to low market dynamism and competition. Evidence from the OECD long-term model shows that a stronger rule of law would have particularly large effects on boosting long-term growth (Chapter 1).

Finally, Peru's competitiveness is set back by the poor quality of its infrastructure (Figure 2.5, Panel A). Despite significant investments and considerable progress in the past decade, which saw important roadbuilding and upgrading especially of national trunk roads, a sizeable infrastructure gap remains. Poor roads limit the access to domestic and international markets for producers in many regions, especially in the Andes and the Amazon. The few existing railways largely serve to transport mineral ore from highland mines to the sea. Congestion along main trade arteries and in the Lima metropolitan area – which hosts the most important air and sea ports for international trade – increases transport times and costs; as do inefficiencies and bottlenecks in the logistics chain. Poor quality of schools and hospitals, and limited coverage of mobile and fixed line broadband, hold back improvements in human capital. The main constraint to building more and better public infrastructure is the low implementation capacity of the state (Figure 2.5, Panel B). Policy implementation in Peru is hampered by limited coordination across institutions and levels of government, a fragmented civil service with weak human capital and high turnover, high corruption, and diffuse incentives and weak accountability of public officials. More generally, insufficient state capacity is a key constraint to creating a favourable institutional framework that promotes an innovative and diversified business economy (OECD, 2015^[1]; World Bank, 2022^[2]; IMF, 2022^[8]).

Figure 2.5. Weak state capacity hampers implementation of projects to close the infrastructure gap



Note: LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX.

Source: World Economic Forum, Global Competitiveness Index 4.0.; and Economist Intelligence Unit.

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Based on this analysis of Peru's business environment, this Chapter proposes recommendations for reforms to boost the economy's growth potential; whenever possible informed by prior work of the OECD with Peru. The next section discusses how to make markets more competitive and innovative: through stronger competition policy, administrative simplification, better regulatory policy, financial inclusion, R&D policy; and by better harnessing Peru's trade openness to foster greater innovation and diversification. The following section proposes two key ways to strengthen the rule of law and thereby create a more predictable legal and regulatory environment: reforming the judicial system and enhancing efforts to fight

corruption. The final section deals with how to make the state a more efficient champion of public investment and high-quality public services. Implementing the civil service reform is key to this, complemented with reforms to strengthen public procurement, multi-level governance and coordination, and modern public sector project management and finance. Other factors that matter for growth including skills, education and training, and labour market reforms are discussed in Chapter 3.

Promoting competitive and innovative markets

Fostering competitive markets with effective competition policy

Peru has a thriving private sector, with many internationally competitive companies. Its competition regime is active and generally in line with internationally recognised standards and practices; The strong and established competition authority, Indecopi, is well-regarded both domestically and internationally (OECD, 2018^[9]). Indecopi has the authority to enforce competition law in all economic sectors except telecommunications, which is under the competence of the sectoral regulator OSIPTEL.

The introduction of a general merger control scheme in 2021 was an important step forward for promoting competition. Merger control regimes are now in place in most Latin American jurisdictions (OECD, 2022^[10]). Under the new regime in Peru, mergers and acquisitions of firms with combined turnover above about USD 130 million require an explicit ex-ante notification, examination, and authorisation by Indecopi. Previously, merger control existed only in the electricity sector. In 2022, Indecopi received 20 merger notifications in the regime's first full year of operation.

However, many markets in Peru are dominated by a few large business groups, resulting in high concentration and low perceptions of competition (see Figure 2.4, Panel C above). High market concentration is prevalent especially in consumer-facing industries and products such as beverages and dairy products (Box 2.1). It is also reported from upstream products and industries such as steel and cement (Durand, 2017^[11]). In addition, many companies with large shares in individual markets including pharmacies, retail chains, and banks are part of a conglomerate (Salazar Vega, 2017^[12]). High concentration limits the number of competitors in a market and as such gives firms market power which can lead to higher prices and less innovation into product quality and differentiation. This has negative effects on the purchasing power and welfare of consumers. In addition, limited competition in upstream sectors can lead to distortions and productivity losses down the value chain (Bourlès et al., 2013^[13]).

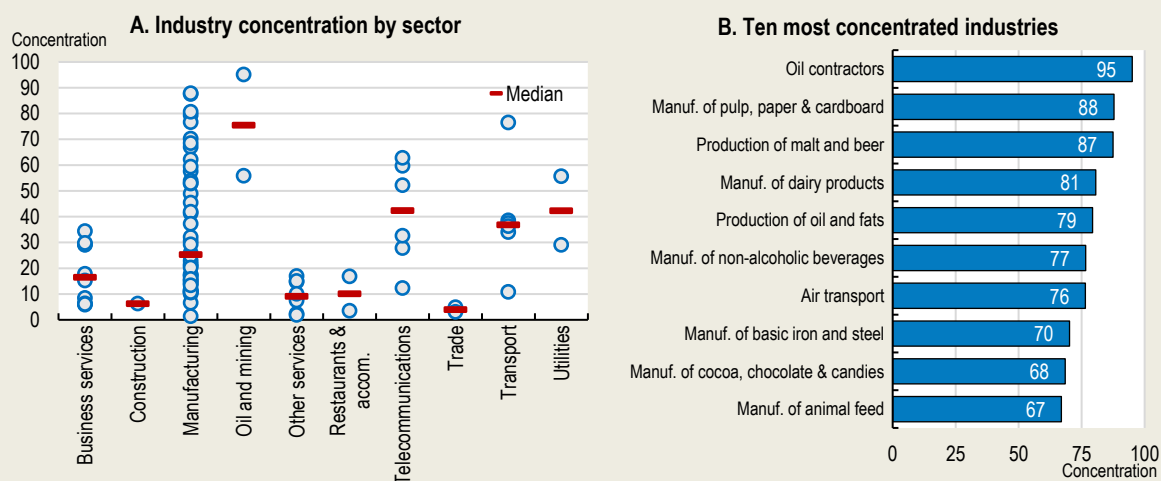
Market concentration is partly the result of consolidation and mergers that took place in the years before the only very recent introduction of the general merger control scheme. Indeed, some firms' dominant market positions resulted from high-profile mergers just before the scheme entered in force. In one prominent example, the merger of the two largest pharmaceutical retail groups, with a combined market share of over 80%, occurred just two years after Indecopi sanctioned price-fixing of the same companies. Other factors, such as the relatively small market size in purchasing power terms, and the high level of informality, discourage the entry of new firms that could compete with large incumbents.

Box 2.1. Measuring the degree of competition in Peru


Evidence on the degree of competition in Peru is scarce, despite widespread perceptions and anecdotal accounts of high concentration. Available data is limited to perception surveys (e.g. by the World Economic Forum) or to empirical studies of individual industries, such as in Indecopi's market studies. By contrast, comprehensive comparable empirical evidence on industry concentration is available for advanced economies in Europe and North America (De Loecker, Eeckhout and Unger, 2020^[14]; Gutiérrez and Philippon, 2018^[15]; Bajgar et al., 2023^[16]) as well as for other countries in Latin America (Eslava, Meléndez and Urdaneta, 2021^[17]).

Results from empirical work for this Survey suggest a high degree of concentration in several Peruvian industries (Figure 2.6). Concentration is measured as the share of value added of the four largest firms in each industry, defined at the 2-digit level. The analysis is based on firm-level data from the 2019 Annual Economic Survey. Participation in the survey is compulsory for large companies, ensuring adequate representation of the largest firms in each industry. However, as coverage of small firms is limited, information on total industry value added from the survey is complemented with information from national accounts.

Figure 2.6. Concentration is high in several industries



Note: Concentration is expressed as the share of value added corresponding to the largest four firms in each 2-digit industry, according to Peruvian national accounts classifications (the CR4 concentration ratio). Data refer to the 2018 financial year.
Source: OECD calculations based on the 2019 INEI Annual Economic Survey (EEA).

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Concentration is particularly high in industries that manufacture basic consumption products such as dairy, beverages, and cooking oil, or provide essential services such as telecommunications (Figure 2.6, Panel B). Such products have limited international competition and few domestic substitutes. Therefore, high concentration has a larger potential to limit competition, leading to higher prices for consumers. By contrast, industries such as construction, food and accommodation, and trade have low concentration, reflecting the presence of many competitors in these sectors.

Source: Garda, Koelle and Ugarte (forthcoming), "Industry Concentration in Peru". *Technical Background Paper*.

Given the high legacy concentration in some markets, effective competition policy that enforces rules concerning cartels and abuse of dominance, as well as competition advocacy, are particularly important in Peru. Competition policy is the competency of Indecopi. The structure of Indecopi is unusual in that it combines both a competition branch (with about 50 staff) and a much larger branch dealing with consumer protection, unfair competition and trade practices, and intellectual property rights (with about 1,300 staff). Indecopi hosts the OECD Regional Centre for Competition in Latin America, which provides training and policy advice for competition experts, regulators and judges in the region.

While Indecopi has an independent legal status, an established institutional track record public recognition, and enjoys high functional, technical, budgetary and administrative autonomy, the legal framework governing appointments to senior roles could be strengthened in order to safeguard the institution against the risk of political interference, given the significant economic interests at stake from its decisions. This has been previously recommended by the OECD (OECD, 2004^[18]; OECD, 2018^[9]). Specifically, formal

procedures should ensure that senior recruitment processes are merit-based, open, staggered, and delegated from the government to a broad-based independent selection committee. The politically appointed board should have no authority over staff assignments.

The risk of price-fixing and other forms of cartel behaviour is higher in more concentrated markets, especially in oligopolies with a small number of similar-sized firms (World Bank, 2021^[19]). Indecopi actively engages in enforcement against collusion (cartels) with several detected and sanctioned cases each year, but could be more active in other areas such as abuse of dominance. The fact that Indecopi has sanctioned multiple cases of abuse of dominance each year since 2021, after a 15 year break in imposing such sanctions, is a positive signal in this direction.

Many competition authorities have the power to impose remedies either as a condition for approving a merger or as a sanction of anti-competitive practices. Peruvian competition authorities can impose both behavioural remedies (e.g. compliance programmes), which are frequently used, and structural remedies, including structural separation or divestiture orders. Indecopi has so far not imposed any structural remedies (such as divestiture of certain assets or business lines) but is in principle in a position to do so. Several countries, including the United States and many European jurisdictions, have made strategic use of structural remedies to break up historically grown quasi-monopolies. However, it should be noted that the imposition of structural remedies outside of merger control (where they are applied regularly as a condition for merger authorisation) is rare and generally seen as a last resort, reflecting the substantial interference in private property rights that this would imply (OECD, 2022^[20]).

Indecopi could consider increasing the number of market studies it conducts and publishes. Market studies are very valuable, especially in the Peruvian context of high legacy concentration, because they inform authorities on market functioning, competitive dynamics, regulations that facilitate anti-competitive behaviour or hinder market entry, and can even reveal indications of potentially anticompetitive behaviour (World Bank, 2021^[19]). Several of Indecopi's proceedings against anti-competitive behaviour were catalysed by the evidence and intelligence obtained from a market study. Market studies further signal vigilance and transparency to market participants, discouraging anti-competitive practices. They also contribute to fostering a competition culture among stakeholders and the general public (OECD, 2018^[9]). According to Indecopi, 14 market studies were published between 2015 and 2022 – about 1.5 per year on average, compared to regional and OECD averages of 2-3 per year.

The resources dedicated to Indecopi's competition branch seem insufficient to perform its required functions. With 46 staff, or about 1.4 per 1 million inhabitants, the competition division is significantly smaller than the average competition agency in the region (4 per million) and the OECD (9 per million) (OECD, 2022^[10]). In addition, members of the commission that decides on cases elaborated by the technical secretariat only work part-time, which hampers specialisation and professionalisation of their role and also poses risks about their independence. While the competition branch's budget increased by 60% to cover the additional responsibility of ex-ante merger review, its budget per staff member (around €50,000) is still only half of the Latin American and a third of the OECD average. Unlike other specialised economic institutions – such as the central bank and banking supervisor – Indecopi's salaries are not detached from the general public sector pay scale. This creates difficulties for attracting and retaining highly qualified, specialised staff.

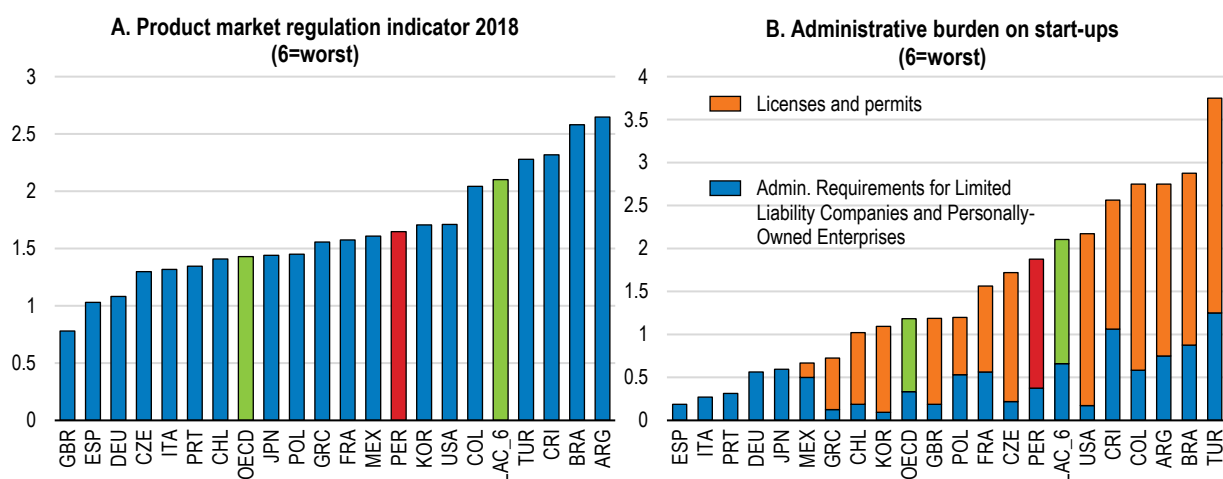
An adequate resource mix involves both own resources raised by Indecopi, and transfers from the central government. Between 2014 and 2022, Indecopi relied entirely on its own income for funding, about half of which is raised from fines, and the remainder from other user fees (especially in the non-competition branches). While directly raised income supports Indecopi's independence, the high reliance on fines for its income potentially creates perverse incentives for Indecopi. In addition, such resources can be highly volatile, and driven by fines of a few large-scale infringement cases. In most OECD countries, competition agencies are funded from general public revenues. In countries where they are (partly) self-funded, agencies typically rely on a mix of sources, such as merger filing charges (e.g. Canada, United States),

earmarked portions of corporate tax revenue (e.g. Italy, Türkiye) or transfers from sector regulators (e.g. Portugal). In 2023, the Ministry of Finance again agreed to a contribution from the general public budget. A recurrent annual transfer from the general budget, which provides Indecopi with a long-term stable and predictable income source, would help support a more strategic and long-term approach to its broad mandate, including competition enforcement and advocacy.

Reducing compliance costs with regulation

Product market regulations are more competition-friendly in Peru than in Latin America on average, but still more restrictive than in the OECD as a whole, suggesting room for improvement (Figure 2.7, Panel A). This is especially true with regards to the administrative burden on obtaining licenses and permits for start-ups (Figure 2.7, Panel B). These can constitute a barrier for setting up a formal firm, and push entrepreneurs either to the informal economy or prevent them from entering the market. Easing business licensing is therefore a key element for reducing compliance costs with regulation.

Figure 2.7. There is room to make regulations more competition friendly



Note: LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX.

Source: OECD 2018 PMR database.

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Peru has enacted several reforms to streamline business licensing in recent years. Remaining barriers to starting a business are largely due to delays and complexities in obtaining municipal operating and construction licenses and permits, with significant differences in the process across municipalities (World Bank, 2022^[21]). Recent legal changes that mandate the use of a standardised procedures for certain local administrative processes has been slow to implement (CPC, 2022^[21]). The use of a pre-existing online platform for business registration (SID-SUNARP), which simplifies some but not all of the procedures to start a business, has seen a sharp spike during the early months of the Covid-19 pandemic, and has stayed high since. However, despite these improvements, currently there is no one-stop shop for starting a business, unlike for example in Chile or in Colombia. There are different models of one-stop shops, for example in Mexico, Spain and Sweden, that integrate national and sub-national procedures (Box 2.2) and which could provide useful examples for Peru.

Box 2.2. One-stop shops for starting a business

In **Mexico**, although a national one-stop shop for starting a business does not yet exist, some sub-national governments, including the capital district and the state of Yucatán, offer fully digital one-stop shops that integrate municipal, regional and national procedures. The one-stop shop in Yucatán further covers land transactions and building permits.

In **Spain**, CIRCE is a one-stop shop run by the Ministry of Industry, Commerce and Tourism directed at small businesses, both for starting a business and for various administrative tasks of operating businesses. CIRCE offers a single online platform that interacts with other government agencies, such as social security. There is an integration with participating municipalities to apply for local licenses.

In **Sweden**, the one-stop shop *verksamhet* is run jointly by the employment agency, companies registration office, tax agency, and agency for economic and regional growth. It integrates information and information on public support available for entrepreneurs, both on business operations such as finance and accounting and on personal matters such as pensions.

Source: Verksamhet; CIRCE; and OECD (2021): "OECD and the Government of the State of Yucatan launch the Digital Window for investment": <https://www.oecd.org/gov/regulatory-policy/oecd-and-yucatan-launch-the-digital-window-for-investment.htm>.

Ill-designed regulations reduce incentives for firms to grow and become more productive. Two kinds of regulations, discussed elsewhere in this Survey, stand out. First, the design of the corporate tax system, with multiple corporate tax regimes for small businesses, provides incentives for firms to remain small (see Chapter 1). Firms subdivide into smaller units, a clearly less efficient form of organisation, to benefit from more favourable tax regimes. Unifying these corporate tax regimes, as recommended in Chapter 1, would improve incentives for successful businesses to grow, and to achieve higher productivity via corporate efficiency gains. Second, Peru's high labour informality lowers productivity through weak incentives for human capital accumulation, for example via on-the-job training (Jaramillo and Escobar, 2022^[22]). High informality also harms competition in Peru, as in other countries in Latin America (Eslava, Meléndez and Urdaneta, 2021^[17]), since it reduces the number of formal (and relatively large) firms that operate in each market, as informal firms' non-compliance with costly regulations and taxes constitutes unfair competition against formal firms. Strict labour legislation, in particular a regulation that mandates reinstatement of a worker following an unfair dismissal, as deemed by a labour court, reduces incentives to hire permanent, formal workers (see Chapter 3). Such a reinstatement regulation is uncommon in OECD countries, and given the shortcomings of the judicial system it heavily relies on (see below), might constitute an unnecessary barrier.

More generally, there is an established mechanism to review and eliminate excessive regulations, through a specialised commission for the elimination of administrative barriers in Indecopi's non-competition branch. The commission can scrap requirements, fees, and restrictions codified in regulations or administrative practice that unlawfully or unreasonably hinder entry into or exercise of economic activity. Cases are brought to the commission either by interested parties and the general public, or are investigated *ex officio* by Indecopi, including through their regional offices. This is a powerful mechanism, and the commission successfully eliminates about 670 bureaucratic barriers per year; and in addition provides incentives for entities to voluntarily review and eliminate more administrative barriers before they are even brought to the commission (around 6,000 a year). The mechanism could be further strengthened by reforming the strict professional requirement on local government attorneys to appeal every case without due regard to merit. While a decision by Indecopi continues to be in force during the appeals process, such automatic appeals are costly and add to regulatory uncertainty. According to Indecopi, most of its decisions are upheld in the final instance. The introduction of systematic monitoring of decisions regarding the elimination of administrative barriers, a new permanent consultative commission on regulatory quality, and a significant increase in training for public officials on administrative burdens are welcome recent

improvements. However, the resources of the commission and its technical secretariat have been recently strained by a large increase in cases; an increase in resources should be considered. Public-private workshops of sectoral dialogue (*mesas de trabajo*) are another mechanism used in Peru to identify regulatory and administrative bottlenecks.

Authorities could go one step further and adopt to a larger degree strategic approaches to reviewing potential administrative barriers, with a view to positively fostering competition. For example, Colombia, with technical assistance of the OECD, undertook a systematic review of regulations in the beverages sector, which gave specific recommendations to eliminate or replace regulations (DNP, 2022^[23]). Similarly, Chile, Australia, and Portugal carried out extensive mapping of licenses procedures in strategic industries and their effects on investment and firm expansion, which in each case led to regulatory simplification reforms (Cavassini et al., 2022^[24]). In Peru, such regulatory sector reviews could be systematically integrated into Indecopi's market studies, which already give recommendations on the market conduct of private firms and public entities. Indecopi currently receives technical assistance from the World Bank Group to review competition in selected sectors at the regional level. The ongoing development of a National Competition Policy, the planned review of "administrative chains", as well as the future implementation of ex post regulatory impact assessments, provide additional opportunities to anchor such strategic approaches. It will be important to ensure these new developments are complementary to and interact with Indecopi's commission. More broadly, the experience of some OECD countries with national productivity boards might be useful to consider for Peru. Such institutions monitor trends, assess policies, and make recommendations for improving productivity and competitiveness (Cavassini et al., 2021^[25]). For example, the license mapping exercises in Australia and Chile were carried out by the countries' national productivity boards, as part of their more general mandate.

Advancing the modernisation of regulatory policy

Peru has made significant progress in its regulatory policy framework in recent years. In line with recommendations of the OECD Review of Regulatory Policy (OECD, 2016^[26]), a regulatory oversight body has been established in the Presidency of the Council of Ministers (PCM) and several instruments to improve regulatory quality through more transparency, predictability and evaluation were created in law. These include simplification of administrative procedures, ex-ante regulatory impact assessments, ex-post evaluation, and stakeholder engagement. This is in line with the key principles of the 2012 *Council Recommendation on Regulatory Policy and Governance*.

The first step towards improving the regulatory policy framework in Peru consisted in conducting a regulatory quality analysis of existing administrative procedures, with a focus on the most prevalent and economically impactful ones. This resulted in a simplification and standardization of many procedures. According to the PCM, the review process will be repeated automatically every three years. This will provide an important mechanism for improving the quality of the stock of existing regulations, especially while systematic ex-post evaluation is not yet actively implemented.

After a transition period, in which they were piloted in a few public entities (i.e., regulatory agencies) with OECD support, in 2022, ex-ante regulatory impact assessments (RIAs) were made mandatory. In the first phase, all primary legislation proposed by 55 public entities of the national government, including all ministries, needs to undergo an RIA. Other central government entities and subnational governments are scheduled to follow such an approach at a later stage. RIA require a comprehensive analysis of the policy problem, an evidence-based evaluation of potential alternative solutions with their economic, social and environmental costs and benefits, and the development of monitoring and evaluation criteria (PCM, 2021^[27]). A Regulatory Quality Commission formed by the oversight body of the PCM, the finance and justice ministries provides quality control and evaluates and approves RIA submissions made by ministries. In line with best practices, the commission can return deficient RIAs for revision (OECD, 2021^[28]). In May 2023, a new General Law of Regulatory Quality Improvement unified the different legal provisions.

Effective stakeholder engagement is an important component of good regulatory policy, as it establishes a feedback mechanism with those who bear the costs or reap the benefits of regulations (OECD, 2021^[28]). Although some form of stakeholder engagements such as pre-publications of legislative proposals have existed before, the full implementation of RIA will make active stakeholder engagement by authorities compulsory. With the introduction of an annual regulatory agenda in 2023, stakeholders will have a better overview and more time to prepare for and engage meaningfully with regulatory proposals. This is a welcome development and should significantly increase stakeholder engagement in Peru.

After these important and positive changes to the policy framework, the challenge is now their implementation in line with best practices, starting with the key central government agencies that participated in the first phase. It is essential for authorities to monitor and reflect on the experiences with the current roll-out of RIA, using the lessons learned for continuous improvement of the process. Peru could also benefit from other countries' experiences. Mexico, for example, has a well-established and systematic process of RIA and stakeholder engagement that is not only more advanced than other Latin American countries, but is also good practice relative to the OECD as a whole. Mexico's central online register contains all draft regulations, the completed RIAs, and authorities' responses (OECD, 2020^[29]).

RIAs demand a high level of technical capacity of officials. While the regulatory oversight body has conducted extensive training with officials and offers technical assistance, additional training and capacity-building of entities beyond the centre of government (key ministries close to the executive power, e.g. PCM, Ministry of Finance), might be needed, especially in local governments. RIAs further rely on extensive data to estimate costs and benefits to various economic actors and social groups, which could create a bottleneck. Given the significant resources and time that the elaboration of a RIA requires, authorities should ensure that their use is proportional to the scope and potential impact of the regulation examined. For example, Mexico and Korea have a requirement for RIA to be proportional to the expected impact of the regulation (see Box 2.3).

Managing such an ambitious reform requires strengthening the Regulatory Quality Commission and providing it with sufficient resources to maintain a high-quality technical secretariat. The secretariat should not only perform quality control but also provide training, technical assistance to implementing authorities, and monitoring and evaluation. While a major independent evaluation of the reform is foreseen after four years, it will be equally important to continuously monitor the rollout of RIA in order to inform any required adjustments and possible improvements. Moreover, the success of the planned evaluation hinges on the availability of adequate statistical data to measure the impact of RIA on firms, citizens, and other stakeholders.

One limitation of the new regulatory policy framework is that it is only mandatory for laws and regulations proposed by the Executive, not by Congress; a situation similar to many OECD countries (OECD, 2021^[28]). Members of Congress are served by a secretariat that advises on legal and constitutional aspects of draft bills, but not on budgetary, economic, or social aspects. While each draft bill receives a formal opinion by the competent congressional committee, limited technical capacity reduces this in practice to a check of formal requirements (OECD, 2016^[26]). For example, in a sample of draft laws discussed in Congress' economic commission, 94% did not come with any cost-benefit analysis (CPC, 2022^[21]). One option to strengthen technical and analytical capacity is the creation of a congressional economic and social research service. Such a service would be at the disposal of members of Congress, and could be called upon to provide technical expertise and advice. For example, in the United States, the Congressional Budget Office (CBO) – besides its role as an independent fiscal institution (IFI) – provides parliamentarians with independent, non-partisan costing and impact assessments of draft bills (OECD, 2016^[30]). In the United Kingdom, the Scrutiny Unit supports parliamentary committees' assessment of draft bills. It further coordinates selective ex-post assessment of legislation. In Sweden, a similar unit that works closely with parliamentary committees also can commission assessments from external experts.

Box 2.3. Regulatory impact assessments and stakeholder engagement in OECD countries

The practice of RIA in **Mexico** encompasses the use of threshold tests to perform analyses that are proportional to the expected impact of the regulation. Specialised assessments analyse effects on competition, risk management, trade, and consumer rights, among others. Policymakers have the obligation to respond in writing to comments received during public consultation of regulatory proposals. Responses to the comments are added to the publicly accessible regulatory proposal.

Korea's 2018 reform of regulatory policy introduced a requirement for analysis to be proportionate to the significance of the regulation. Stakeholder consultation is carried out through different ways including virtual conferences, public meetings, email and letters. Two independent public research centres support cost-benefit analysis, provide guidance and training, and conduct evaluations of regulatory policy.

Source: OECD (2021) Indicators of Regulatory Policy and Governance 2021: Korea and Mexico.

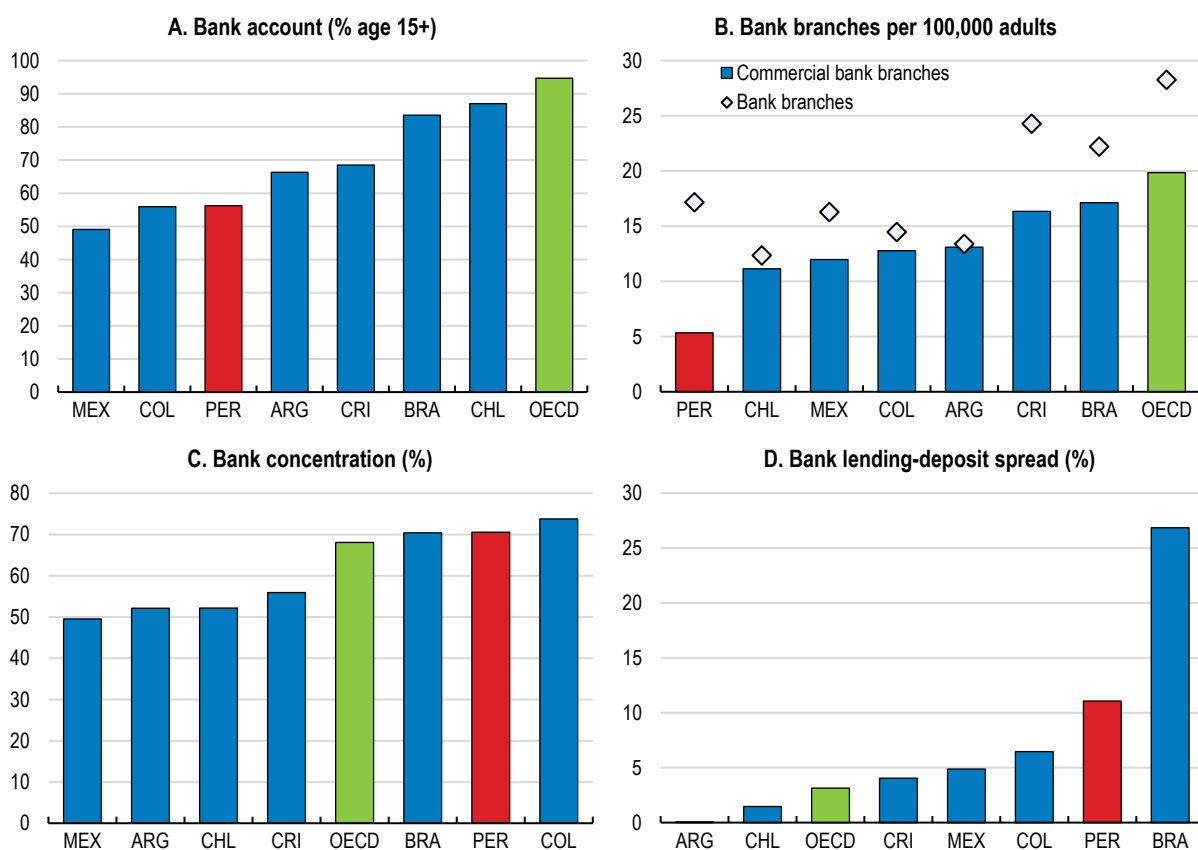
Leveraging financial inclusion and promoting financial competition

Financial inclusion and digital payment technologies can contribute to more competition by improving consumer choice through better information and access to finance, and by bringing more market participants into formal markets and platforms. Cashless payment technologies have been found to improve the competitiveness of traditional retailers and tax compliance in Mexico (Higgins, forthcoming^[31]), thus fostering competition and formalisation. Similarly, the rich information on economic transactions inherent in financial technology can shrink the informal economy and illicit financial flows (OECD, 2018^[32]). Policy should steer these trends and to ensure that they are beneficial in fostering competition.

Financial inclusion in Peru is low (Figure 2.8). Few Peruvians have access to a bank account, a credit card, or a bank branch. To some degree, this reflects the underprovision of commercial banking services outside larger cities, with many provincial towns only served by the state-owned *Banco de la Nación*. Unlike other state-owned banks in Latin America, *Banco de la Nación* does not compete with private banks, but rather handles financial transactions of the state and carries out the implementation of financial inclusion policies by offering basic checking and savings accounts. A digital savings account for every citizen, accessible with only the national identify document (*Cuenta DNI*) is currently being rolled out, starting with people in poverty or extreme poverty, and has been integrated with new digital payment systems (see below). Low financial inclusion, however, is also a reflection of limited financial literacy, trust in financial institutions, and financial culture, as evidenced by the popularity of early pension fund withdrawals.


The private commercial banking system is relatively concentrated (Figure 2.8, Panel C). This does not necessarily imply that banks have price-setting power in all market segments, as regional credit and savings associations, cooperatives, microfinance institutions, and various non-bank consumer lenders compete in different market segments. The presence of such non-bank financial institutions is larger in Peru than elsewhere in the region (Figure 2.8, Panel B). However, evidence from the small business lending segment in Peru shows that higher concentration among lenders reduces access to finance especially for new potential entrants, leading in turn to higher concentration and lower competition in product markets (Burga and Céspedes, 2021^[33]). More generally, banking competition is important for growth by fostering creative destruction (Bertrand, Schoar and Thesmar, 2007^[34]).

Figure 2.8. Access to finance lags behind



Note: In Panel B, “Bank branches” include commercial banks and non-bank financial institutions (credit and savings associations, cooperatives, microfinance institutions). In Panel C, concentration refers to the share of assets held by the largest 3 banks. Data refer to 2021.

Source: World Bank, Global Findex Database; World Bank, Global Financial Development Database; International Monetary Fund, Financial access survey.

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Payment systems in Peru have traditionally been characterised by a lack of competition, resulting in high interest rates on credit cards and high merchant fees (INDECOPI, 2021^[35]). The market was long characterised by vertically integrated acquirers that exclusively handled cards of a single issuer, with Visa (69% of cards) and its acquirer Niubiz (76% of card payments) having the largest market share. In 2020 acquirers switched to a multi-card model, but continue to be vertically integrated with card issuers, which reduces incentives to provide a level playing field. The exponential growth of digital currency wallets during the pandemic has disrupted payments systems in Peru, and increased the share of cashless transactions. The monetary authority, which had laid the regulatory ground for these developments well in advance of the pandemic (Vega and Vásquez, 2022^[36]), took appropriate action and mandated the interoperability of digital wallets to foster competition and consolidate the adoption of cashless payments. The developments in this dynamic market should continue to be monitored to understand its competitive evolution and to determine whether further regulatory action is need; to this end the central bank and competition authority could establish a joint information system.

Most payment cards and digital wallet accounts are issued by banks that belong to one of the main Peruvian industrial conglomerates, which have strong footholds in consumer sectors such as insurance, supermarkets, non-food retail trade, pharmacies, and food product manufacturing. This provides conglomerate business groups with access to potentially large amounts of customer data that can help

them gain an advantage against competitors in many markets. Privileged access to data, especially by firms who are in a position of acting as gatekeepers to markets, is at the forefront of competition concerns relating to conglomerates (OECD, 2020^[37]) and more generally in digital markets (Nicoletti, Vitale and Abate, 2023^[38]; OECD, 2022^[39]). These concerns extend to platforms such as delivery and ride-sharing apps, which are very active in Peru. It would be useful for authorities to monitor these markets – such as through Indecopi’s March 2023 market study of the Fintech sector – and to gather information on the extent of the role that proprietary data plays in them, in order to assess possible implications for competition.

Diversifying exports and moving up the value chain

Exports are heavily concentrated in primary goods and commodities (see Chapter 1). Mining, agriculture, and energy make up 85% of all exports. Peruvian soil is rich in mineral deposits, and the country is the world’s second largest copper producer and a leading exporter of gold, silver, zinc, lead and tin. This strong position is the result of both natural advantages and deliberate policies such as the pre-eminence of macroeconomic stability and strong constitutional guarantees for the security of foreign and domestic investment in the form of legal stability agreements that take precedence over legislative changes for an agreed time period. By contrast, free trade agreements play only a marginal role for mineral exports, for which unilateral import tariffs of major importers are already mostly very low.

Such a heavy specialisation in commodities limits the complexity and value added embedded in Peruvian exports. Peru ranks 105 of 130 worldwide in the Economic Complexity Index. It stands on the first rungs of global value chains (GVCs), meaning that a large share of Peruvian exports are processed in other countries into other export goods (i.e. high forward participation in GVCs). This and the fact that China is the largest trading partner means that Peru benefitted greatly from the Chinese export and construction boom (Arnold et al., 2023^[5]). The flipside is that the Peruvian economy is also very vulnerable to economic fluctuations in China. This was felt again recently during the pandemic, but also after 2014 when the global commodity super-cycle came to an end (see Section 2.1.).

Gradual diversification of exports and upgrading of Peru’s position in global value chains is a major challenge. While there are some future opportunities especially in copper mining and lithium production, which will be essential for the global green transition, adding more diversified and complex products to the export mix would boost productivity and increase resilience of the economy. There are good experiences in agro-industry, tourism, metal-mechanics, and forestry in Peru that can serve as an example of successful diversification and upgrading of the production structure (OECD, 2016^[40]). This would help to create higher-quality jobs and increase incomes, particularly in the manufacturing and services sectors, a major challenge for the Peruvian economy (see Chapter 3). There are successful experiences with diversification within the primary sector, where Peru has moved into higher value products in agriculture. The country has become a major global exporter of fresh horticulture products such as asparagus, grapes and blueberries (Box 2.4). In other commodities such as bananas or coffee, Peru moved into premium niches such as fair trade, organic, and single-origin. Peru also grew its services exports, notably in tourism, building on its rich cultural and archaeological heritage and increasing reputation as a culinary destination. However, service exports still account for only 5% of overall trade; a similar share as in other countries.

There is room to harness the openness to both trade and international capital flows to further diversify and upgrade Peruvian exports. Empirical evidence from agricultural export diversification points to the role of several interlinked enabling factors: free-trade agreements open up foreign markets to new products (Mincetur, 2015^[41]); strong state institutions such as sanitary and phytosanitary control agencies help exporting firms meet the strict compliance and certification requirements of export markets (Vásquez, 2015^[42]); complementary infrastructure such as large-scale irrigation projects lower production and trade costs (Monjarás Saldaña, 2014^[43]); as do special tax and labour regimes targeted at the agricultural sector (Castellares and Martínez, 2023^[44]); and export promotion agencies help firms establish a foothold in foreign markets (Volpe Martincus and Carballo, 2008^[45]). In addition, factors discussed before in this

Chapter such as improving transport infrastructure (ports, airports, and their congested feeder roads), strengthening the business environment, and streamlining regulations would increase private sector incentives to invest in industries with high export potential.

Box 2.4. How Peru became the world's largest blueberry exporter in a decade

Peru started producing blueberries for the first time in 2010. By 2020 it had become the world's largest exporter and second-largest producer. In 2022, the industry exported USD 1.4bn (0.6% of GDP and 2% of exports) and employed 120,000 workers during the peak season. Blueberries were introduced from Chile by a Peruvian agro-entrepreneur who optimised them for local conditions in collaboration with Peruvian and foreign universities. Peru's mild climate allows for year-round production with high yields.

Initially most production took place in Peru's Northern coast, where large-scale irrigation projects had just recently transformed swaths of desert into productive agricultural lands. Blueberry production and exports were spearheaded by firms that had already gained experience and built supply chains as leading exporters of other fresh horticultural products such as grapes, asparagus, and avocado. Production has since spread to other coastal regions. The industry is very dynamic and attracts many new entrants, such that the largest firm's market share reduced from 60% in 2013 to below 20% today.

Source: IABD (2022), Blueberries and the Promise of Agricultural Innovation in Latin America. <https://blogs.iadb.org/ideas-matter/en/blueberries-and-the-promise-of-agricultural-innovation-in-latin-america/> and <http://arandanosperu.pe>.

The success of other countries such as Costa Rica (see Box 2.5) with export diversification, including through strategic attraction of foreign direct investment (FDI), points to the importance of paying greater attention to industrial clusters and domestic supply chains. Interactions between domestic firms and the multinationals they supply led to significant spillovers in terms of productivity and employment in Costa Rica (Alfaro-Ureña, Manelici and Vasquez, 2022^[46]). In the Czech Republic, strategic attraction of FDI with a high innovation potential, and the creation of joint ventures between multinational and local enterprises, contributed to the country's success with generating such spillovers (OECD, 2020^[47]). Often such spillovers are local (Greenstone, Hornbeck and Moretti, 2010^[48]), which is why countries such as Costa Rica and the Czech Republic put special emphasis on strategies that promote the clustering of enterprises. However, any export diversification strategy also needs to take into account the limiting role of the special geographic conditions of Peru, in particular its remoteness (Salinas, 2021^[49]). Deepening regional integration, especially with the Pacific Alliance countries where port-to-port distances are much shorter, has a particularly large potential in Peru. Existing multinational FDI networks could constitute a promising starting point given the importance of multinational firms for international trade (Cadestin et al., 2018^[50]).

Box 2.5. Costa Rica's experience with harnessing FDI to build a modern diversified economy

Costa Rica's productive transformation moved the country from being an economy based on agricultural commodity exports, first to a prime destination of ecotourism and an important producer of microchips, and lately to a leading exporter of medical instruments and ICT and other knowledge-intensive consulting services. A stable pipeline of FDI inflows, particularly in the manufacturing sector and from the United States, has underpinned this shift towards higher-value addex exports.

Costa Rica's success with economic diversification is the result of favourable enabling conditions, many supported by deliberate policies. Macroeconomic stability and long-standing commitments to openness to trade and capital flows, a favourable geographic location close to major markets, and strong property rights protections make the country an attractive investment destination. Costa Rica used free trade zones (FTZ) to transparently target support to strategic high value-added sectors and to create

economic clusters and enhance value chain linkages and spillovers, including to domestic firms. Strong and effective public institutions, especially investment and export promotion agencies, not only help foreign firms to establish themselves but also actively promote linkages between firms, especially with domestic companies. Evaluations suggest that these programmes were successful in creating spillovers (Rodríguez-Alvarez and Monge-González, 2013^[51]). Costa Rica periodically evaluated such support policies and adapted them to changing circumstances. Finally, enabling conditions such as adequate infrastructure, political stability, universal access to health and education, and a strong commitment with sustainability played a role in attracting foreign investors.

Source: (OECD, 2023^[52]; OECD, 2016^[53]) *OECD Economic Surveys: Costa Rica*.

A well-functioning logistics chain that links export clusters with sea and air freight terminals matters for export performance. Evidence from Peru sheds light on, for example, the importance of roads that connect producing regions to ports (Volpe Martincus, Carballo and Cusolito, 2017^[54]) and efficient important and export processing, including customs (Carballo et al., 2023^[55]). Peru has made important progress in these areas, for example with the introduction of a single window for customs, and the introduction of online applications to estimate customs clearings delays in real time. Similarly, processing times for sanitary and phytosanitary controls of agricultural exports have been significantly reduced, although further room for improvement remains. However, traffic congestion around ports, especially Callao which handles 50% of overall seaborne goods volume and 90% of all container volume, adds to logistics costs (CPC, 2022^[21]). Initiatives such as the amplification of regional ports and the construction of bypass roads should be continued and prioritised. In addition, where geographical conditions allow, such as along the coast, railways such as the proposed combined passenger-freight line connecting Lima with neighbouring regions would contribute to decongestion and at the same time help advance decarbonisation (see Chapter 1). Intermodal connections with road freight, for example from agricultural areas in the mountains, could further enhance the usefulness of railways. More generally, development of export clusters and export logistics should be closely coordinated to avoid bottlenecks (see Box 2.6 for a case study from Arequipa).

Box 2.6. Regional economic diversification: the case of Arequipa

Arequipa, Peru's second largest city with about one million inhabitants in its metropolitan area (10% the size of Lima) is the capital of a region about twice the area of Ireland. While mining contributes almost one quarter of the region's GDP, sectors such as construction and ICT have grown particularly strongly in recent years. Arequipa host several renowned universities, including a public one well-endowed with mining royalties, which supply skilled graduates especially in STEM fields as well as research activities that contribute to the region's innovation.

The regional government plans to foster high-tech service exports through the creation of a mining hub and the opening of a technology business park. A large-scale irrigation project would unlock new agricultural lands for export-oriented production, but it has been paralysed for years. Better infrastructure, especially interconnections to seaports, would lower trade costs as well as air pollution.

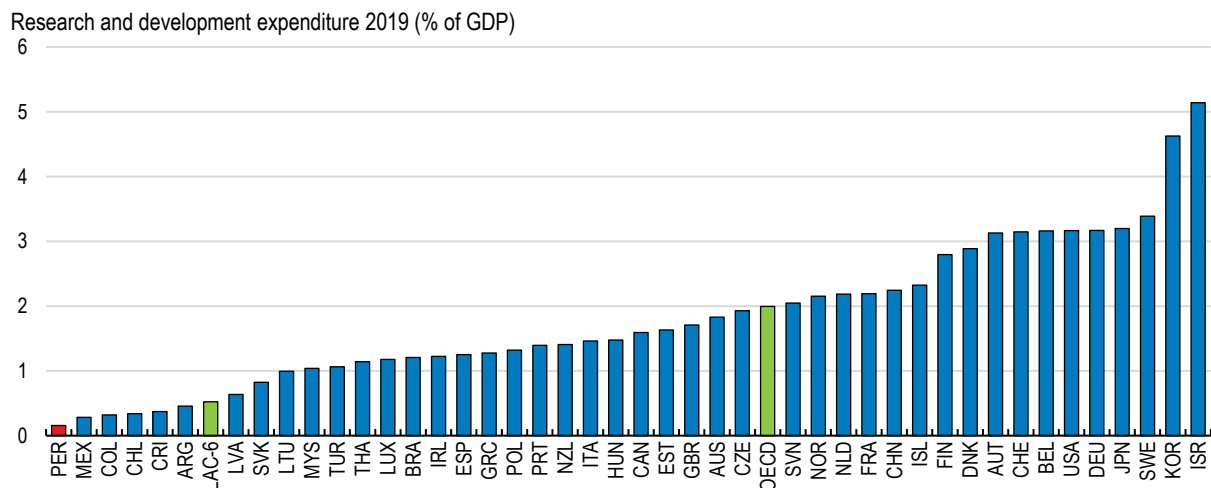
Improving innovation and R&D support

Innovation and the adoption of new technologies is key to improving productivity within sectors and firms. Public and private expenditure on research and development (R&D) is low (Figure 2.9). In 2019, Peru only spent 0.16% of GDP on R&D, less than any other country in the region and considerably less than the average in OECD countries, which is around 2%. However, this still represents an improvement over time: in 2012, only 0.06% of GDP was destined to R&D. The pandemic further brought to the fore the importance of public investment in science, technology, and innovation. Government scientific funding has since

continued to increase (Bertelsmann Stiftung, 2022^[56]). However, weak human capital especially in the regions, weak intellectual property rights, and a still emerging scientific culture that does not yet produce a critical mass of basic research all limit incentives to engage in R&D (CONCYTEC, 2020^[57]).

Different instruments for R&D support are offered by the national science, technology and innovation council (CONCYTEC) and by the Ministry of Industry (PRODUCE) to various stakeholders including firms and research institutions. They include competitive grants for basic and applied research, R&D tax incentives, and business support centres, such as the regional Centres for Innovation and Technology Transfer (CITE). International support for Peru's systems for science, technology and innovation and technology adoption by private sector firms is given by the World Bank and the Inter-American Development Bank.

Figure 2.9. R&D spending is low



Note: LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX.

Source: World Bank, World Development Indicators (WDI).

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R&D tax incentives are offered by almost all OECD countries to stimulate business R&D by private firms. International evidence has shown that this is an effective tool (Guceri and Liu, 2019^[58]), especially in smaller firms which are typically subject to larger financial constraints (Dechezleprêtre et al., forthcoming^[59]; OECD, 2020^[60]). In Peru, R&D tax incentives in the form of enhanced deduction of R&D expenditure were introduced in 2016, in line with recommendations from the initial OECD Multidimensional Review (OECD, 2015^[1]). However, take-up has been limited – only about 18% of the total available funding for R&D tax incentives was spent in 2019, even though most applications made by firms were approved (CONCYTEC, 2022^[61]). Several adjustments were made over time, including an increase of the deduction rate up to 240% for small and medium enterprises in the latest iteration of the programme (2023-2025). Authorities should continue to evaluate the programme to generate evidence of its impact and to inform adjustments for future iterations. For example, one shortcoming is the limited transferability of tax deductions over time, which reduces incentives for participation by small firms and start-ups that might be loss-making or have otherwise limited tax liabilities for several years. To remedy this, Peru could follow countries such as Chile, Colombia and Mexico and convert at least a part of the enhanced R&D deduction into tax credit. An additional measure that goes one step further, and is used for example in Australia, Canada, Norway and the United Kingdom – and proposed in Chile – would be to make the tax credits refundable, at least for small firms (OECD, 2022^[62]).

Research and innovation are still incipient in Peru. For example, articles in scientific journals or patent applications relative to population are below most OECD countries, and the vast majority (92%) of patent applications are filed by non-residents (CONCYTEC, 2023^[63]). Peru is currently upgrading its STI support system. This includes the elaboration of a new national STI Policy, and an integrated project with World Bank support with three strategic axes: green economy and climate change resilience, health, and digital transformation. The challenge for Peru is to create a critical mass of high-quality research that is at the same time relevant for addressing the country's structural challenges. Moreover, while a greater availability of scholarship programmes in the last decade contributed to increasing the number of Peruvian postgraduates trained at world-leading universities abroad, a challenge is to attract and integrate these potential scientists into Peruvian research institutions. Such researchers also typically have existing links to foreign institutions, which could be leveraged for increased international research collaboration. One example for Peru to consider is Mexico's National System of Researchers SNI, which on a competitive basis awards academic recognition, financial incentives and better research conditions.

Peru could improve its link of R&D policies with other industrial policy objectives, such as improving diversification (see above), food security, or the transition to carbon-neutral energy production. All of these areas require high degrees of innovation and advanced technology adoption. To achieve such objectives, Peru needs to increase the knowledge capacity in environmental science and related fields – including through technical and scientific training (see Chapter 3) – and build innovation ecosystems in these areas. For example, as detailed in Chapter 1, Peru has a high potential in renewable energies such as solar and wind power, and in technologies of the future such as green hydrogen. Such a potential could be leveraged to increase participation in sustainable mining, given anticipated demand for the global green transition (e.g. of copper and lithium). Social conflicts in mining are also often framed around environmental issues (water security, air and water pollution), which could be mitigated with more advanced and environmentally clean production technologies. In doing so, Peru could take advantage of the increased availability of international funding for the development and adoption of clean technologies.

Strengthening the rule of law

Continuing the fight against corruption

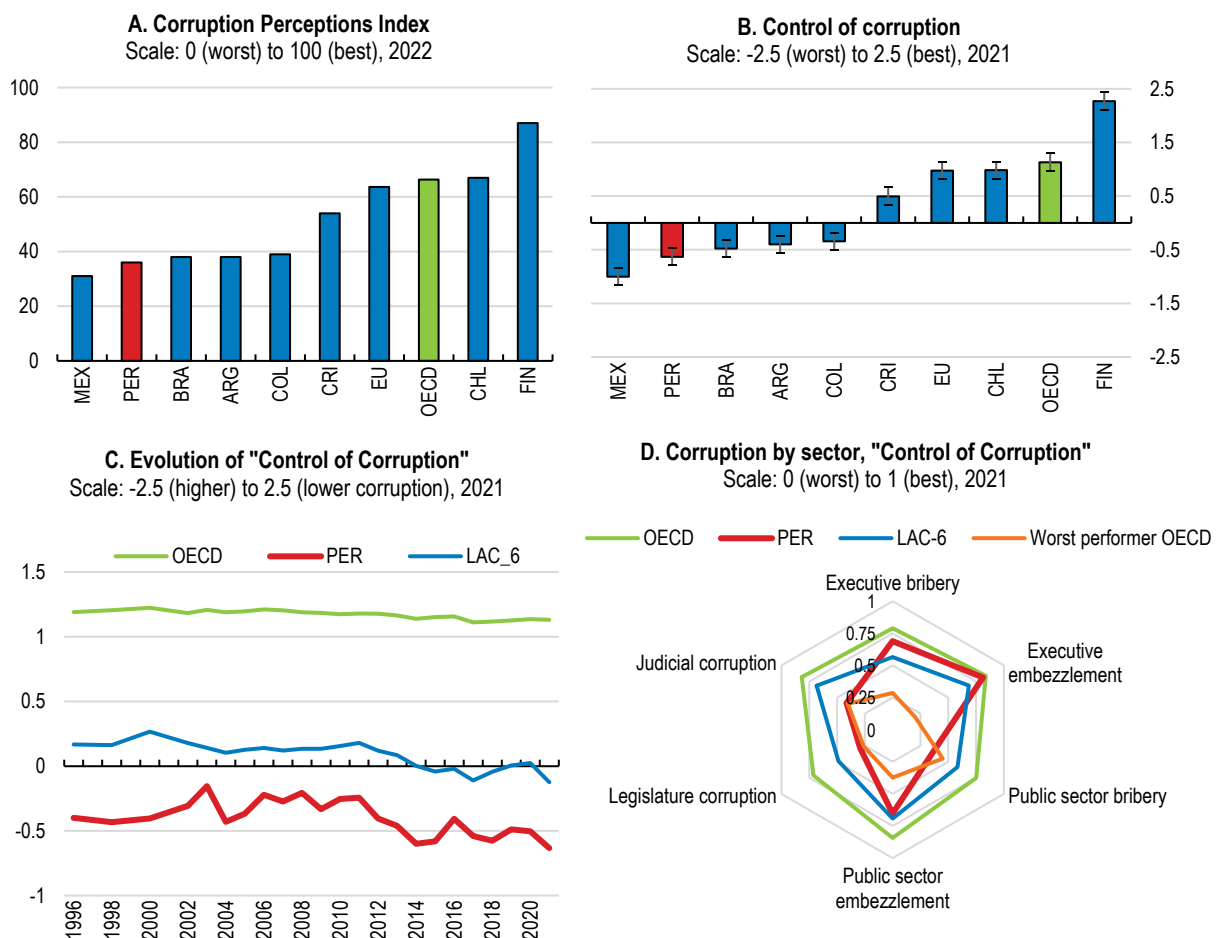
Corruption stymies growth by affecting the provision and quality of public goods and services, diverting public resources, distorting capital and labour allocation in the economy, reducing the government's ability to correct externalities, and lowering trust in public institutions (Olken and Pande, 2012^[64]). Especially harmful forms of corruption emerge when public objectives are misaligned with private rents, since the latter can be shared with bureaucrats to pervert incentives via bribery (Banerjee, Mullainathan and Hanna, 2012^[65]). Corruption creates an uneven playing field that is biased in favor of businesses that engage in corrupt practices, providing them with an unfair advantage over their competitors. It can also increase the costs of doing business by increasing red tape and imposing additional expenses on firms that are required to pay bribes to secure contracts, permits, or licenses. This can lead to reduced profitability, decreased investment, and ultimately, can affect negatively productivity and reduce economic growth. Corruption also undermines the government's ability to implement policy, collect revenues, and enforce laws and regulations according to public interest criteria.

Peru has made some progress in implementing anti-corruption measures in recent years (Shack, Pérez and Lozada, 2022^[66]). Based on the National Integrity and Anti-Corruption Policy and Plan, which are currently being updated, and in line with recommendations of the 2017 OECD Integrity Review (OECD, 2017^[67]), authorities integrated the anti-corruption unit (the Public Integrity Secretariat) into the Presidency of the Council of Ministers, enacted an electoral reform to strengthen internal party accountability mechanisms, systematised public asset and interest declarations of politicians and public servants, and

strengthened the national control system. The supreme audit institution, the Comptroller General's Office (CGR) plays a key role in conceptualising, steering and implementing external control policies.

Corruption is still perceived to be high in Peru (Figure 2.10). Moreover, indicators suggest that control of corruption has eroded over time since its peak shortly after the return to democracy in 2001 – which was itself fuelled by the discovery of evidence of pervasive corruption cases involving senior politicians, judges, and businesspeople (McMillan and Zoido, 2004^[68]). In opinion surveys, even during the COVID-19 pandemic, Peruvians consistently name corruption as the most important problem that the country faces. High-level bribery and influence-peddling scandals have involved all branches of government and may have contributed to the salience of corruption. Most former presidents of recent years have been facing criminal prosecution for alleged corruption. Public sector bribery and judicial corruption are the areas in which Peru is particularly vulnerable (Figure 2.10, Panel D).

Figure 2.10. Corruption indicators



Note: Panel B shows the point estimate and the margin of error. Panel D shows sector-based subcomponents of the "Control of Corruption" indicator by the Varieties of Democracy Project. LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX.
Source: Panel A: Transparency International; Panels B & C: World Bank, Worldwide Governance Indicators; Panel D: Varieties of Democracy Project, V-Dem Dataset v12.

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About 3% of GDP is lost to corruption each year, according to the Peruvian Comptroller General (CGR, 2022^[69]; Shack, Pérez and Portugal, 2020^[70]). This represents about 14% of total government expenditure, with important variation across levels of government, sectors, and regions. Corruption leakages account for 22% of all expenditure in regional governments, 30% in the transport and communications sector, 20%

in the education sector, and 15% in the health sector. These are precisely the sectors that are key to close gaps in infrastructure and provision of social services to all Peruvians (see below and Chapter 3). Corruption therefore deprives especially the most vulnerable of essential public services. Corruption leakages are generally higher in the largely poor and rural southern regions that also receive the highest share of mining royalties. Nevertheless, they are highest in Callao, part of Lima's metropolitan area, where 40% of all public expenditure is lost to corruption.

Peru is in the middle of a major overhaul of its national control system, kicked off by a reform legislated in 2017. A key element of this reform is the gradual introduction by the CGR of concurrent audits ("*control concurrente*"), a mechanism for continuous monitoring along the project cycle. This approach was piloted in a few emblematic major infrastructure projects, including the works for the 2019 Panamerican Games held in Lima.

In Peru, few irregularities identified by audits lead to an application of sanctions for the public officials involved, even if the audit recommends judicial prosecution (Shack, 2020^[71]). This reflects to a large degree the deficiencies of the judicial system (discussed in the next subsection). Being caught is not a sufficiently powerful incentive to deter corruption. Preventive mechanisms that aim to dissuade, detect and correct irregularities early along the project cycle are therefore especially important in Peru and in Latin America more generally. Countries in the region such as Colombia and Brazil have recently adopted similar mechanisms, and others such as Mexico are considering their adoption (OECD, 2021^[72]). Moreover, the introduction of a system based on prevention, early correction, and risk management represents an ongoing cultural shift away from a traditional, punitive control system (CGR, 2021^[73]). However, such a system requires the collaboration of many institutions (CGR, Public Integrity Secretariat, national procurement and infrastructure authorities, and internal audit offices) to avoid either duplicating or undermining efforts, which has occurred in the past (OECD, 2017^[74]). Strengthening links and the smooth interplay between concurrent audits and anti-corruption policy more generally, on the one hand, and improvements to the public procurement framework (see below), on the other hand, would result in complementarities and ultimately higher effectiveness of efforts.

The external control mechanisms promoted by the Comptroller General's Office would be much more effective if they went hand in hand with strengthening public entities' internal control functions. More than half of Peruvian public entities have internal control systems that are either non-existent or very rudimentary (CGR, 2022^[75]). A major factor seems to be the lack of accountability and alignment of internal control with the objectives and day-to-day functioning of entities (OECD, 2017^[67]). Very few entities have internal audit offices that advise senior management on the adequacy of control processes and risk management. Most OECD countries use a three-tier system of internal control, with internal audit offices being complemented by corporate functions such as compliance, human resources and accounting, and managerial control over their areas of responsibility; the elements of each tier are defined by recognised international standards (see Box 2.7). Peru has made important advances in this direction with the preventive integrity model promoted by the Public Integrity Secretariat (SIP). One of its pillars are institutional integrity offices, corporate functions supporting line and senior management that, while receiving functional support by the SIP, report ultimately to the highest level within each entity. This is a step in the right direction as it strengthens oversight of and support for the entity's risk management process and thus contributes to corruption prevention and the promotion of integrity. However, there should be a separation of responsibility from audit and control functions (OECD, 2019^[76]). A next step would consist in the establishment of internal audit offices, high-level independent advisers that report directly to an entity's governing body (i.e., the board of directors, or the ministry an entity depends on) that would provide an additional layer of assurance.

The government should further ensure the coordination of anti-corruption policy across all institutions of the state, with the ultimate goal of improving its efficiency and effectiveness. In particular, Peru could take the opportunity to analyse the current institutional setting of its integrity system and identify scope for improving its steering, co-ordination and coherence. Importantly, it is the government's role to provide

political leadership for the overall direction of such policies, and to ensure a consistent approach across all relevant public entities. This should be based on international best practices and evidence from pilot programmes. For example, evaluations of concurrent audit pilots suggest significant value for money, with 6 soles saved in project overcosts for every sol invested (Shack, Portugal and Quispe, 2021^[77]). Despite the success of pilots, the limited take-up is due to a lack of assigned resources. To implement concurrent audits beyond flagship projects, it will be important to ensure that their scope is proportional to the corruption risk and the resources at stake in each project (OECD, 2020^[78]).

Box 2.7. The three lines of defence model of internal control

The general international standard for internal control systems in public entities follows the “three lines of defence” model (OECD, 2017^[67]; IIA, 2013^[79]):

- The **first line** corresponds to mid-level line management of operational units, who own and manage risks in their area of responsibility. This includes supervising and monitoring their staff.
- The **second line** corresponds to corporate functions outside operational units but within each entity’s corporate hierarchy and chain of control that provide specialised tasks which support both line management and senior management. Such corporate functions include compliance, human resources, accounting, and others such as financial or quality control depending on each entity’s line of activity. The institutional integrity offices in Peru are situated here.
- The **third line** corresponds to internal audit, a function that according to recognised international standards offers independent assessment and assurance of an entity’s procedures, governance, and risk management directly to the entity’s governing body (e.g., board of directors, responsible ministry). The key distinction from the second line is the level of independence from day-to-day activities and internal management and reporting structures of the entity. There are different arrangements, with some countries (such as the United Kingdom and Brazil) opting for a centralised model where a dedicated government agency incorporates all internal audit units, and others having internal auditors attached to each entity.

External auditors, attached to the supreme audit institution (CGR in Peru) complement these functions with external scrutiny and oversight. Importantly, supreme audit institutions should not be involved in internal audit; and in countries where internal audit functions are centralised, they are attached to other entities (e.g., the ministry of finance in the United Kingdom).

By contrast, in Peru, there exist institutional control offices (OCI) that are attached to the CGR, with a role more oriented towards compliance and oversight, rather than advising management on processes. Civil servants tend to view them as punitive. At the same time, the presence of these offices tends to create confusion, diffuse accountability, and limit management involvement in internal control, since they feel it is the OCI’s responsibility.

Source: (OECD, 2017^[67]) OECD Integrity Review of Peru: Enhancing Public Sector Integrity for Inclusive Growth.

More generally, fighting corruption requires a comprehensive strategy in which preventive control measures are complemented by public sector reforms that reduce opportunities for engaging in corruption, provide full transparency to increase the likelihood of detection, and improve the alignment of the private incentives of politicians and civil servants with public policy objectives. Progress in the fight against corruption is likely to be gradual, needs political will and perseverance to continuously upgrade institutions and policies over several years. Measures include designing regulations, simplifying administrative procedures, reforming the civil service, public procurement, decentralisation, and ensuring effective and efficient enforcement by the judiciary (OECD, 2018^[80]) – all topics that are discussed elsewhere in this Chapter. Similarly, reducing opportunities and incentives for corruption should also be considered in a

reorganisation of subnational finances (see Chapter 1). In general, special efforts should be made to strengthen integrity systems of sub-national entities (OECD, 2021^[81]). Moreover, a well-functioning framework requires a professional and ethical civil service as a key pillar and the heads of agencies, ministries and public enterprises must promote ethical behaviour by example. Finally, simplification and unification of administrative proceedings, for example in procurement, would reduce the number of irregularities detected due to simple errors, improving the effectiveness of control systems in deterring corruption.

Regulation and transparency of lobbying and political finance are important tools to ensure the inclusive and fair participation of different interests in public decision-making process, and to avoid policy capture by special interests (OECD, 2021^[82]; OECD, 2017^[83]). In Peru, illicit political funds from illegal economic interests including narcotics, illegal mining, and illegal forestry are seen as especially important topics; as is the association of members of Congress with special interests, for example in private education. Peru was a pioneer in the region in establishing its lobbying law in 2003, and in recent years has made progress in several areas, including asset and conflict of interest declarations of political candidates, public visitor registries in all major entities, cool-down periods for public officials, and establishing criminal sanctions for recipients of illicit or undeclared political finance. However, several provisions that have been already legislated, such as holding internal primary elections for party candidates, have not been implemented yet. Such provisions would be especially important in the context of chronically weak political parties in Peru, which are often highly personalised, short-lived, and lack broad-based membership (Levitsky and Cameron, 2003^[84]; Vergara and Augusto, 2022^[85]) and thus are particularly susceptible to capture by special interests.

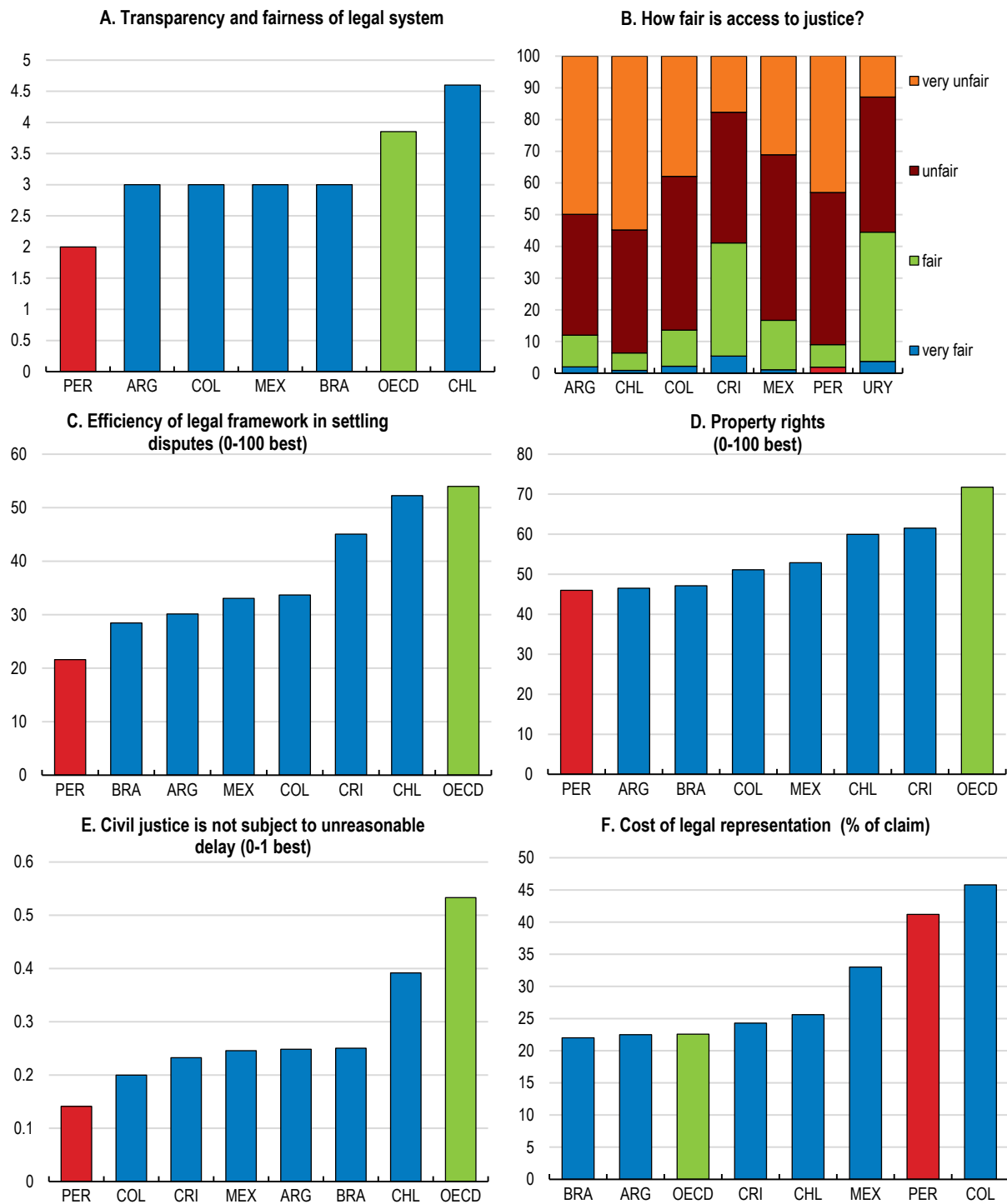
Improving judicial performance

An independent and effective justice system is vital for fostering trust in governance and institutions and creating an attractive business environment (OECD, 2022^[86]; World Bank, 2017^[87]). Protection of property rights, appropriate application of regulations, and enforcement of private contracts all depend on an effective justice system (Palumbo et al., 2013^[88]). Those institutions in turn protect the returns of investors, reduce transaction costs and dissuade opportunistic behaviour, thus incentivising savings, investment, and complex economic interchanges which are the basis for trade and specialisation. Evidence shows that slow courts significantly reduce economic growth, especially in industries where well-functioning contractual relationships with suppliers are particularly important (Amirapu, 2021^[89]). Accessible, fair and efficient justice institutions also render growth more inclusive, reduce poverty and inequality, and improve opportunities (OECD, 2021^[90]).

Performance of the Peruvian justice system lags behind both OECD countries and peer countries in the region (Figure 2.11). The justice system is perceived by businesses and citizens alike to be lacking in transparency and accessibility (Figure 2.11, Panels A and B), and ineffective and inefficient in settling disputes (Figure 2.11, Panel C). The latter reflects in part the large delays in bringing cases to a close and the high cost of judicial representation. Peruvian courts face a significant backlog of cases, which has increased during the COVID-19 pandemic (Poder Judicial, 2022^[91]). However, low perceptions of justice not only reflect inefficiencies in its administration, but also a perceived lack of fairness. More than 80% of Peruvians do not feel that they are treated equally before the law (Latinobarómetro, 2021^[92]). Control of judicial corruption is lower than in any OECD country (see Figure 2.10, Panel D above).

Peru is currently undergoing a challenging modernisation agenda of its complex and fragmented justice system (Box 2.8). After previous unsuccessful reform attempts, authorities seized the opportunity following a widely publicised high-level influence-peddling and corruption scandal in the judiciary (World Bank, 2019^[93]). This led to the Wagner commission report with recommendations on justice reforms. These recommendations are reflected in the current 2021-25 Public Policy for the Reform of the Justice System. Their implementation has been set back so far by political volatility and instability in the Ministry of Justice.

Figure 2.11. Performance of the justice system



Note: The data refer to the following latest available years. Panel A: 2023; Panel B: 2020; Panel C: 2019; Panel D: 2019; Panel E: 2022; Panel F: 2020. Panel A reflects the perceptions of business leaders, whereas Panel B is based on interviews with citizens by Latinobarómetro.

Source: Panel A: Economist Intelligence Unit, Business Environment Indicators; Panel B: Latinobarómetro; Panel C&D: World Economic Forum, Global Competitiveness Index 4.0; Panel E: World Justice Project, Rule of Law Index; Panel F: World Bank, Doing Business.

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Box 2.8. The Peruvian justice system

The Peruvian justice system consists of five constitutionally autonomous institutions:

- The **Judiciary** (*Poder Judicial*) is the independent branch of the state that administers justice in all courts except the Constitutional Court, and employs all their judges.
- The **Constitutional Court** (*Tribunal Constitucional*), with members elected by Congress, is the final instance in constitutional matters, including individual constitutional rights.
- The **Attorney General's Office** (*Ministerio Público – Fiscalía de la Nación*) investigates and prosecutes criminal cases, and employs all public prosecutors.
- The **National Justice Board** (*Junta Nacional de Justicia, JNJ*) selects, appoints, evaluates and removes judges and prosecutors. It was created in 2020 after its predecessor institution was at the centre of a major corruption and influence-peddling scandal.
- The **Judicial Academy** (*Academia de la Magistratura*) trains and accredits prospective and sitting judges and prosecutors, and cooperates with JNJ in performance evaluations.

In addition, the **Ministry of Justice and Human Rights** (MINJUSDH), a part of the Executive Branch, develops and oversees public policies in the justice sector, protects human rights, and ensures access to justice. It employs state attorneys (*procuradores*), which represent the state's interest in court, and public defenders; and implements alternative dispute resolution mechanisms. The budget of all justice system institutions is proposed by the **Ministry of Economy and Finance** and voted on by **Congress**.

Source: (World Bank, 2019^[93]).

A significant share of judges (61%) in Peru is employed on short-term contracts and can easily be removed from their position (Table 2.1). This share increased sharply by 5 percentage points during the COVID-19 pandemic (CPC, 2022^[21]). On top of the regular merit-based selection of regular judges, two mechanisms exist for appointing temporary judges. First, regular judges (*jueces titulares*) can be hired in an acting capacity for a higher role than they were initially appointed to (so-called 'provisional judges'). Second, supernumerary judges are temporary hires not selected through the merit-based process. For example, they might be chosen among the longlist of unsuccessful applicants. A similar system is used for public prosecutors. The appointment of temporary judges became widespread in the 1990s under the authoritarian regime in an attempt to curtail judicial independence (Lovatón Palacios, 2017^[94]).

Table 2.1. Distribution of judges by appointment type

June 2022

	Regular	Temporary		Total
		Provisional	Supernumerary	
Supreme court judges (<i>jueces supremos</i>)	8 (14%)	48 (86%)	0	56
High court judges (<i>jueces superiores</i>)	399 (50%)	377 (48%)	15 (2%)	791
Specialised court judges (<i>jueces especializados o mixtos</i>)	801 (40%)	320 (16%)	905 (45%)	2026
Justices of the peace courts (<i>juzgados de paz letrados</i>)	162 (25%)	0	481 (75%)	643
Total	1370 (39%)	745 (21%)	1401 (40%)	3516

Note: Specialised courts have jurisdiction for one area of law (civil, criminal, commercial, labour, administrative, etc.). In rural areas, they might be of mixed jurisdiction. They are the first instance for many cases. Justices of the peace courts hear small claims civil cases up to specific monetary ceilings, and family matters.

Source: Poder Judicial, *Boletín Estadístico Institucional No 02-2022, Anexo No 6*.

This overreliance on temporary judges can impact the independence, quality and efficiency of the justice system. First, it results in high turnover of judges, as they are moved, removed, or seek more stable employment elsewhere. Replacement of a judge in the middle of a trial can significantly impact the speed, efficiency, consistency and predictability of the case's resolution. Large turnover also limits the specialisation of judges in specific areas of the law or structural features of cases, and prevents accumulation of human capital, which is crucial for a justice system to develop expertise and build capacity. Second, temporary nominations lack competitive selection processes and can result in appointments of unqualified or inexperienced judges. Third, the precarious nature of temporary employment, and the untransparent and arbitrary power over judges that other stakeholders inside and outside the judicial system have impairs judicial independence and creates significant conflicts of interest. This is particularly true for judicial appointments given the large degree of professional autonomy that the role of a judge requires, and the binding and final nature of judicial decisions in applying and enforcing the law. The temporary status of judges can make them more susceptible to external influence, leading to biased or unjust decisions and possibly corruption.

Several elements risk undermining the independence of regular judges (Figuroa Gutarra, 2020^[95]). The initial recruitment processes lack guarantees of due process, and the recruitment panel has large discretionary power. There is no established career path for judges, either through a seniority-based promotion system (typical in civil law countries) or participation in open professional competitions for higher courts (typical in common law countries). Sitting judges need to have their appointment re-ratified every 7 years (and performance appraisals take place every 3.5 years). The Inter-American Court of Human Rights has repeatedly ruled that this constitutes a violation of the principle of judicial independence enshrined in the Inter-American Convention of Human Rights.

To make the judiciary more independent, Peru could consider strengthening the independence of regular judges and reduce the high reliance on temporary judges. There are several interlinked elements to be considered to achieve these objectives. First, creating more permanent positions requires better strategic human resource planning. Although many temporary judges are assigned to nominally temporary courts tasked with reducing backlogs, the persistent nature of these arrangements suggests structural rather than one-off needs. Second, coordinated efforts between the judiciary and the Ministry of Finance could deliver a more predictable and adequate budget for the judiciary. This would require a better identification and justification of the judiciary's funding needs. Third, a more clearly defined and transparent appointment process and career path for judges would increase their independence, create career incentives against corruption, and reduce the need to fill positions on an interim basis. Fourth, an overhaul of the performance appraisal process for judges could support effective human resource management. Fifth, as with civil servants (see below), salaries that better reflect the degree of responsibility, rather than the contract type, would help to delineate career paths and set desired incentives.

Modern case and court management systems using digital technology can improve accesibility and the efficiency of courts (World Bank, 2019^[93]; OECD, 2020^[96]). They also generate large amounts of detailed statistical data, which can be used to better identify bottlenecks and target resources, and which increase transparency. Digital case management systems have been introduced in many OECD countries, including in New Zealand, Portugal, and the United Kingdom, where in each case this was part of a wider modernisation programme to make justice systems more efficient and closer to citizens (OECD, 2020^[96]). In Peru, a digital case management system (*expediente judicial electrónico*) has been piloted since 2017. Evaluation of these pilots points to significant time and cost savings (World Bank, 2019^[93]). However, digital tools have mostly been introduced in isolation, through the initiative of individual institutions of the justice system, and sometimes also within specific courts. Moreover, this system is not yet interoperable, both within the judiciary across different IT systems and applications, and with other justice institutions that maintain separate electronic file management systems. Therefore, the current level of implementation does not always improve bottlenecks in a system that requires simultaneous inputs by many actors to advance cases and the need to maintain digital and analog systems in parallel may even increase workload.

Peru could consider advancing the implementation of the digital case management system, and make special efforts to ensure that it is interoperable across all relevant institutions in the justice system. Many countries, including Colombia and Spain, have created special inter-institutional commissions to coordinate the implementation of interoperable digital justice tools. In Peru, a bill to create a Permanent Inter-Institutional Technical Commission for Data Management and Interoperability of the Justice System was presented to Congress but was not passed by majority. The government should continue to promote the cooperation of justice institutions to achieve interoperability. At the same time, it should also promote the large-scale introduction of the digital system, taking into account the lessons learned with the pilot programmes. Sufficient resources, including hardware, software, and network infrastructure, should be devoted to this. The process could also be supported by the digitalisation unit of the Presidency of the Council of Ministers and integrated into a general digital strategy of the Peruvian state.

The forthcoming OECD Justice Review of Peru as well as the technical OECD accession assessment of the Peruvian justice system will provide an opportunity to identify good practices and concrete recommendations to support Peru in its reform efforts to develop a modern, independent and effective justice system.

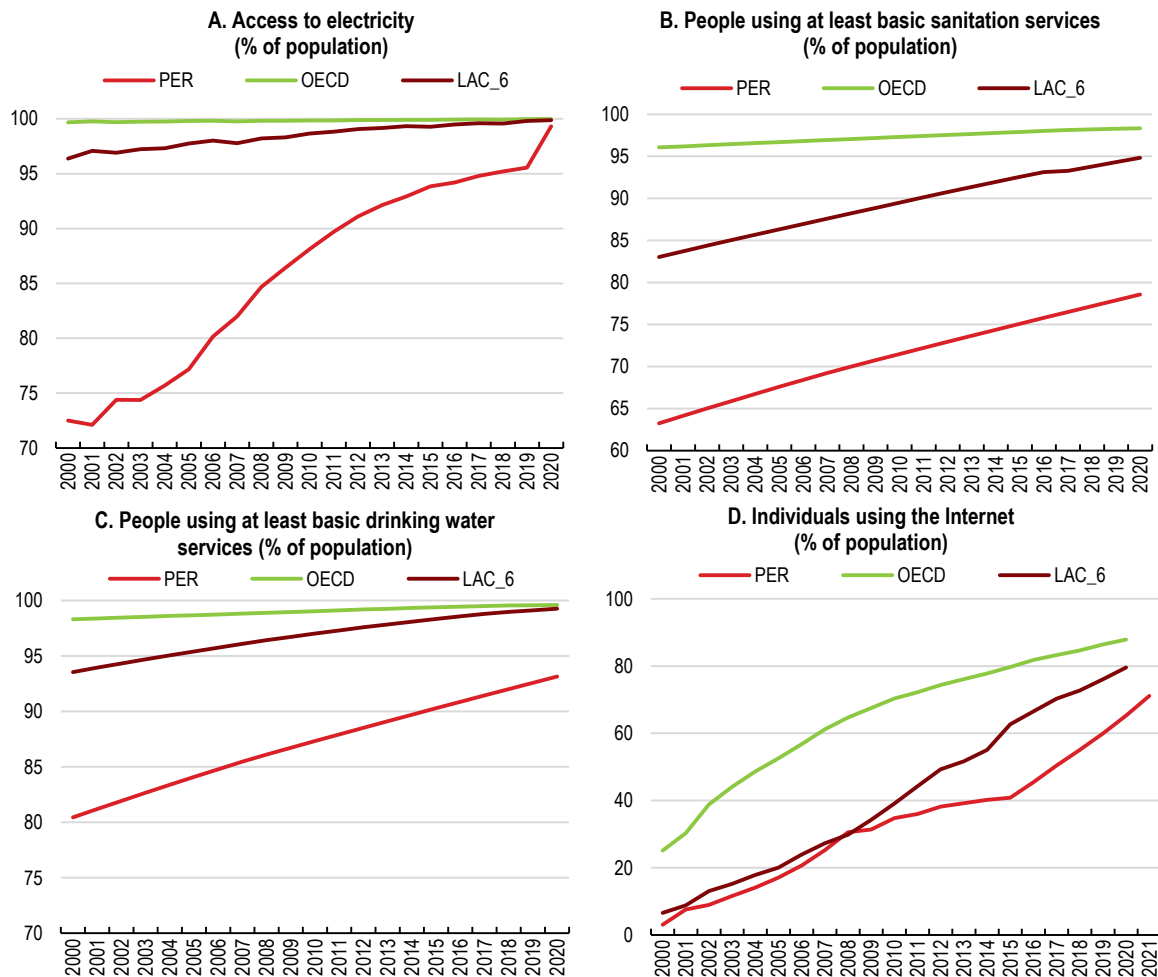
Improving state capacity for public investment and service delivery

Closing infrastructure gaps requires significant public investment

Despite significant progress in some areas, a large infrastructure gap remains. This gap extends beyond modern digital infrastructure, such as broadband and high-speed mobile networks, or transport infrastructure such as roads and railways, to include basic services like safe water and sanitation (Figure 2.12). Although impressive progress was made especially in electrification and roadbuilding, with rural electrification increasing from 56% in 2010 to 97% in 2020 and paved road surface doubling in the same timeframe, investment needs are still high. Peru's complex geography complicates implementation, but building resilience to climate change and natural hazards, such as seismic activity, will be critical as Peru is especially vulnerable, as discussed in Chapter 1.

Massive investments are needed to close infrastructure gaps. Investment of almost 50% of GDP (around PEN 360bn in 2019 values) would be required to bring Peru to OECD averages in most areas of infrastructure, and to regional averages in domestic transport infrastructure (MEF, 2019^[97]). This massive volume of investments partly requires additional fiscal resources (see Chapter 1), but also increased involvement of the private sector in project financing (see below); as well as high-quality cost-benefit analysis to prioritise the projects with the greatest social value for money. The largest investment needs, more than 20% of GDP alone, are in transport infrastructure, especially roads and railroads (Figure 2.13). Around a third of this has been already allocated to 72 megaprojects, which are prioritised through triannual infrastructure plans. However, implementation even of already budgeted investment is slow: between 2019 and 2022, only about 12% (PEN 13.7bn) of the investment scheduled in the infrastructure plan for a five-year period was executed (MEF, 2022^[98]). While the pandemic certainly played a role, the example demonstrates that Peru requires, on the one hand, more credible and realistic infrastructure plans and, on the other hand, significant improvements in implementation capacity and investment efficiency. Moreover, the increased vulnerabilities to natural disasters that global climate change implies for Peru, highlight the need for additional modern, resilient and sustainable infrastructure as acknowledged in the 2022-25 National Plan for Sustainable and Competitive Infrastructure. Currently, public investment amounts to about 6% of GDP annually, almost double the OECD average of 3.3%, but investment efficiency is low.

Figure 2.12. Many Peruvians still lack access to basic public services



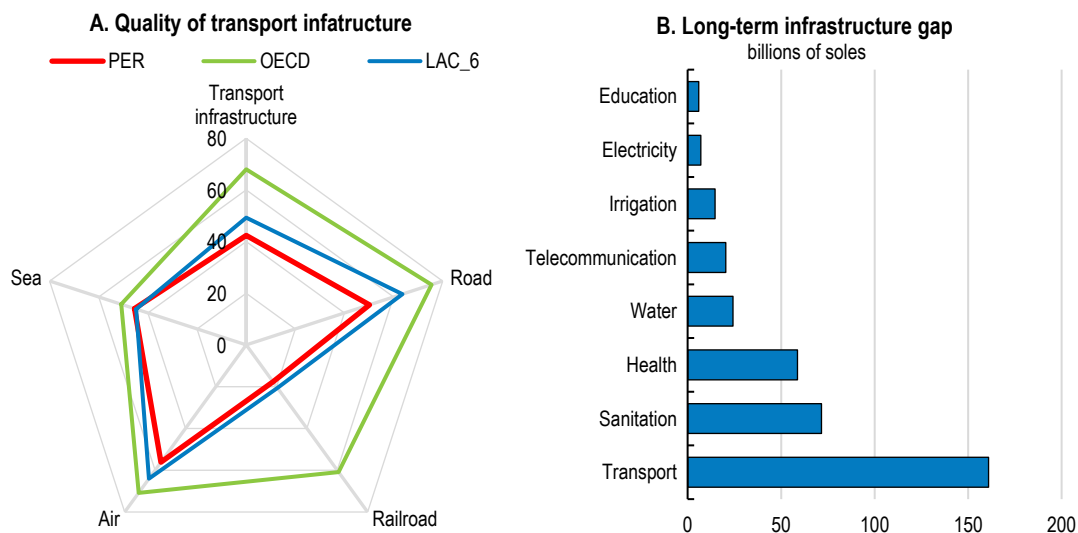
Note: Basic sanitation and drinking water implies access to facilities, but not necessarily that these facilities are 'safely managed' according to global health standards, which would imply compliance with WHO guidelines on toxic and bacterial substances, and adequate wastewater treatment. LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX.

Source: World Bank, World Development Indicators (WDI).

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Closing the infrastructure gap will not only happen through megaprojects, but just as importantly through a large number of small, local public works that are not always part of the national infrastructure plan. Water and wastewater networks, hospitals, and schools are mostly built and maintained by sub-national governments. Together these sectors make up half of the total investment gap (Figure 2.13, Panel B). At the same time, there is a large regional dispersion in the quality of physical infrastructure, such as schools (Figure 2.14). Many public works projects are abandoned or remain unfinished ("white elephants"). For example, in a national sewage programme this concerned 75% of all projects at some point in time (Bancalari, 2020^[99]). Abandoned projects not only deprive citizens of essential services and signify a waste of scarce public resources (thus contributing to Peru's overall low spending efficiency); they can also become a health hazard. Even completed projects take much longer than foreseen. A leading factor in project delay and abandonment are judicial processes revolving around project irregularities, either due to corruption or to poor project management, for example deficient technical specifications (OSCE, 2020^[100]). Improving the coverage and quality of infrastructure therefore requires improving technical capacity especially in sub-national governments. Continued efforts to fight corruption and improve judicial effectiveness, and modern control mechanisms that try to correct deficiencies on the way would also help (see above).

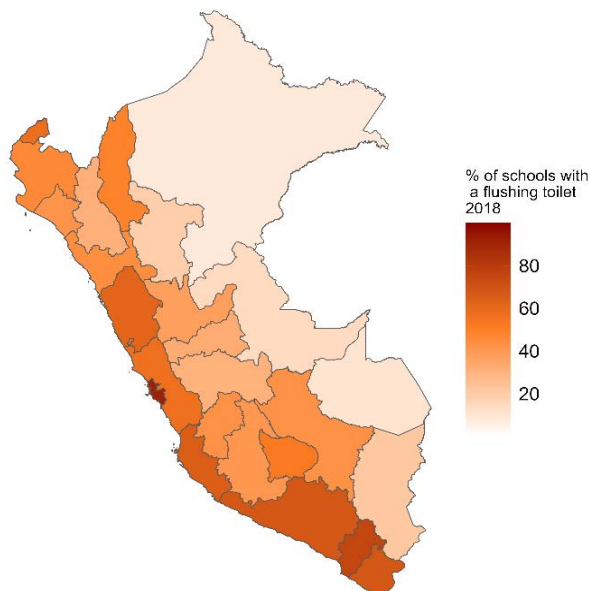
Figure 2.13. Closing the infrastructure gaps requires significant investment



Note: Panel B shows investment needs to close the gap to the OECD average in sanitation, water, telecommunications, airports, electricity, and education; to the Pacific Alliance countries in railroads; to middle income countries in roads; to upper middle income countries in health and irrigation; and to Asian exporting economies in seaports. LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX.
Source: World Economic Forum, Global Competitiveness Indicators 4.0 and (MEF, 2019[97]), Plan Nacional de Infraestructura para la Competitividad.

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Figure 2.14. There are large regional differences in the quality of public infrastructure



Note A flushing toilet corresponds to a having a toilet that is connected to a public sewage system, rather than a septic tank or a latrine.
Source: INEI, Encuesta Nacional a Instituciones Educativas, 2018.

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Creating a modern and effective state capable of delivering high-quality services and investments to citizens and businesses throughout Peru requires ambitious reform packages in several key areas. These include the civil service, public procurement, multi-level governance and coordination, infrastructure long-term planning, public finance and project management, including PPP governance. The legal bases for many of these reforms have already been laid, and support units at the centre of government have been established. The ongoing creation of an Advisory Commission for the Development of National Infrastructure, inspired by the United Kingdom's National Infrastructure Commission, is another positive step in this direction. The challenge now lies in fully implementing these reforms throughout the entire government and across the entire country. This will require bold leadership from the top of government to convince all stakeholders of the need to change established behaviours and embrace the best practices of modern public sector management.

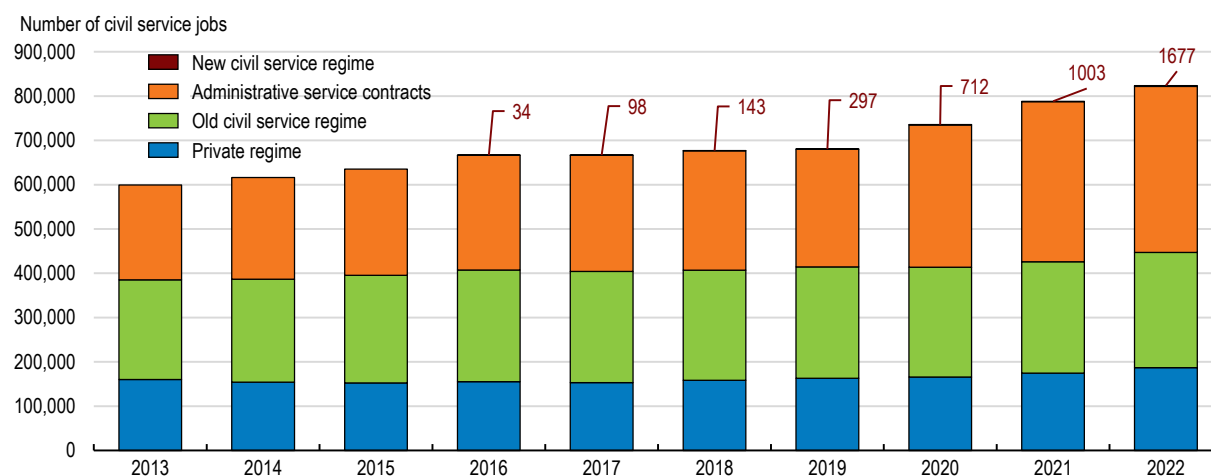
Re-starting the civil service reform

In all countries, civil servants are at the forefront of delivering public investments and services (OECD, 2017_[101]). Civil servants need to have the capabilities to formulate technical project specifications, manage project implementation by contractors, and ensure adequate maintenance and supplies. They need to conduct procurement processes in a way which maximises public value for money. Building experience and continuity enables them to manage projects with long horizons, plan strategically, and develop trust and coordination mechanisms with other institutions and stakeholders. Civil servants are also often driven by pro-social motives and are motivated by pride in providing public goods and services (Ashraf et al., 2020_[102]). The absence of some or all of these elements in Peru are a main contributor to delays, cost overruns, and abandonment of public works and underprovision of public services.


The Peruvian civil service is fragmented and over-reliant on ad-hoc administrative service contracts - CAS (Figure 2.15). For a long time these contracts were temporary, resulting in high turnover and low career incentives, which has severely hampered the accumulation of experience and long-term capacity for undertaking needed reforms and implementing public policies. It has also provided insufficient deterrence against corruption. A contract could be as short as a few months, and hiring was extremely personalised to the degree that often entire teams were replaced with new hires when a manager changes (OECD, 2016_[103]). All of this breeds a culture of personal loyalty to the immediate superior rather than to the law, institution, the civil service, or the general public interest. Service contracts are also frequently used for political appointments, which reach far below the actual political level of the administration, and are used to reward party members or other connected persons with a government job. Turnover of ministers (on average every 8 months), but also of directors-generals, the highest professional level (every 12 months) is high and increasing (CPC, 2022_[21]). By contrast, in two thirds of OECD countries even the highest level civil servants remain in place with a change in administration (OECD, 2016_[103]). A previous career civil service regime (green bar in the below figure) was “frozen” in 1992 and although positions under this regime can still be re-filled, no new ones can be created (see Box 2.9).

In 2021, this already complex civil service framework was further complicated by new legislation by Congress and a subsequent decision by the Constitutional Tribunal to convert all temporary service contracts that were in force on the day of the law's enactment into permanent ones. All other contract elements – including remuneration, tasks, and other aspects of the job – remained valid, even though they had been individually negotiated outside the civil service's pay scales and human resources frameworks, generally with a view to the temporary nature of the contract. For example, there is not even a defined retirement age for workers on such contracts. Workers have the right to remain indefinitely in the position they held in March 2021, with very limited mobility, possibility of reassignment, advancement, or separation. In late 2021, hiring on temporary contracts was made possible again, but only for new workers.

Figure 2.15. The civil service has become dominated by ad-hoc service contracts



Note: Labels correspond to the number of civil servants under the new civil service regime (Ley 30057) in each year, depicted by purple bars.
Source: Ministerio de Trabajo y Promoción de Empleo (MTPE), Anuario Estadístico Sectorial, 2013-2022.

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Box 2.9. The Peruvian civil service

Prior to the civil service reform, three main contractual regimes existed in public administration:

- **The “old” career civil service regime** (DL 276), established in 1984, was “frozen” in 1992. No new positions under DL 276 could be opened since, but existing positions are turned over and new replacements hired under the legacy contract type.
- **The “private sector” regime** (DL 728), created in 1992, provided for hiring of civil servants on open-ended contracts under the same conditions as in the private sector. Due to budgetary considerations, growth of this regime has mostly stopped.
- **Administrative service contracts** (CAS, DL 1057) allow to hire independent contractors for full-time work in a public institution. Workers enjoy some labour rights, including paid vacation, sick and maternity leave, annual bonuses, and health insurance.

In 2013, a civil service reform was passed (*Ley 30057*). The reform introduces a new professional civil service regime that was designed in consistence with OECD best practices. Its implementation was delegated to the National Civil Service Authority (SERVIR). The main elements of the reform are:

1. Professionalisation of the civil service through meritocratic approaches to recruitment, retention, and job progression.
2. Restriction of political appointments to 5% of all staff in each entity.
3. Standardisation the employment framework into job families and pay grades.
4. Consolidation and modernisation of human resource management (HRM) and training.
5. Mandatory performance management linked to career progression and termination decisions.

Sources: (OECD, 2016^[103]), *OECD Public Governance Reviews: Peru - Integrated Governance for Inclusive Growth*; (OECD, 2023^[104]) *Gestión de las Finanzas Públicas en el Perú: Una revisión de pares de la OCDE*.

This system significantly constrains building a professional, skilled and experienced civil service that embodies modern approaches to public management and a culture of integrity. There is consensus across the public administration that high turnover has prevented experience and other forms of job-specific human capital from being accumulated. The lack of standardised job descriptions, hiring criteria, pay grades, and competitive and meritocratic hiring and performance evaluation processes contributes to skills mismatch and stifles modern human resource management. It also makes assessing the adequacy of a hire's skills and experience e.g. by an external auditor very difficult. The high personal dependence of hired contractors leaves the door open for nepotism and corruption. The virtual absence of defined career paths in the civil service removes a key performance incentive for civil servants (Bertrand et al., 2019_[105]).

Implementation of the 2013 civil service reform (see Box 2.9) has been very weak. Ten years after the reform law was passed, only about 1,700 civil servants (0.2% of the target population) have transited to the new regime (depicted as narrow red bar segments in Figure 2.15). Only 14 institutions (of a total of more than 2,500) have been certified to hire under the new regime (OECD, 2023_[104]); and only 8 have actually done so. One critical factor is the complex and burdensome certification process, which requires elaboration of several advanced human resource management planning instruments, including a complete mapping and classification of all roles in the organisation before the first civil servant under the new regime could be hired. Although this process has recently been simplified, according to the National Civil Service Authority it remains sufficiently complicated to disincentivise entities from following through with certification. In addition, the conversion of temporary contracts into permanent ones has changed the original logic of the civil service reform, which was meant to start with the transition of workers on temporary service contracts. Moreover, the absence of clear deadlines to complete the process, and the absence of earmarked funds for the transition, limits institutional incentives and results in implementation being perceived as voluntary rather than mandatory.

Another key constraint is the apparent lack of individual incentives for most civil servants to transit to the new contract. An important disincentive is related to differential tax treatment. Service contracts are taxed as self-employment income, which enjoys a much higher personal tax allowance than wage income and dispensation from mandatory pensions affiliation. Beyond the fact the service contract remuneration is negotiated outside any reference frame, compensation comparisons are complicated by the fact that for some civil servants, as little as 10% of their gross pay corresponds to nominal wages (which are often frozen at their early 1990s values), with the difference made up by various allowances and bonuses. This muddles pay comparisons and blurs career profiles and creates an informal sector among the government's own employees. In most OECD countries the largest part of public sector remuneration consists of base salary. Allowances and other remuneration concepts play a more exceptional role to compensate specific working conditions, skills, or responsibilities (OECD, 2021_[106]). Moreover, the pay scale of the new civil service contract was set in 2014 and has not been updated since. Many civil servants further express concerns about how mandatory performance evaluations under the new civil service regime would affect them.

A new impulse for implementing the civil service reform is necessary, with political support from the highest level and the backing of the whole of government. A more gradual and flexible approach to implementation that prioritises conversion of individual civil servants to the new scheme seems the most promising path. This could include offering one-time bonuses to civil servants for making the transition; linking conversion to career progression; providing greater budgetary leeway to individual entities for conversions; making pay grades more flexible and tailored to the requirements of different institutions; and non-economic incentives. This might require mobilising more resources than currently foreseen, especially in the short term as transitions might result in temporary duplicity of expenses, and because many of the parameters of the framework such as salaries were set a decade ago. Better individual incentives should be complemented by other measures, such as automatically re-assigning posts to the new contract type whenever they become vacant due to natural turnover.

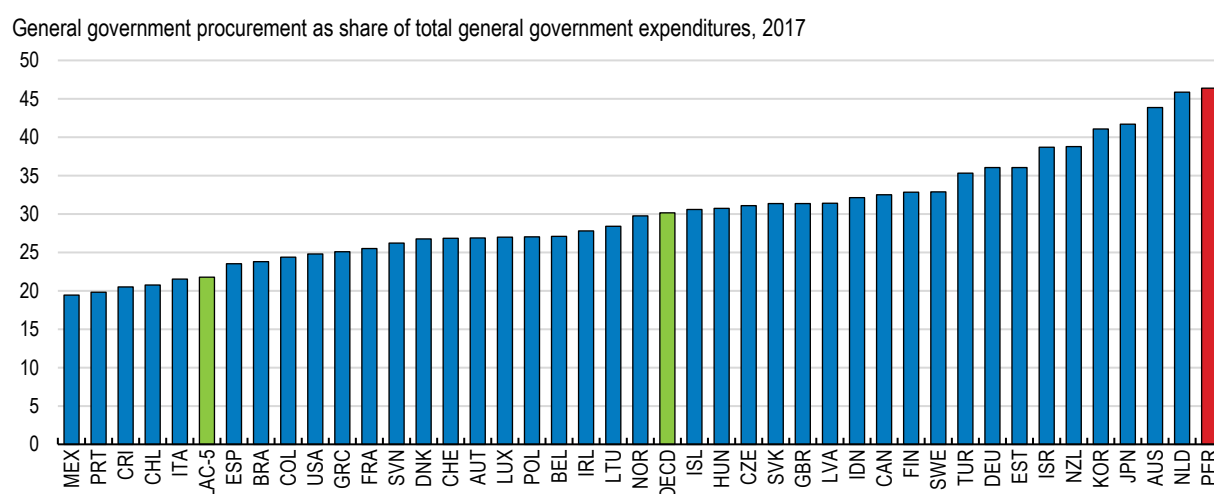
Such renewed efforts should be accompanied by a systematic and independent assessment in order to measure progress and be able to take informed actions to adjust the implementation of this important reform. This could include evaluating the success of different contract parameterisations on conversions to fine tune the most effective combination of incentives. For example, a pilot initiative in Mexico used modern impact evaluation methods to assess the effects of different monetary and monetary incentives in attracting public sector workers (Dal Bó, Finan and Rossi, 2013^[107]). Simulations of net and gross pay under the existing system and suitable reform options can also help assess the net fiscal cost of the reform.

Strengthening public procurement

Public procurement plays an outsized role in the activities of the Peruvian government. Half of all government expenditure is devoted to public procurement, more than in any OECD country (Figure 2.16). Public procurement is also a critical factor in the strategic government objectives of closing gaps in infrastructure and service provision. As the difficult experiences with procuring protective and medical equipment during the COVID-19 pandemic, and the failure to procure alternative fertiliser supplies following Russia's large-scale invasion of Ukraine have underlined, effective, efficient and resilient public procurement is vital for supporting lives and livelihoods. At the same time, in most OECD countries public procurement is one of the highest-risk areas for corruption, underlining the need to create transparent procurement systems with solid risk management (OECD, 2016^[108]).

Public procurement in Peru consists of a comparatively large number of actors, with sometimes competing roles: the central purchasing body (*Perú Compras*), the procurement supervisor (OSCE), contracting authorities, the Comptroller General, and the Ministry of Economy and Finance. OSCE and the ministry play a strong central supervision and approval role; they define very detailed budget lines and maintain mandatory electronic purchasing and public investment systems. At the same time, procurement is decentralised into over 3,000 entities, including more than 2,000 subnational governments. There is a strong and well-known freedom of information law, and a high degree of transparency through routine disclosures. For example, information both on individual contracts as well as aggregate statistics on procurement trends are made publicly available. These are widely used by the media and the general public to monitor integrity in contracting with the government.

Figure 2.16. Public procurement makes up a large share of government spending



Note: LAC-5 is the unweighted average of BRA, CHL, COL, CRI, and MEX. Data for ARG is not available.

Source: (OECD, 2020^[29]) *Government at a Glance: Latin America and the Caribbean*.

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Public procurement in Peru has historically focused more on ensuring compliance with procedures than on driving efficiency and ensuring value for money (OECD, 2017^[74]). Around 1.2-1.9% of GDP each year is lost due to inefficiencies in public procurement in Peru (BCRP, 2023^[109]). The World Bank estimated that more efficient procurement strategies would yield up to 0.4 percentage points of GDP in fiscal savings (World Bank, 2017^[110]). A new procurement law in 2014, and subsequent legislative changes in 2018, shifted the focus towards efficiency and value for money and created the central purchasing body. The planned next steps are to amend the law to new contract types that have already been tried out in government-to-government projects under foreign law, and to put greater emphasis on using procurement strategically to improve sustainability, corporate social responsibility, and support innovative domestic firms. These measures represent further steps in the right direction. Other important areas for improvement are increasing the number of bidders in public tenders to make the public buyer benefit from competition, and to fight bid-rigging (OECD, 2021^[111]).

Public procurement would benefit from strengthening the effective role of the policies defined in the public procurement law such as centralised purchasing. The main goal of central purchasing systems in the OECD is to increase efficiency in purchasing by leveraging the buyer power of a large purchaser to obtain lower prices and reduced transaction costs (OECD, 2017^[74]). Counterintuitively, achieving this might require providing contracting authorities with more flexibility and reducing excessively strict and cumbersome regulatory processes. For example, unlike Peru, most OECD countries make the use of framework agreements mandatory only for contracting authorities at the central level, but voluntary at other levels (OECD, 2019^[112]). Voluntary agreements have to be competitive to incentivise local authorities to use them. By contrast, in Peru, contracting authorities seem to find ways to get around notionally mandatory mechanisms that are seen as too rigid and bureaucratic. One third of the total procurement volume consists of small contracts below PEN 40 000, that fall outside the scope of the public procurement law, and this share has strongly increased over time (OSCE, 2022^[113]; OSCE, 2018^[114]). According to the Comptroller General, procurement contracts tend to be divided into smaller instalments so that they fall below the threshold (CGR, 2023^[115]). This not only opens the door to corruption, but also cancels any potential benefits from bulk purchasing. At the same time as making centralised purchasing tools more attractive, authorities should detect and sanction divisions of contract volumes that evade the procurement law, monitor the efficiency of procurement at the entity level, and use the Ministry of Finance's transaction databases to actively promote the use of centralised contracting. Greater use of centralised contracting mechanisms would also be facilitated by improving planning capacities and budget security of local governments (see below), as well as by avoiding the creation of new special purchasing regimes.

Greater professionalisation of the procurement function would enhance capacity, facilitate strategic workforce planning, and help disseminate the strategic vision of the national procurement system from the centre of government to contracting authorities. Many OECD countries are currently grappling with the development of a procurement professionalisation strategy. Procurement is recognised as a standalone administrative profession only in a third of OECD countries (OECD, 2023^[116]). It requires a unique skills profile that mixes law, economics, public administration, and other fields (OECD, 2017^[74]). Given the large number of entities in Peru's procurement system, a recognised procurement professional career could lead to greater policy coherence, attraction of talent, and accumulation and diffusion of experience. An existing training and certification programme, run by OSCE, could serve as a basis for that purpose. A recent evaluation using the OECD MAPS methodology provides policy options to increase professionalisation (OSCE, 2019^[117]). Advancing the implementation of the civil service reform would support the professionalisation efforts in public procurement.

Improving multi-level governance and coordination

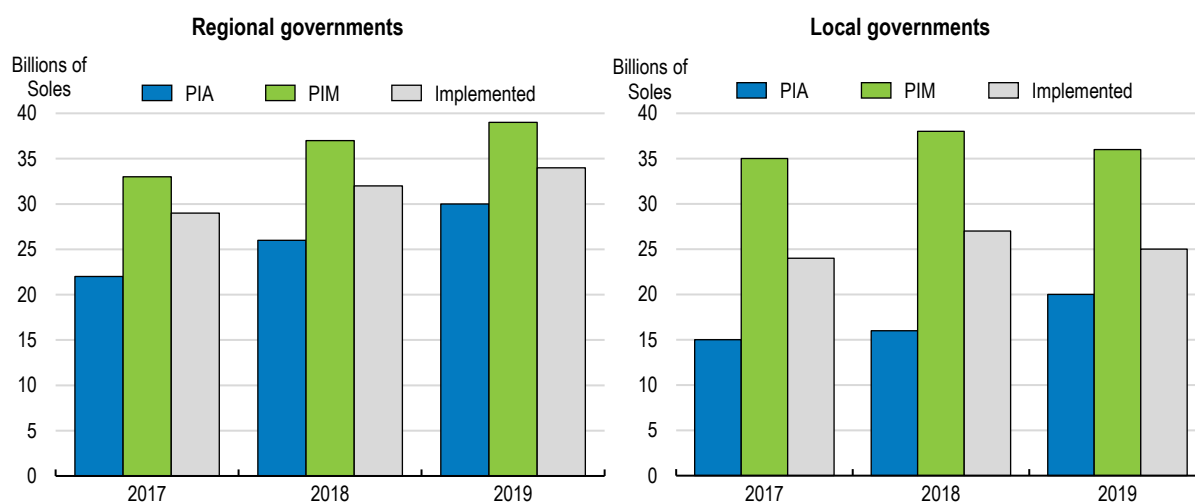
Sub-national governments are responsible for 62% of public investment in Peru, more than in most OECD countries. Typically, only federations such as Mexico, Switzerland, Australia or Germany assign a higher expenditure share to sub-national entities. Most sub-national spending corresponds to local governments,

of which there are more than 1,800 in Peru. These governments mostly have no resources on their own, but rather are allocated a quota of the national budget, often tied to specific income sources (OECD, 2023_[104]).

The predictability of the committable annual budget for local authorities is weak. Although a multiannual financial framework exists at the national level, and budget lines for individual entities including subnational governments are determined at the beginning of each year in the budget approved by Congress, final funding allocations are only determined towards the end of the fiscal year. While small inter-annual adjustments occur in many OECD countries, in Peru such adjustments correspond to more than 50% of the approved budget, on average (CGR, 2022_[118]). At the extreme, for local governments, such variation implies that the final budget can reach two to three times the initial amount (Figure 2.17). Since this difference is systematic, the initial budget is not credible and all actors expect it to be raised; but since local authorities can commit funds only when they are included in a formal budget, this greatly constrains their annual planning (OECD, 2023_[104]). This is one factor behind the low budget implementation capacity of local governments, which in 2021 amounted to 65% of the (end-of-year) budget (Comex Perú, 2020_[119]).

Greater predictability and ability to make realistic annual spending plans would help budget implementation of subnational governments. One key element seems to be closing the gap between initial and end-of-year budget lines. This likely requires complementary measures, such as de-linking individual expenditure and revenue items, improving initial revenue forecasts, and introducing effective budget control mechanisms (OECD, 2023_[104]). Improving the technical quality of project appraisals, especially for larger and more complex projects, would result in more realistic cost estimates that could be reflected already in the initial budget. Other recommendations of this Chapter, such as improving internal control mechanisms in public institutions, deterring corruption and professionalising the civil service, would likely also contribute to the success of such measures by improving capabilities and accountability of local governments. This could also lay the ground for the assignation of own resources and rule-based transfers to subnational governments, managed under their own responsibility; as is the case in most OECD countries.

Figure 2.17. Initial budgets for subnational governments systematically understate available funds



Note: PIA = initial budget (*presupuesto institucional de apertura*); PIM = final budget (*presupuesto institucional modificado*).

Source: (OECD, 2023_[104]) Public Financial Management in Peru: A Peer Review.

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Better coordination between national, regional and local governments would increase efficiency in several areas, including investment planning and public procurement. First, there is a lack of mechanisms for coordination between regional governments and municipalities. Regional governments could take up such

a coordinating role within their territory, and also undertake more sub-regional projects that benefit several municipalities but which are beyond the scale and capacity of individual local jurisdictions; as discussed in Chapter 1. The “micro-regions” program in Mexico, which bundled interventions by several ministries in a group of rural localities, with involvement of and accountability to local communities, might be another example to consider (OECD, 2003^[120]). Second, investment projects by ministries or subnational governments are often not connected to strategic plans or holistic needs assessments; and neither are fiscal plans (OECD, 2016^[121]). The national infrastructure plan, despite its strategic orientation and focus on closing infrastructure gaps, has a focus on megaprojects executed at the national level without involving subnational governments (OECD, 2023^[104]). Recent legislation that encourages subnational governments to align their local projects with the plan, is a step in the right direction. Colombia, for example, derives its prioritisation of transport infrastructure projects from a holistic transport masterplan based on high-quality data and empirical methods (OECD, 2023^[104]). Subnational and sectoral development plans could also be more closely aligned with national priorities and policy objectives, such as the ones articulated in the National Infrastructure Plan, National Competitiveness and Productivity Plan and the Strategic National Development Plan. Public procurement could benefit from better coordination among buyers such as local governments to strategically aggregate demand and take advantage of better prices and conditions through framework agreements and corporate purchases (OECD, 2017^[74]). Critically, this would again require public entities to make realistic annual plans of their procurement needs rather than engaging in small-scale, reactive purchases (OECD, 2021^[111]).

Strengthening the governance of public infrastructure investment

The private sector plays a significant role in infrastructure investment in Peru. Private sector involvement is usually done through Public-Private Partnerships (PPPs) and Works for Taxes, a mechanism through which public investment projects are financed and implemented by private firms. Together these mechanisms account for over 1% of GDP in infrastructure investment per year. Peru was an early adherent, in 2016, to the OECD Principles for Public Governance of Public-Private Partnerships. Foreign governments also participate in infrastructure investment through Government-to-Government (G2G) agreements, which were pioneered in Peru for the implementation of the 2019 Pan-American Games and have since included other areas, for example with France for the delivery of equipped hospitals. PPPs and G2G agreements usually correspond to major infrastructure works, such as highways, ports, airports, large-scale irrigation projects, and urban transport networks while Works for Taxes projects have typically smaller volume, for example schools or urban roadworks. The government is currently creating a central project management office, the National Infrastructure Authority, to manage all major infrastructure projects and to ensure their resilience against natural disasters.

Given the size of investment needs in Peru and the importance of respecting fiscal rules, involving the private sector is of utmost importance. Furthermore, given the documented limitations of technical and project management capacities at national and subnational levels, burdensome procurement processes, corruption, and substantial cost overruns and delays, including through frequent judicial disputes between the state and construction companies, the private sector (and foreign governments) is perceived to be more efficient in delivering projects (IFC, 2018^[122]). Other advantages are risk-sharing between private and public actors, and the fact that (under PPP and Works for Taxes) initial construction is pre-financed by the private counterpart, and only paid back over time by the state through transfers or foregone income. The Peruvian state, through its investment promotion agency ProInversión, actively encourages private participation in infrastructure projects. At the same time, implementation of private-public partnership projects might also come with potential drawbacks, including misaligned incentives, inadequate control over projects and their costs, and implicit fiscal contingencies (World Bank, 2017^[123]). This requires strong and effective governance arrangements for public infrastructure projects.

Authorities should continue to strengthen governance of public-private and G2G projects, ensure an appropriate choice of project implementation mechanism, and build capacity in the public sector. This

includes continuously evaluating and improving value for money metrics; including retrospectively when the true costs of projects become known. The new central project management office will help anchor project management expertise in the government, and contribute to stronger project governance. A remaining challenge is strengthening such expertise beyond megaprojects, especially in local and regional governments. The most common mechanism used there, Works for Taxes, has no built-in learning component, other than how to administer the programme itself (Backus, Proinversión & USAID, 2015^[124]); and firms often implement projects that are far away from their core business competence (e.g. a brewery might deliver a school to a local government). Authorities should also evaluate the efficiency of Works for Taxes beyond completion times, since the full cost pass-through provides itself no incentives for cost-saving project implementation.

Knowledge transfer and capacity-building in sub-national governments to supervise and eventually implement projects should be enhanced. For example, local governments could be more systematically involved in centrally managed infrastructure projects in their territory, both direct works and those implemented using PPP, G2G and Works for Taxes. Colombia's *Contratos Plan* might be a useful example for Peruvian authorities to consider. Those contracts are binding agreements between the national government and sub-national authorities to coordinate their investment agenda and jointly deliver a defined list of interventions (OECD, 2016^[121]; OECD, 2014^[125]). Within the contract framework, the sub-national government has certain autonomy to decide on how to allocate the given budget to achieve the plan's objectives, while working together with national officials. This contributes to building implementation capacities at the subnational level.

Better monitoring of the physical advancement of infrastructure works would help advance projects. Currently, the government only monitors budget execution of public works, not physical execution. There is a system maintained by the Comptroller General's Office (Infobras) that systematically publishes information on project execution, but it relies on self-reporting of the physical execution status, thus leading to a vast underreporting of physically paralysed projects. In addition, the Ministry of Economy and Finance also monitors publicly and privately implemented investment projects, including those prioritised in the national infrastructure plan. The new project management office could be responsible for monitoring project execution with a risk-based approach, and intervene with the contracting authority to provide support when possible interruption is detected in financial data. This requires coordination with the Comptroller General's Office, which through new concurrent audit mechanism already provides such monitoring from an audit and control (and less from a project management) perspective, and other entities.

Table 2.2. Main findings and recommendations

FINDINGS	RECOMMENDATIONS (key recommendations in bold)
Promoting competitive and innovative markets	
Many markets are dominated by a few large firms. Market concentration predates a recently introduced general merger control scheme.	Increase competition enforcement and improve detection of cartels and abuse of dominance. Improve incentives to better retain qualified competition experts.
Barriers to starting a business are largely due to delays and complexities in obtaining municipal operating and construction licenses and permits.	Introduce one-stop shops that integrate municipal and national procedures for starting a business.
New legislation for regulatory policy that includes stakeholder engagement, regulatory impact analysis, and ex-post evaluation has been adopted and is being slowly implemented.	Ensure effective gradual implementation of the new regulatory policy law, with a focus on training and capacitation of officials.
Financial inclusion is low and concentration in the banking and payment systems is high. The payment systems market underwent rapid change during the pandemic with the entrance of new digital payment systems.	Promote competition in the payment systems market, for example by reviewing and potentially revising financial regulations.
Openness to trade is high, but exports are dominated by commodities, with high dependence on specific goods and export markets.	Gradually diversify exports and upgrade the position in global value chains by improving logistics infrastructure and supporting industrial clusters.

Strengthening the rule of law	
High corruption significantly affects the business environment, rule of law, and policy implementation capacity. Few detected irregularities lead to successful prosecution. Preventive anti-corruption measures have recently been introduced, but there is room for improvement.	<p>Establish a comprehensive strategy for effective corruption deterrence by strengthening preventive anti-corruption measures and implementing complementary reforms in key areas of justice, civil service, public procurement, infrastructure governance, and regulatory transparency.</p> <p>Strengthen internal control mechanisms and concurrent audits, ensuring their complementarity in corruption prevention.</p>
The justice system lacks in transparency, accessibility, efficacy, and fairness. Large case backlogs and long delays hamper the administration of justice. Judicial corruption is high. Overuse of temporary judge positions creates inefficiencies and conflicts of interest.	<p>Reduce the share of temporary judges by replacing them with career positions.</p> <p>Define clear criteria for tenure and career advancement of career judges. Advance the introduction of a digital case management system that is interoperable across all institutions in the justice system.</p>
Improving state capacity for public investment and service delivery	
The civil service is fragmented and over-reliant on ad-hoc service contracts with high turnover and low career incentives. A civil service reform has failed to be implemented.	<p>Improve individual and institutional incentives for civil servants to switch to the new regime.</p> <p>Perform progress and impact evaluations of this new implementation stage to inform any further adjustments that might be required.</p>
Centralised purchasing tools are underutilised, and many small contracts fall below the threshold for application of the public procurement law.	<p>Increase the attractiveness of centralised purchasing tools through administrative simplification and providing greater flexibility for contracting authorities.</p> <p>Sanction the undue division of contracts.</p>
Infrastructure gaps require significant investment. Subnational governments bear the responsibility of implementing most infrastructure projects, but face budget execution challenges and local projects are disconnected from national plans.	<p>Improve the technical quality of national infrastructure planning and coordination and consistency of national plans and local infrastructure project implementation.</p> <p>Improve the budget process and ensure a predictable and committable annual budgeting mechanism for subnational governments.</p> <p>Enhance formal co-ordination mechanisms between levels of governments and strengthen the role of regional governments in coordination and planning of regional development.</p>
The private sector and foreign governments play a crucial role in infrastructure development, given high investment needs and fiscal constraints. Public sector implementation capacity is weak, especially in subnational governments. Governance and evaluation against value for money could be improved.	<p>Provide the new National Infrastructure Authority with technical capacity and budget.</p> <p>Promote knowledge transfer and capacity generation especially in subnational governments.</p>

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3 All together: Making growth more inclusive in Peru

Paula Garda

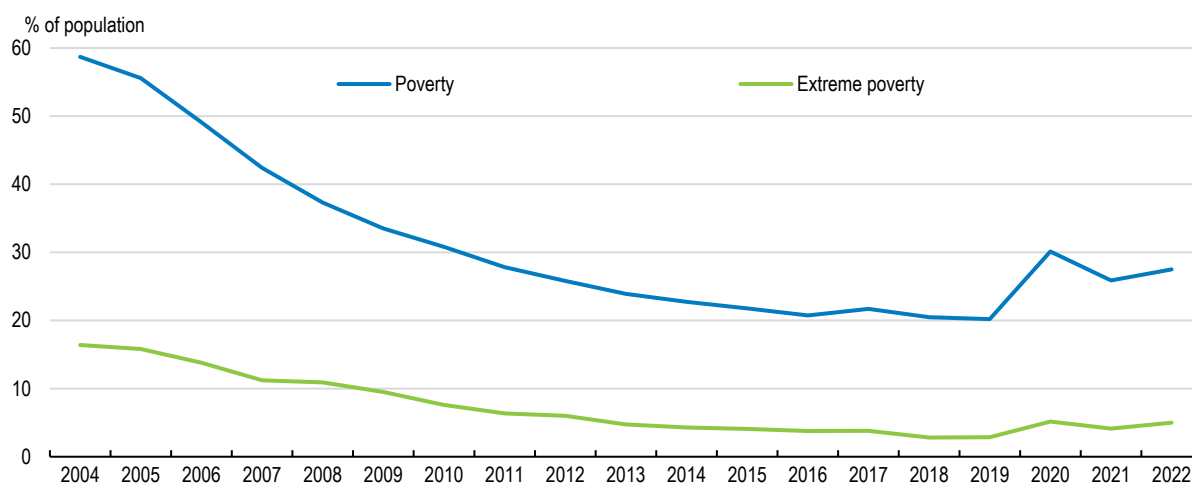
Elena Vidal

Peru has experienced a steep reduction in poverty and inequality in the last two decades. However, the COVID-19 pandemic has worsened Peru's social disparities, particularly due to the high social protection gaps, a large proportion of informal workers without access to employment protection or social insurance, and unequal access to high-quality education and health services. The prevalence of informal employment, which accounts for over 75% of the workforce, presents significant challenges to reducing poverty, addressing inequalities, and promoting inclusive economic growth. To significantly increase formalisation and social protection coverage, deep reforms to social security, including the pension and health systems, and social assistance schemes, coupled with changes in labour, educational, and training policies, are needed. These reforms will require additional fiscal resources. A politically viable reform agenda should be gradual and follow an adequate sequencing and prioritisation of reforms. These reforms will not only allow to reduce poverty and inequalities, but also to boost productivity.

Introduction

Peru has experienced remarkable success in reducing poverty over the last two decades. Poverty fell by 38 percentage points between 2004 and 2019, an average of 2.5 percentage points per year (Figure 3.1), one of the steepest reductions in poverty during that period in Latin America. Sustained economic growth and macroeconomic stability driven by a robust macroeconomic framework and structural reforms played a crucial role in poverty reduction.

Figure 3.1. Poverty reduction has been steep over the last two decades



Note: Poverty rates using the national definition based on the calculation of the basic food consumption basket.

Source: INEI.

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However, the COVID-19 pandemic has also exposed major structural problems, such as a high share of informal workers with no social insurance, the low coverage of social assistance programmes, and unequal access to education. Peru was among the hardest-hit countries, experiencing high rates of infection and deaths, as well as a significant decline in economic activity. The comprehensive social emergency response was crucial in preventing steeper fall in incomes; however, Peru needs to redouble its efforts to prevent the impacts generated by COVID-19 from becoming permanent and deepen pre-existing inequalities.

Widespread informal employment in Peru, accounting for over 75% of the workforce, poses significant challenges to reducing poverty, addressing inequalities, and promoting inclusive economic growth. Informal workers lack employment protection, sick leave, and social insurance benefits, which leaves them vulnerable to poverty. Although informality is widespread along the income distribution, many of them earn low wages, have meagre savings or poor access to credit to rely on during crises, and have limited access to the internet and digital tools and policy support, such as wage subsidies and state-guaranteed loans. Informal workers are often exposed to poor housing conditions, such as overcrowding and inadequate sanitation facilities. Women, young and rural areas face larger informality. All these factors exacerbated the impact of the COVID-19 pandemic. Informal workers typically have limited access to training, and often work in small and low-productivity firms which avoid expanding their businesses to avoid detection by regulatory agencies, hindering overall productivity and tax collection.

Many Peruvians work in informal jobs because they lack the education and skills required for formal jobs. Learning outcomes are not only low but also largely driven by families' socio-economic status, perpetuating inequalities, and poverty. Such poor outcomes are caused by limited access to quality educational infrastructure and materials, insufficient teacher quality, and inadequate public financing. Higher education

is often misaligned with labour market needs, leading to skill mismatches. The outbreak of the pandemic has made things worse by causing long school closures and creating large learning losses and gaps between those who had access to distant learning and those who didn't.

Among the many roots of informality, including low access to high-quality education and training and a weak institutional framework and enforcement, high labour costs are a key factor, resulting in low social insurance coverage. High labour costs, driven by strict employment regulations and mandatory social contributions, which fund social insurance benefits such as pensions, health, and unemployment protection, discourage formal job creation, particularly for low-income and vulnerable workers. High non-wage costs, bundled with a relatively high minimum wage, close to the median wage, and complex and strict regulation of formal employment, leave many workers in informal jobs. Because regulations are imperfectly enforced, firms regularly evade the costs of social insurance and hire salaried workers informally.

To increase social protection coverage, authorities have created multiple regimes that allow smaller firms to pay lower contributions and taxes. However, these schemes create awkward incentives for firms, encouraging them to remain small and informal with low productivity. A fragmented health system leads to deficiencies diminishing access to high-quality services. A pay-as-you-go public pension system operates alongside a funded private pension component, creating competition instead of complementarity, leading to inefficiencies and inequities in access to a system with low coverage and pension benefits. The popularity of withdrawals from private pension funds since the pandemic indicates discontent with the pension system and creates significant old-age poverty risks, which could turn into a contingent fiscal risk.

Peru has established non-contributory pillars in pensions and health to address the lack of coverage in social protection in the last two decades. These have been complemented by social assistance programmes, including conditional cash transfers to fight poverty. However, non-contributory pensions and cash transfers programmes have low coverage and benefit levels due to limited financial resources. The non-contributory health system provides universal coverage, but its provision of equal health benefits to informal, either for free or at a reduced cost, and formal workers, promotes informality.

A comprehensive, long-term strategy is needed to significantly increase formalisation and social protection coverage in Peru. This requires deep reforms to social security, including pensions and health, and social assistance schemes, coupled with changes in labour, educational, and training policies. These reforms must be accompanied by improvements in the enforcement of labour and tax laws, while making the labour market more flexible and decreasing non-wage labour costs, strengthening the institutional framework, simplifying the tax system and improving product market regulations. Implementing these reforms will require additional fiscal resources, but Peru has ample room to do so, given that Peru's tax revenues are low by international and Latin American standards and there is also space to improve spending efficiency, as outlined in Chapter 1. It will be essential to ensure that spending reforms are fiscally sustainable. To achieve this, it is necessary to first increase permanent public revenues, allowing for a gradual implementation of spending reforms while maintaining fiscal responsibility. The political economy of overhauling existing institutions and frameworks, along with implementing tax reforms to secure additional revenues, is likely to be challenging. But the benefits of such reforms in terms of higher living standards for all, lower informality, higher revenue collection, and higher productivity are worth. The need to revert the pervasive impact of the COVID-19 pandemic along with the OECD accession process, could serve as a catalyst for the necessary political debate.

A politically viable reform agenda should be gradual and follow an adequate sequencing and prioritisation of reforms. First, social assistance programmes, including non-contributory pension benefits and programmes to tackle poverty could be gradually strengthened. A comprehensive pension reform should also address existing inequalities. Secondly, gradually reducing labour costs of formal job creation for low-income workers would reduce informality and benefit productivity, equity, and public finances at the same time. This will require the gradual modification of current schemes that charge social security contributions

based on firm size, transitioning to a system of progressive social contribution rates based on workers' incomes. Improving access to high quality health services will require gradually increasing the financing of health from general taxation and tackling the fragmentation of the health system. Improving the quality and access to education should proceed gradually and would raise formality and productivity while reducing inequities and boosting female labour force participation. Reducing low-income workers labour costs would not only particularly benefit low-income workers by boosting formal employment, but would reduce gender inequalities in the labour market by boosting female formal job creation. Clear communication on the benefits and costs of reforms will also be instrumental to gather support for the reforms.

This chapter analyses the challenges and shortcomings of the current labour market, social protection and education frameworks and reviews policy options to boost formal employment, which is one of the most salient policy priorities for Peru. The benefits of the discussed reforms should be potentiated by simultaneous policy action in other policy areas, including reforms to boost the structurally low and stagnant productivity and investment, as discussed in Chapter 2 of this Economic Survey.

Poverty and inequality remain high

Poverty and inequality significantly declined in Peru in the last two decades (Figure 3.2, Panels A and B). Poverty reduction was particularly rapid during the commodity price boom from 2004 until 2015, but since then, the pace of poverty reduction has slowed, stagnating since 2018, and even reversed during the pandemic. Inequality has also declined compared to other Latin American countries, particularly during the commodity price boom (Figure 3.2, Panel B). The middle class, measured as those with daily income between USD 5 and 12.4, also grew substantially during the same period, by around 25 percentage points to 75% of the population, but in 2017 42% of the population remained vulnerable to falling into poverty (de la Cruz, Manzano and Loterszpil, 2020^[1]).

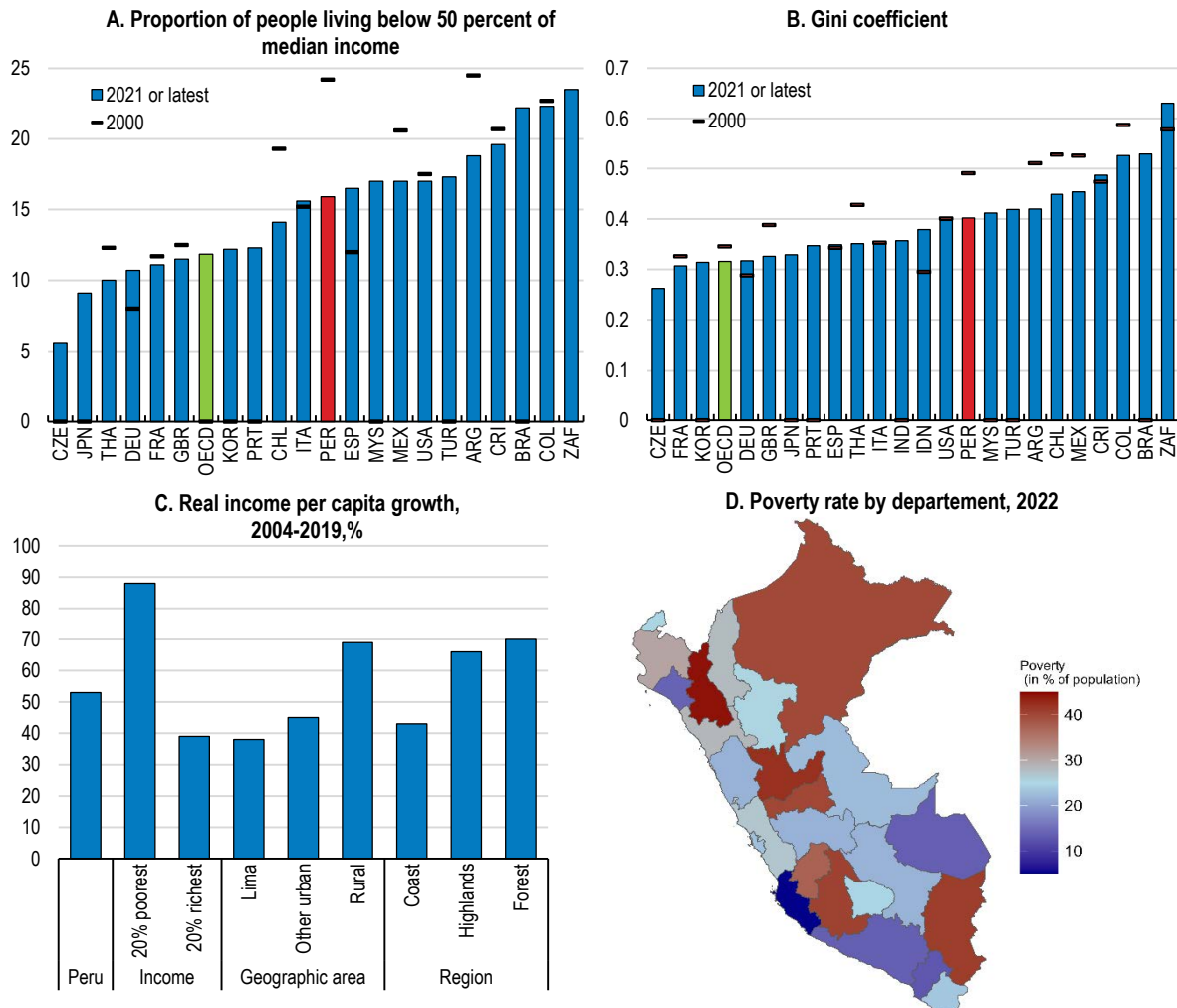
The main factor contributing to the overall decline in inequality is the reduction of inequality within regions (Castillo, 2020^[2]). While economic growth between 2004 and 2019 benefited more the poorest rural areas, the highlands, and forests (Figure 3.2, Panel C), these regions still face persistent disparities with higher poverty levels. However, poverty has become increasingly more urban. Poverty in urban areas increased 6 percentage points between 2011 and 2022, while in rural areas it decreased 15 percentage points. Finally, although poverty levels began to decline again in 2021, they remain high and experienced an increase in 2022 due to high inflationary pressures, particularly in specific regions (Figure 3.2, Panel D).

Peru is a diverse country with a rich ethnic composition. Mestizos make up the largest ethnic group in Peru, comprising approximately 60% of the population, including individuals of mixed indigenous and European ancestry. The Quechua population is the largest indigenous group, comprising approximately 20% of the population. The Aymara population is estimated to be around 5% of the total population. Afro-Peruvians represent about 4% of the population, while the white population, which refers to individuals of primarily European descent, represent around 6% of the population according to the Census of 2017. Ethnic economic inequalities have also narrowed in the last two decades, with the mestizo group surpassing the white group in expenditure per capita due to rural-to-urban migration and increased access to education. The indigenous population has also seen a reduction in the income gap relative to the white population, albeit at a slower pace than mestizo, partly due to a lower rate of rural-to-urban migration (Salinas, Zamora and Chavez, 2022^[3]). Nevertheless, indigenous peoples and the Afro-Peruvian population typically face higher poverty rates than the rest of the population. By 2021, the poverty rate was 7 to 8 percentage points higher among indigenous and Afro-Peruvians than among the white or mestizo population (World Bank, 2023^[4]).

Over the past two decades, economic growth has been the primary factor driving poverty and inequality reduction and the growth of the middle class in Peru (Mazeikaite, 2022^[5]; World Bank, 2023^[4]; OECD, 2016^[6]). Social assistance programmes have also played a crucial role (Mazeikaite, 2022^[5]; Correa,

2021^[7]). In-kind transfers, particularly education and healthcare services, also contributed significantly to living standards (Lustig, 2016^[8]). However, taxes and transfers had a relatively low redistributive impact compared to peer countries in Latin America due to low social spending (Lustig, 2016^[8]; Jaramillo, 2013^[9]).

Figure 3.2. The COVID-19 pandemic reversed a long decline in poverty and inequality



Note: In Panel A, poverty is defined as the share of people living in a household below the 50% of the median disposable household per capita income (or, in some cases, consumption expenditure). This poverty measure is different from the national definition of poverty by INEI, which is used in Panel D. Panel D shows poverty using the national definition based on the calculation of the basic food consumption basket.

Gini index measures the extent to which the distribution of income (or, in some cases, consumption expenditure) among individuals or households within an economy deviates from a perfectly equal distribution.

Source: INEI; World Bank, WDI; OECD, IDD database.

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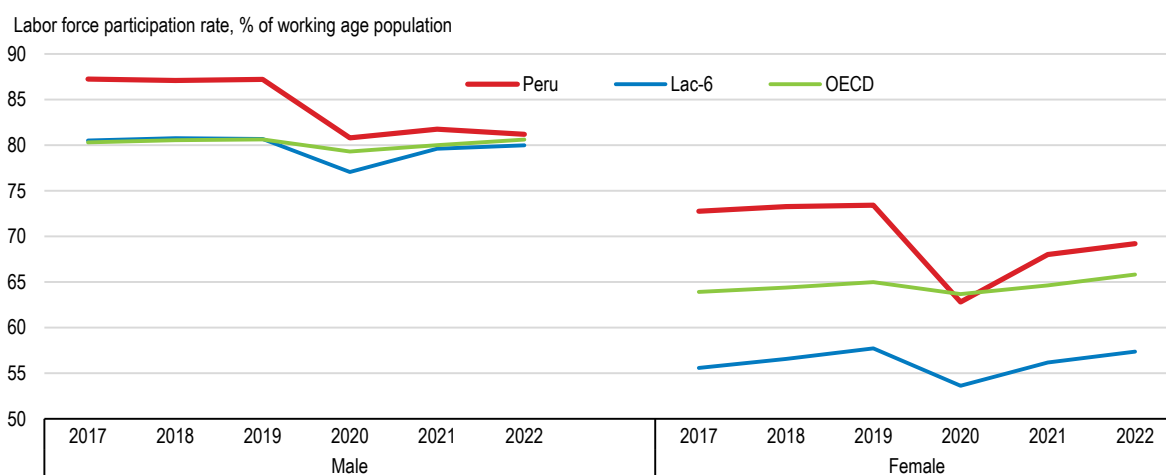
Widespread informality undermines convergence to higher living standards

Despite a decrease in informality over the last two decades driven by economic growth, informality remains stubbornly high and has even increased again since 2019 (Figure 3.4, Panel A). Approximately three out of every four workers are informal, and even more in the case of women and rural areas, one of the highest shares among Latin American countries. While informality is prevalent across the income distribution, low-income households are mostly informal (Figure 3.4, Panel B), and informality is associated with high levels of poverty, income inequality, and social exclusion (Box 3.1), particularly in highlands and forest regions where informality rates exceed 85% (Figure 3.4, Panel C). Small firms are typically informal and tend to

have a higher proportion of informal workers (Figure 3.4, Panel D). Larger firms, more often formally established, also hire workers informally. More than half of the population lives in a household that depends solely on informal employment, while another 30% lives in households with at least one informal worker (OECD et al., 2021^[10]). High informality rates are the other side of the coin of low unemployment rates, which averaged 3.9% during 2015-2019 and rose to 5.7% in 2021. Workers often turn to informal work, often self-employment, to sustain their income during periods of unemployment.

Persistent gender gaps in the labour market undermine economic and social well-being. Although the participation rate gap between men and women is relatively low compared to other Latin American and OECD countries (Figure 3.3), it increased from 17% in 2019 to 20.5% in 2020. When in employment, they tend to hold lower quality jobs. Women are more likely to be self-employed (38%, compared to men's 35%) and work in informal jobs (75%, compared to men's 68%). Informality among women worsened with the COVID-19 pandemic and is a significant contributor to labour market disparities between men and women (OECD, 2022^[11]). Around 22.1% of women are unpaid family workers or domestic workers, compared to only 5.7% of men. Women face a greater burden of care responsibilities at home, which further limits their job prospects and development. These differences between men and women translate into differences in labour income. The gender pay gap was already significant before the pandemic, with women earning 12% less than men on average in 2019. However, this gap widened to 19% during the pandemic, and women in households with school-age children face an even larger pay gap of 23%. Access to high-quality childcare is insufficient and highly unequal across the income distribution, exacerbating the impact of the pandemic on women's labour market outcomes.

Figure 3.3. Female labour force participation is relatively high but decreased during the pandemic



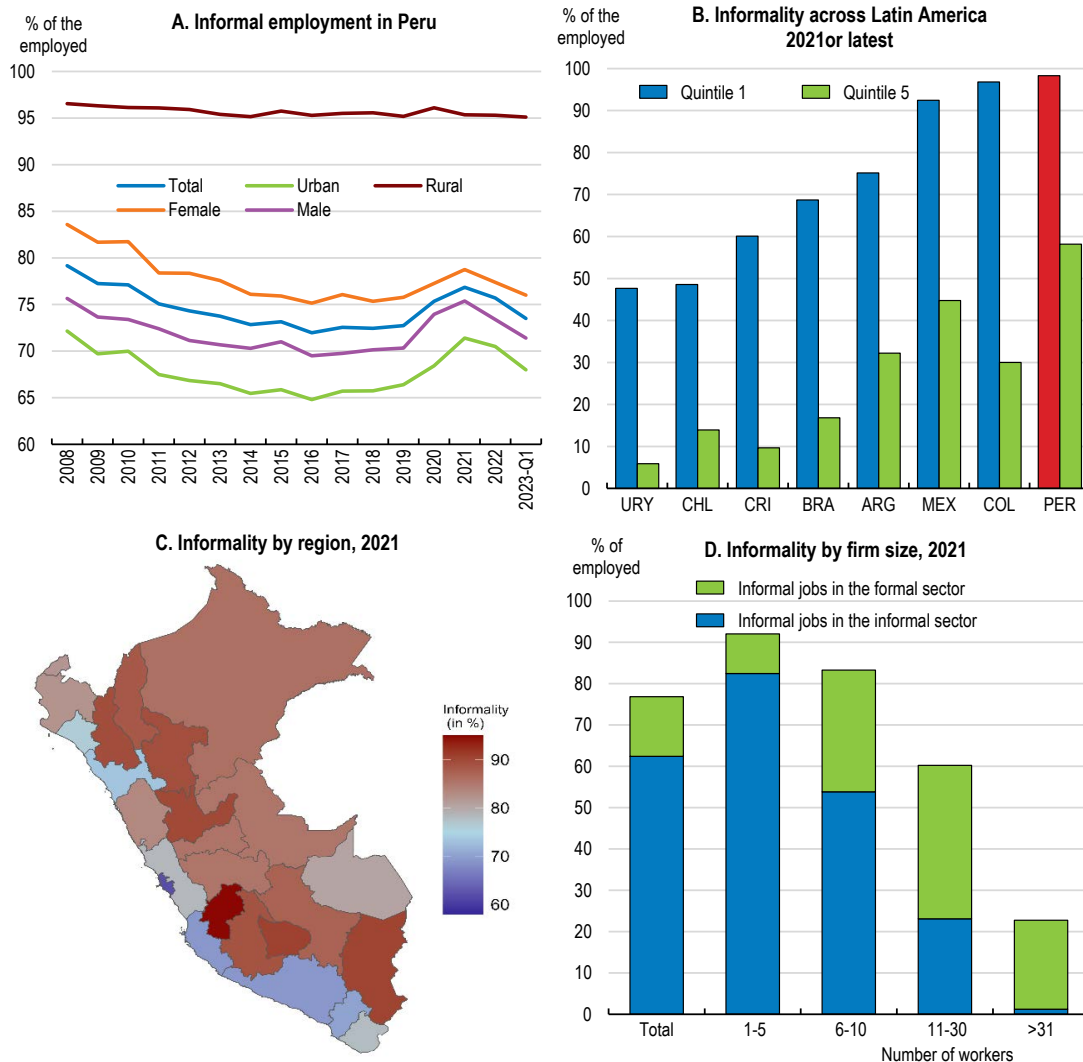
Note: LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX.

Source: ILOSTAT database; OECD LFS database.


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Ethnicity and migration status are additional factors that contribute to labour market disparities and informality in Peru. Informality is very high among indigenous people (89%) and Afro-Peruvians (82%). Venezuelan migrants are also vulnerable, with more than 1.4 million living in Peru in 2022. Despite their potential to contribute to the economy, they face significant barriers. Although most are of working age and have more years of education than the Peruvian average, 94% of Venezuelan migrants work informally and lack access to adequate housing and health insurance. The hourly earnings of Venezuelan workers are approximately 37% lower than those of their Peruvian counterparts who perform similar job functions. The job security of these workers is further threatened due to their migrant status and limited ability to validate their educational degrees, which adds to their vulnerability in the labour market (World Bank, 2023^[4]).

Figure 3.4. Informality is stubbornly high and affects the vulnerable the most

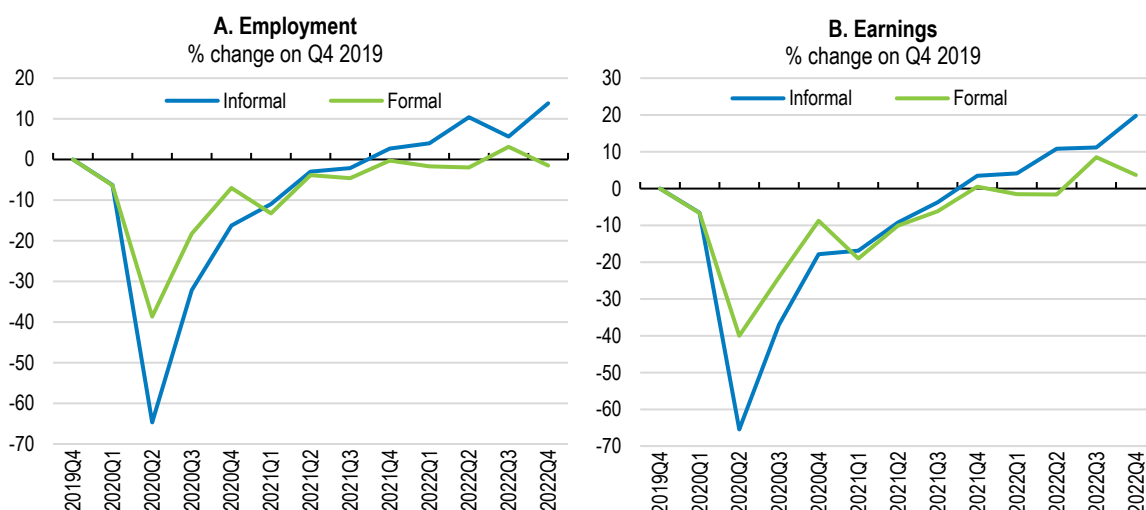


Note: Panels A, C and D show INEI's definition of informality, which includes employers and own-account workers whose productive unit are not registered with the tax authorities; wage earners without social security contributions; and unpaid family workers, regardless of the formal or informal nature of the productive unit where they work. In panel B informal workers are defined as those not paying pension contributions. In Panel D, informal employment outside the informal sector refers to informal jobs in institutional sectors that are by definition formal. Source: INEI; IADB,SIMS.

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The COVID-19 pandemic has exposed the vulnerabilities of a significant proportion of informal workers. They often lack savings and access to unemployment benefits and are typically in jobs that cannot be performed remotely, resulting in greater employment and earnings losses compared to formal workers during the first months of the pandemic (Figure 3.5). Women and youth were disproportionately affected by the pandemic as they hold more frequently informal jobs. Women labour force participation declined sharply, mainly to care for children and the elderly, given the closure of schools and less support of care systems (World Bank, 2023^[41]). After the initial months of the pandemic, informal workers could not afford any more to adhere to public health recommendations to stay home, with subsequent high contagion rates. Since the economy started recovering, informal jobs are leading the way in employment growth, threatening to increase informality permanently and widen gaps in income and job quality. The COVID-19 pandemic has had a profound impact on poverty and inequality, and even as of 2021, these effects have not been fully reversed. Although economic activity has returned to pre-pandemic levels, poverty and inequality have not.

Figure 3.5. Informal workers, though recovering faster, suffered more during the pandemic



Source: ILO, Ilostat database; COMEX.

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Box 3.1. The faces of informality in Peru

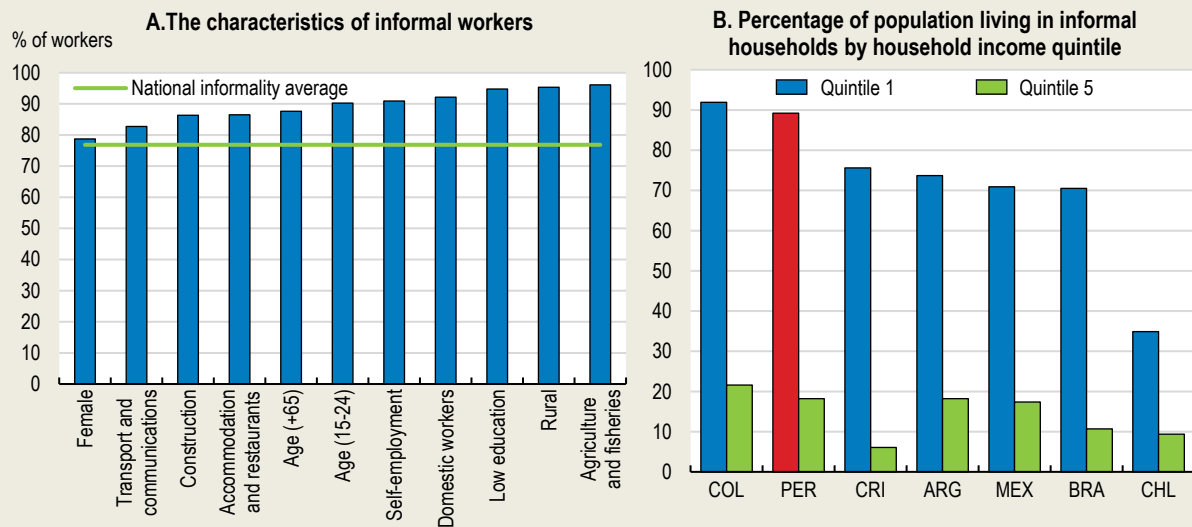
There is no unique international definition for informal employment. However, a generally accepted definition is a type of work that is not taxed, registered by the government, or compliant with labour regulations. Labour informality is not always illegal, as some types of workers, such as self-employed, domestic workers or employers, are not obliged to contribute to the pension or health systems. Businesses can also be informal by not registering with the tax administration or keeping formal accounting, which typically means failing to pay social security contributions for their workers.

Informal employment is highly stratified by socioeconomic characteristics (Figure 3.6, Panel A). Rural workers as well as young and older workers are more likely to hold informal jobs. Self-employment in Peru, at 38%, is one of the highest among OECD and peer Latin American countries, and most of these jobs are informal. Informal workers are concentrated in the agricultural sector, retail, hotels and restaurants, and the construction industry. There is a strong correlation between low skills and informality, with the rate of informality decreasing as workers attain higher levels of education.

Lower-income households tend to have all their members working informally, making them highly vulnerable to shocks (Figure 3.6, Panel B). Informal workers typically have lower and more unstable incomes, which limit their ability to cope with income shocks. In 2021, informal workers earned an average of 40% less than their formal counterparts, and the incidence of extreme low pay is higher among them (Figure 3.7). Most informal jobs are in informal enterprises or in self-employment, yet one in four informal jobs were within formal enterprises in 2019 (Ñopo, 2021_[12]).

Widespread informality is cause and consequence of low productivity in Peru. Many firms and self-employed workers often avoid expanding their businesses to avoid detection by regulatory agencies. Most informal jobs are concentrated in small firms with a high incidence of low skill and low-productivity occupations. Over 80% of workers are employed in firms with fewer than five workers. The informality rate of these firms, as measured by their registration with tax authorities, amounted to 86% in 2021, according to the Peruvian foreign trade chamber (Comex, 2022_[13]), which is highly correlated with low compliance with hiring formal workers, and sanitary standards. This keeps incomes low and dampens productivity (Ñopo, 2021_[12]).

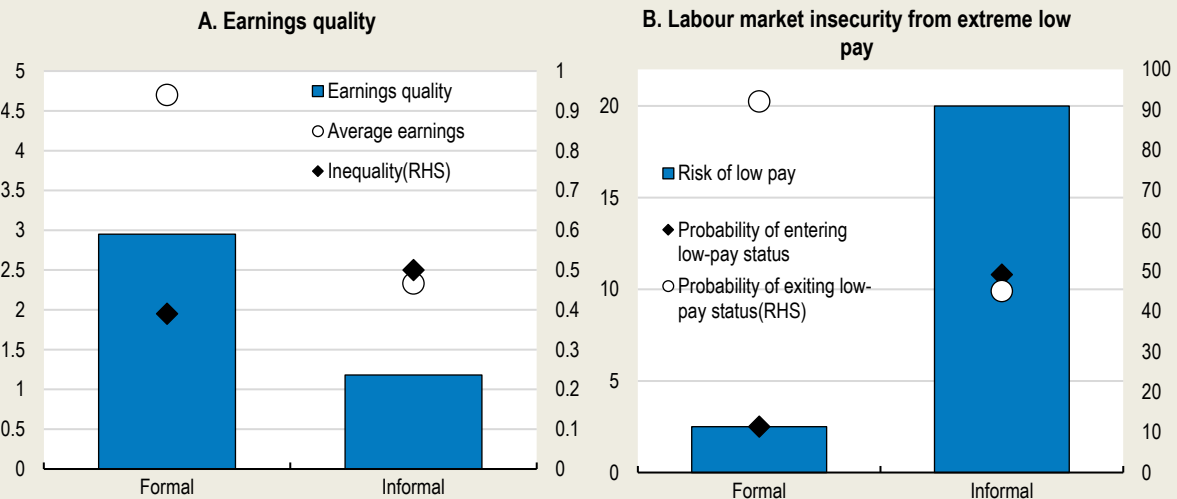
Figure 3.6. Informality rates vary strongly with socioeconomic characteristics



Note: In Panel A data are for year 2021; in Panel B for year 2018. An informal household has all its workers in informal work. Quintiles are based on monthly total household consumption or income.
 Source: OECD calculations based on INEI data and OECD Key Indicators of Informality based on Individuals and their Households (KIbIH) database.

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Figure 3.7. Informal jobs typically offer lower job quality



Note: Informality is defined using the legal definition, i.e. a worker is considered informal if (s)he does not contribute to any pension scheme nor accumulates rights to a retirement pension in the old age. Only dependent workers are considered. Labour market insecurity due to unemployment is not estimated, given lack of unemployment insurance for informal workers. The OECD index of earnings quality combines the level of earnings and their distribution across the workforce. Average earnings correspond to net hourly earnings and inequality is measured by Atkinson Index. The risk of extreme shows the likelihood that an individual's earnings are below the low pay threshold at any given time. The low pay threshold is set at USD PPP 1 in terms of net hourly earnings and corresponds to a disposable income per capita of USD PPP 2 per day in a typical household of five members with a single earner working full time.

Source: OECD calculations based on ENAHO survey for 2014 from (OECD, 2019^[14]).

Labour market reforms to boost job quality

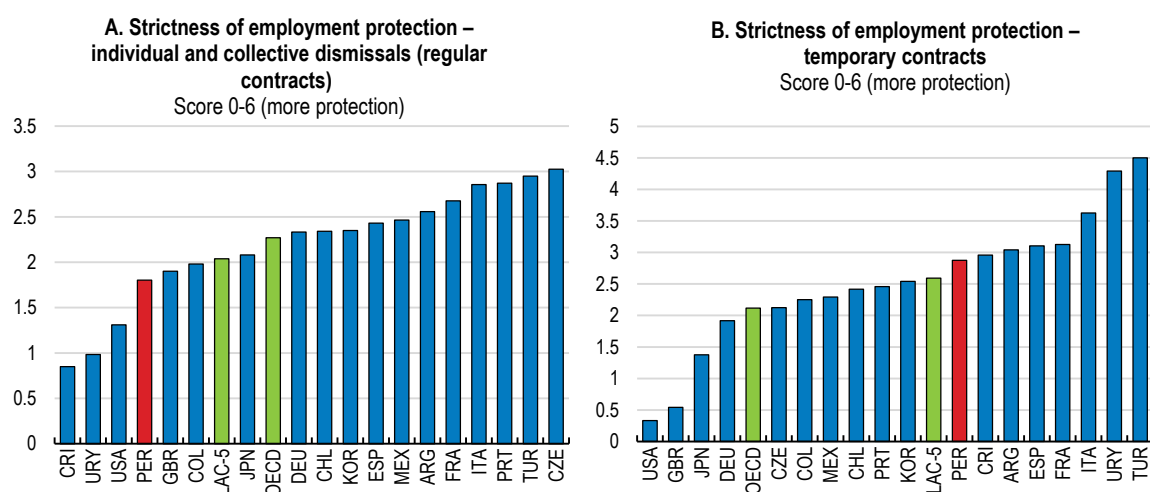
Rigid employment regulations prevent many workers from accessing high-quality jobs

In Peru, employment regulation for regular contracts is slightly less strict than in the average OECD and in most of Latin American (Figure 3.8, Panel A). However, a reinstatement regulation that is uncommon in OECD and Latin American countries limits possibilities to have dismissal decisions recognised as justified (e.g., due to misconduct, incapacity, or economic reasons). If a worker brings a case to court and the dismissal is deemed unfair, reinstatement is nearly automatic and prevails over compensation, discouraging the hiring of permanent and formal contract workers. Evidence shows that to circumvent this issue firms opt to hire workers informally or on formal fixed-term contracts, leading to higher worker turnover, discouraging investment in training, and reducing workers' productivity and incomes (Jaramillo, Aknibacud and de la Flor, 2017^[15]).

A wide asymmetry between the regulation of permanent and temporary contracts (Figure 3.8, Panels A and B), together with a weak enforcement of labour standards leads to a high share of informal jobs and formal temporary contracts (OECD, 2020^[16]). About 80% of dependent formal workers are hired on fixed-term contracts or special (short-term) regimes, compared to an average of 12% in a typical OECD country, leading to high job rotation though comparable to Mexico and Brazil (Jaramillo and Campos, 2021^[17]). The labour inspection system is weak, lacking financial resources, infrastructure, inspectors, and training for personnel (Leyva De Amat, 2020^[18]). In addition, the legal framework, with its more than 1 800 pages, is difficult to understand and therefore difficult to comply with and monitor. Monitoring is very difficult because of the multiple special regimes and total or partial contracting exceptions (Ñopo, 2021^[12]).


Employment protection legislation should be reformed to reduce the stark differences between the regulation of permanent and non-permanent contracts that incentivizes informality and the excessive use of temporary contracts leading to high rotation in the labour market. The government could consider alleviating the protection provided by permanent contracts. For individual dismissals, the outstanding legal barriers that prevent employers from the possibility to plea for a justified dismissal could be relaxed, and adverse economic circumstances could be recognised among the reasons justifying a dismissal. Improved enforcement of labour standards will also be key. More effective public employment services and a higher coverage of training would also be needed to support workers during job transitions.

Figure 3.8. Employment protection is rather strict in Peru, especially for temporary contracts



Note: Data refer to 2019. Panel A refers to version 4 of EPL; panel B refers to version 3. LAC5 is the unweighted average of ARG, CHL, COL, CRI, and MEX.

Source: OECD indicators of employment protection database.

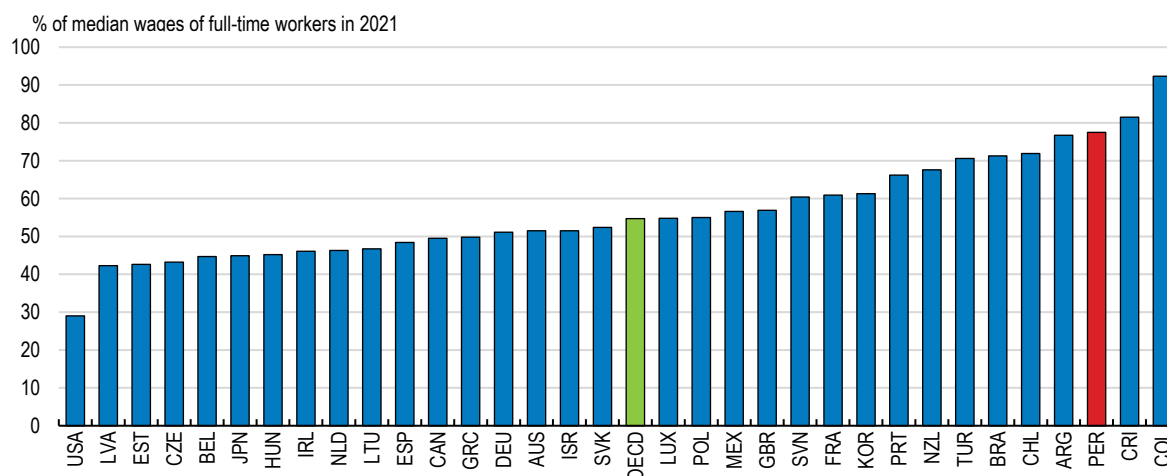
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The minimum wage is relatively high compared to the median wage

As of 2022, Peru's monthly minimum wage (*Remuneración Mínima Vital*) stands at PEN 1 025, roughly USD 280. From April 2018 to April 2023, the minimum wage saw only one increase in 2022, and as of April 2023, the real minimum wage is 7% below pre-pandemic levels. However, Peru's minimum wage, which stands at 77.5% of the median wage and 58.7% of the mean wage for full-time employees in 2021 (Castellares et al., 2022^[19]), is high compared to OECD economies (Figure 3.9). Less than half of the population earns the minimum wage, with the share being lower for self-employed, women, informal, young, low-skilled, and rural workers (Figure 3.10). The minimum wage regulation is mainly intended for salaried workers and does not apply to self-employed and domestic workers. The percentage of workers earning below the minimum wage declined from 2007 to 2015 but has been growing since then (Figure 3.10).

Statutory minimum wages are a key tool for governments to influence wage levels. The high minimum wage should be considered in the light of the low unionization and limited role of collective bargaining in Peru, with only 6% of private sector workers unionised, as it is one of the few ways for trade unions to improve working conditions (OECD, 2016^[20]). However, pressures to raise the minimum wage can neglect its impact on informal workers and can reduce formal employment prospects, particularly for low-skilled workers, youth, and people in rural and less developed regions. International evidence shows that moderate minimum wage increases tend to have a small impact on employment but can have more negative effects on vulnerable groups like the youth (OECD, 2015^[21]). In developing countries with high informal employment, high minimum wages that are not effectively enforced can result in employees being displaced or moved from formal to informal employment (Nataraj et al., 2013^[22]; Del Carpio and Pabon, 2017^[23]). Some international studies show that minimum wage hikes can reduce wage inequality (Engbom and Moser, 2018^[24]; Maurizio and Vázquez, 2016^[25]). However, setting the minimum wage too high can result in job losses and a shift to informality, leading to undesirable distributional effects (Jaramillo, 2013^[9]).

Figure 3.9. The statutory minimum wage is relatively high

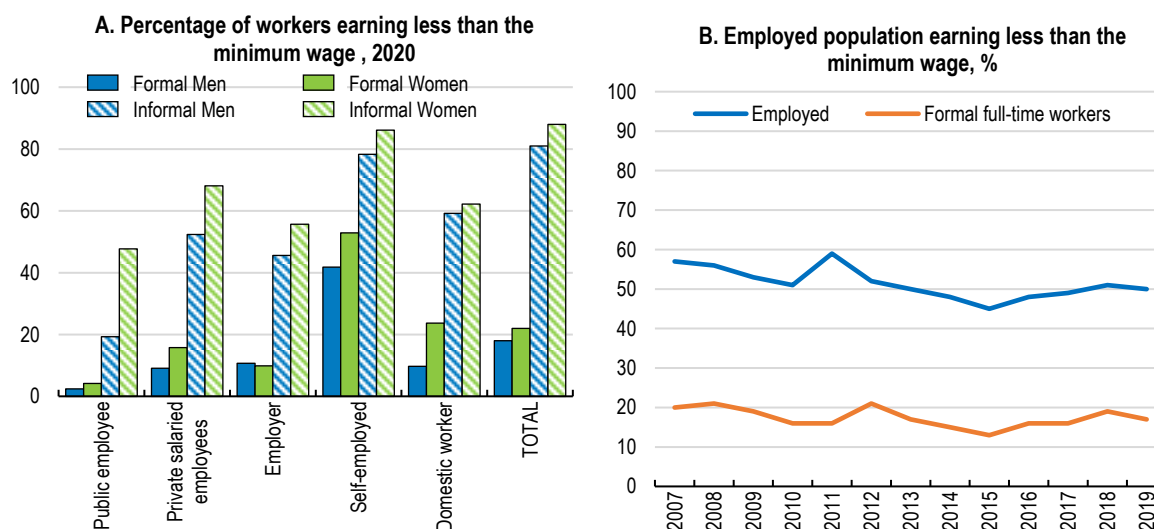


Note: Data are 2019 for Argentina and Brazil. For Peru, wage comes from the main job of a dependent worker who works more than 40 hours per week as calculated by (Castellares et al., 2022^[19]).


Source: OECD, OECD Employment Outlook Database. Instituto Brasileiro de Geografia e Estatística (Pesquisa Nacional por Amostra de Domicílios); International Labour Organisation (ILO) Database on Conditions of Work and Employment Laws; National Institute of Statistics and Census of Argentina.

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Figure 3.10. A large share of workers earns less than the minimum wage



Note: Income from work in the main occupation. Panel B excludes unpaid family workers and the employed with no income.
Source: OECD calculations based on INEI – Households surveys (2020); Ñopo (forthcoming) and (Ñopo, 2021^[12]).

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The impact of minimum wage increases depends on various factors, including its current level, binding nature, compliance and enforcement, competition in labour and product markets, and employer behaviour (OECD, 2018^[26]; OECD, 2022^[27]). Evidence from Peru is mixed with some studies suggesting negative effects on total employment and an increase in informality following minimum wage increases (Cespedes, 2006^[28]; Cespedes and Sanchez, 2013^[29]; Del Valle, 2009^[30]; Jaramillo, 2012^[31]) while others a slightly positive or nil impact on salaried employment generation (MTPE, 2022^[32]). Economic sectors and regions with a higher ratio of minimum wages to average wages tend to have larger shares of informality (Castellares et al., 2022^[19]).

Future minimum wage increases could be determined on technical grounds, taking into consideration the impact on employment and informality. The National Labour Council, operating under the Ministry of Labour and led by the Minister himself, comprises the most representative workers and employers' organizations. Its primary responsibility is to propose minimum wage adjustments with the final decision resting with the executive branch. In addition to minimum wage discussions, the council discusses labour policies, employment promotion, and social protection to foster national and regional development.

A methodology for minimum wage adjustments based on inflation and productivity, approved in 2007, has never been formally implemented. Although authorities attempted to establish technical criteria for predictable minimum wage increases in 2019, this was postponed due to the COVID-19 pandemic. It is important to pursue efforts to set technical and objective criteria to guide minimum wage increases in line with inflation and productivity in the future. A technical secretariat within the Council or an independent commission could be established to monitor labour market and productivity developments and provide recommendations for minimum wage increases, similar to what other OECD countries such as France, Germany and the United Kingdom (Low Pay Commission UK, 2018^[33]; Eurofound, 2018^[34]; Vacas-Soriano, 2019^[35]). This commission would be integrated by labour market experts, appointed through a rigorous and transparent selection process designed to minimize political influence. It would have the ability to set its own research agenda and have access to relevant data and resources, allowing it to gather and analyse information independently. Its advice would be used to establish criteria for increases in the minimum wage and monitor their impact on employment and informal jobs. This commission would help ensure the objectivity and transparency of the minimum wage setting process.

Peru could also consider differentiating the minimum wage by age or region to aid formalisation of youth and low-skilled workers in rural areas. A differentiated wage would help young workers enter the labour market and reduce unemployment (OECD, 2019^[14]). While minimum wage practices across OECD countries vary, many countries have a minimum wage that differs by age group (to recognise that the young are generally less experienced, so the minimum wage is a greater hurdle to employment) and/or by region (to account for differences in living costs and local labour market conditions). A scheme differentiating minimum wages that allows for gradual differentiation and increases, like Australia or the Netherlands, limits job separation risks and supports youth workers' career progression. In Latin America, other countries, such as Chile differentiate the minimum wage by age. In Uruguay, minimum wages are determined by occupational category in tripartite wage councils at the sectoral level. Differentiating the minimum wage would imply a constitutional change which makes this reform politically difficult and a need to achieve broad consensus in the political debate. Furthermore, continuous monitoring and evaluation when implementing minimum wages is warranted to avoid potential drawbacks.

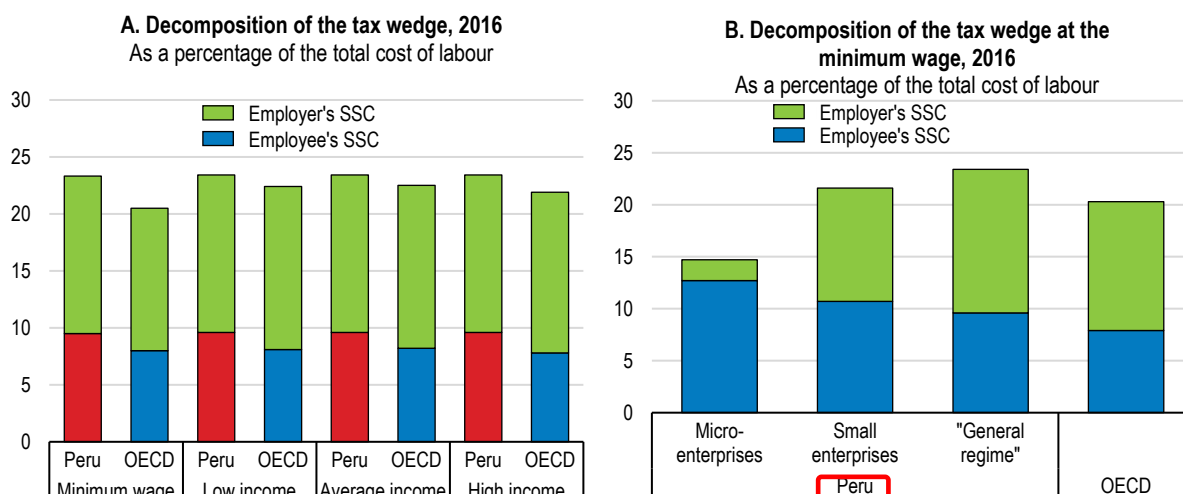
High non-wage labour costs are a barrier to formalisation

Social contributions to health and pensions, levied both on the employee and the employer, amount to 23.4% in Peru for workers with an average income. This is slightly above the OECD average. However, there is a wider difference between the OECD and Peru for low-income workers and those earning the minimum wage (Figure 3.11, Panel A). Although social security contributions do not seem extremely high, often the employer and employee agree not to contribute to pension and healthcare so that the employer reduces its labour costs and the employee increases its net payment, thereby encouraging informality. Social security contributions represent a barrier to formality particularly for low-income groups: for informal salaried workers in the first decile of the income distribution, social security contributions can amount to 124% of their labour income, making it unaffordable (OECD, 2019^[36]).

There are special regimes with lower social security contributions (Table 3.1) for self-employed workers or employees in micro and small firms (Figure 3.11, Panel B). Self-employed workers that declare income to tax authorities pay lower contributions to the health system unless they belong to a poor household, in which case they are exempted. Social contributions for pensions are voluntary for self-employed workers. However, these social contributions represent 90% of the income of self-employed workers in the fourth decile, being a clear barrier to formalisation (OECD, 2019^[36]). Other regulations concerning unemployment benefits, paid annual leave, profit sharing and family allowances are also considerably higher for medium-sized and large firms.

Although these special regimes and cost difference were set up to encourage formal firm and job creation, they add complexity and create strong distortions discouraging firms to grow or promoting splitting into small units (Garicano, Lelarge and Van Reenen, 2016^[37]; Dabla-Norris et al., 2018^[38]) and encourage informal employment (Dabla-Norris et al., 2018^[38]). It would indeed be important to lower social security contributions for low-income workers while avoiding large jumps depending on firms' size. One option is shifting from the schemes based on firm size to progressive social security contributions linked to workers' income. This would remove the current disincentives for firms to grow and formalise while incentivising labour formalisation in a fiscally neutral manner. Evidence from the 2012 reform in Colombia shows the importance of decreasing non-wage labour costs to reduce informality (Bernal et al., 2017^[39]; Morales and Medina, 2017^[40]; Garlati-Bertoldi, 2018^[41]). Several OECD countries, including France and Germany, have implemented strategies to encourage the employment of low-income workers by reducing their social contributions for this group (Cahuc and Carcillo, 2012^[42]; Galassi, 2021^[43]). Lower social contributions for low-income workers in Germany have shown to boost female employment (Konle-Seidl, 2021^[44]). Similarly, Chile has introduced programmes aimed at formalising vulnerable workers, particularly youth and women, through employment subsidies that cover a portion of total social contributions and have proven effective in promoting formal employment (Bravo and Rau, 2013^[45]).

Figure 3.11. Social security contributions are high, particularly for low-income workers



Note: Data refer to single individuals without children, within the age range 15-64 and working as dependent workers in formal sector. Low income refers to 67% of the average wages; average-income refers to 100% of average wages; high-income refers to 167% of average wages. For Peru, the obligatory universal contributions paid by the employer comprise Health Insurance and the employer's contribution to the unemployment benefit system (Compensación por Tiempo de Servicio, CTS, compensation for length of service). Those paid by the employee are contributions to the pension system.

Source: Data for the OECD come from Taxing Wages 2017, data for Peru are OECD calculations based on information provided in Policy Questionnaire by MTPE and ENAHO 2016.


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Table 3.1. Non-wage labour costs by firm size

Employers' social security contributions (% gross wage)	Micro-enterprises	Small enterprises	General regime
Health (EsSalud)	0.8% (supplemented by state subsidies)	9%	9%
Unemployment benefits (CTS)	-	4.2%	9.7%
Life insurance	-	0.6%	0.6%
Risk work insurance	-	1.2%	1.3%
Training Fund	-	-	0.8%
Holidays	-	8.3%	17.3%
Bonuses	-	-	-
Family allowance	-	-	10% of minimum wage
Severance payment	0.33 per month of salary up to 3 salaries	0.66 per month of salary up to 4 salaries	1.5 per month of salary up to 12 salaries
Profit-sharing	-	Applies	Applies
Employees' social security contributions (% gross wage)			
Pensions	13%	13%	13%

Note: Profit sharing applies for firms of more than 20 workers and depends on the sector of activity. For labour legislation, micro enterprises are those with annual sales below 150 Tax Units (UIT, which is approximately USD 1200), small enterprises are those with annual sales between 150 UIT (approximately USD 180 000) and 1700 UIT (approximately USD 2 million), and enterprises with higher sales fall under the General Regime.

Source: OECD based on (Ñopo, 2021_[12]).

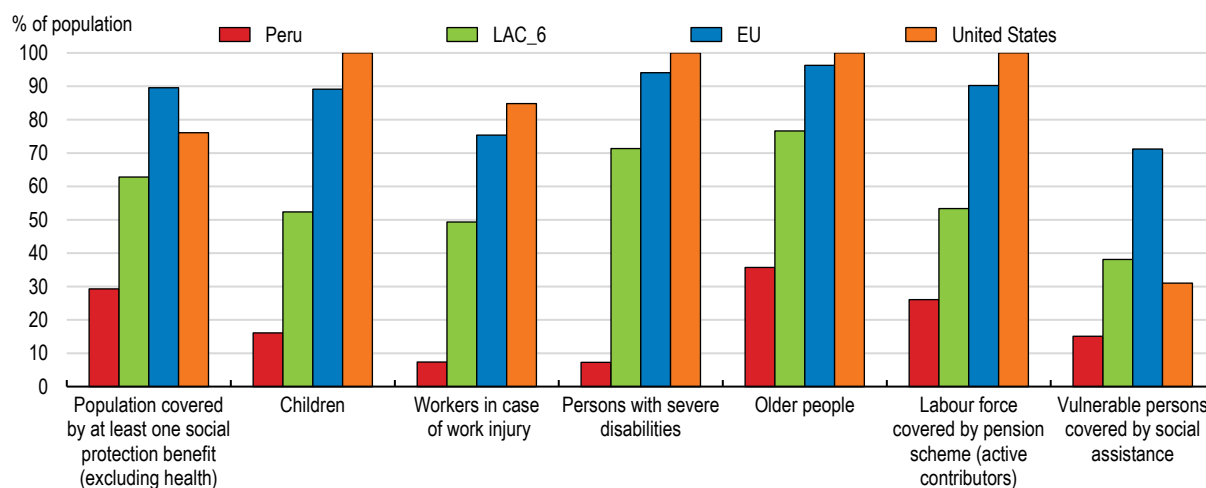
Achieving universal social protection while reducing incentives to informality

Social protection is fragmented and has low funding and coverage

Peru has a well-established social protection system, but it faces several challenges such as fragmentation, low funding and low coverage, while its design incentivizes informality. The system comprises health, pensions, and poverty alleviation programs, while there is no unemployment insurance. Contributory “social security” benefits are available to formal workers, while non-contributory “social assistance policies” support the poor. Peru has also a semi-contributory healthcare system for some workers, such as the self-employed, with the state financing part of the social contribution. The result of this set-up is a segmentation of the labour force into two categories: formal workers covered by contributory benefits and employment protection regulations, and informal workers, covered by non-contributory social assistance programmes if they are poor. High informality prompts the need for non-contributory social protection benefits. These benefits provide vital aid to those in need but sustain the informal sector and perpetuate the fragmentation of the social protection system.

The system also creates inefficiencies in service provision and coverage gaps (Figure 3.12). The highest-income workers are more frequently protected by contributory schemes, the lowest-income workers by non-contributory schemes, but a large mass of middle-income workers who are vulnerable to falling into poverty and move frequently in and out of formality are left unsupported, except for health that provides universal coverage. Low social spending compared to developed economies and Latin American peers (Figure 3.13), is another key factor contributing to large coverage gaps in social protection.

Figure 3.12. Many individuals are left behind by the social protection system

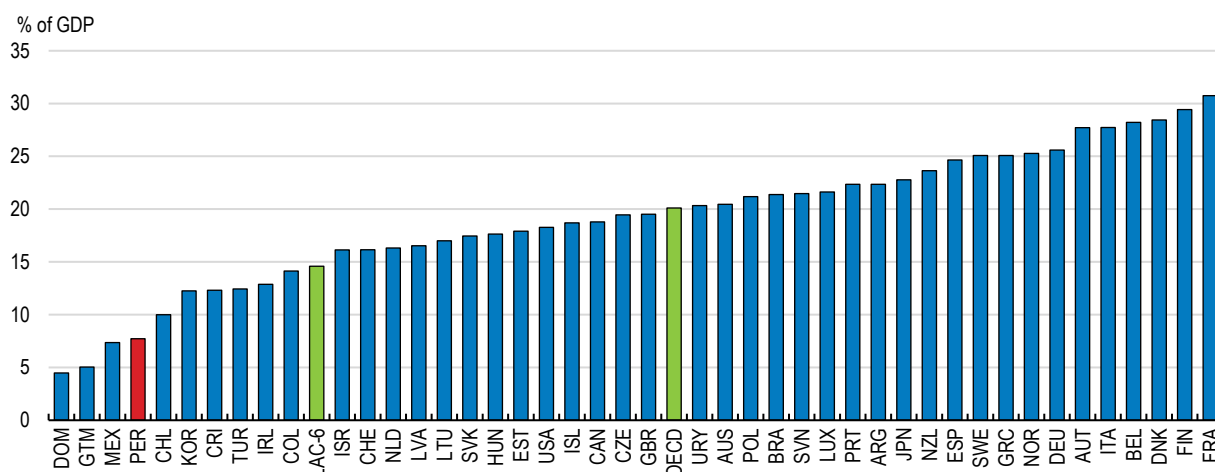


Note: 2020 or latest year available. Vulnerable people are defined as all children plus adults not covered by contributory benefits and people above retirement age not receiving contributory pensions. LAC6 is the unweighted average of Argentina, Brazil, Chile, Colombia, Costa Rica and Mexico. LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX.

Source: ILO, World Social Protection Database, based on the SSI; ILOSTAT.

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Figure 3.13. Social spending is low



Note: Year 2019. Social expenditure comprises old-age, survivor, incapacity-related, health, family, unemployment, housing, active labour market support and other social policy areas. It comprises cash benefits, direct in-kind provision of goods and services, and tax breaks with social purposes. LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX.

Source: OECD Social expenditure database; CEPAL.

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Stepping up the fight against poverty

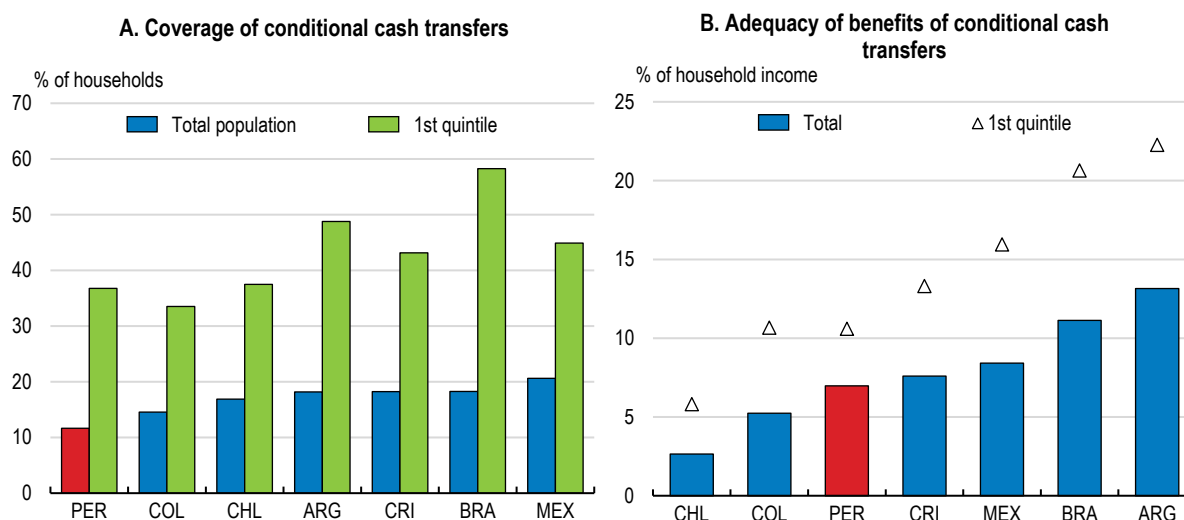
Since the 1990s Peru has increased social spending to fight poverty, expanded coverage of social services and developed targeted social programmes. However, cash transfer programmes continue to provide low coverage and limited generosity, leaving many households without any support. *Juntos*, the main anti-poverty programme, is a conditional cash transfer programme introduced in 2005 for Peruvian families living in extreme poverty in rural areas. It aims to generate human capital and break the cycle of poverty by providing monetary incentives to households with at least one programme target member, such as pregnant women or children/adolescents, provided the household falls within the socioeconomic classification of poverty or extreme poverty and resides in a district with a poverty incidence higher than 40%. Evidence shows that *Juntos* increased demand for health checks for children, increased household consumption, and reduced poverty levels (Perova and Vakis, 2012^[46]). It also had positive impacts on nutritional, cognitive and educational outcomes (Sánchez, Meléndez and Behrman, 2020^[47]; Sánchez and Jaramillo, 2012^[48]; Gaentzsch, 2020^[49]).

Despite its positive effects, a low share of Peruvian families benefited from *Juntos* (Figure 3.14), and spending was low (0.1% of GDP in 2021). Benefit levels are also low, limiting their impact on families and poverty. *Juntos* provides PEN 100 (USD 26) per household monthly, equivalent to 30% of the poverty line in 2021, one of the lowest in emerging markets (ILO, 2017^[50]), where on average amounts to USD 78 (Gentilini et al., 2021^[51]). The benefit does not consider household characteristics and has not been updated since 2005, resulting in a loss of purchasing power.

Juntos has been redesigned in 2021 to improve coverage and impact. The programme now targets extremely poor households regardless of their geographical location and gives benefit top ups to incentivise further human capital development and health. An early childhood transfer of an additional PEN 50 is conditioned on access to basic health services, and a pilot programme offers an additional transfer of PEN 80 for households with children in secondary school in areas with higher school dropout rates.

The pandemic has highlighted the need for more wide-ranging measures to protect vulnerable populations. While emergency cash transfers helped ease COVID-19's impact on poverty and income loss (Figure 3.15 and Box 3.2.), more permanent solutions are needed to fight poverty and address income losses during periods of hardship.

Figure 3.14. Cash transfers programmes leave many poor households without any support



Note: Data refer to 2019.

Source: World Bank, Atlas of social protection: Indicators of resilience and equity (ASPIRE).

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Box 3.2. Social policy in Peru and the challenges and responses during the COVID pandemic

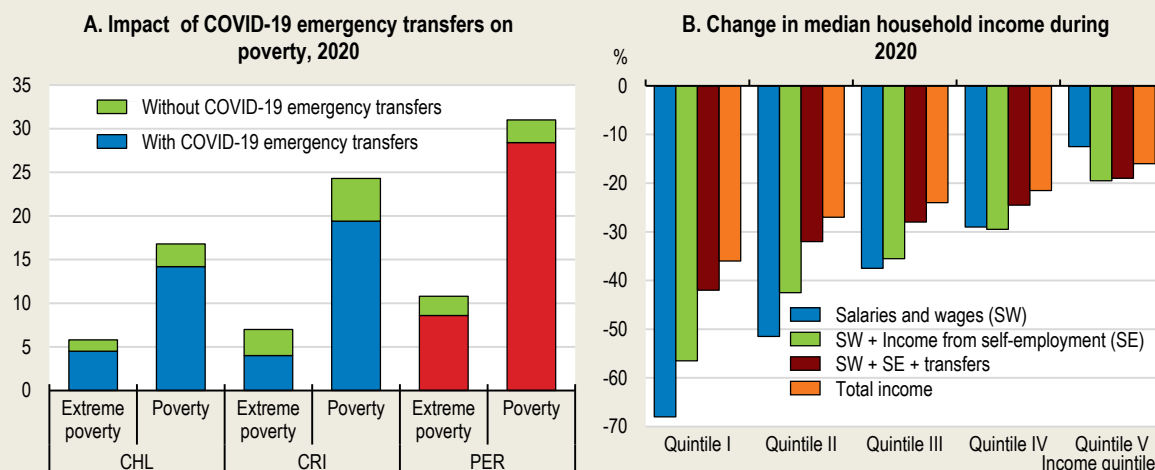
Currently, social policy is channelled through seven nationwide social programmes, of which *Juntos* (conditional cash transfers), *Pensión 65* (non-contributory pension), *Qali Warma* (nutritious meals and snacks to children in public schools and early childhood development centres), and *Contigo* (unconditional transfer for people with severe disabilities who are in poverty) are the most important. Social spending on these programmes was about 0.5% of GDP in 2021.

To respond to the COVID-19 pandemic, authorities implemented various emergency measures, including delivering food vouchers, creating new cash transfer programs, and expanding existing ones to provide support to vulnerable households and encourage social distancing, all of which have been temporary and have been already phased out. These programs targeted poor households and informal workers who were not previously covered by government social policies and or other responses to the pandemic. Evidence shows that these schemes helped prevent significant increases of poverty and income losses across the income distribution (Figure 3.15), particularly among rural inhabitants, indigenous peoples, and afro Peruvians (World Bank, 2023^[4]). However, the initial implementation suffered from low coverage, difficulties reaching vulnerable populations and significant delays providing support during the crisis (Correa, 2021^[7]). As the pandemic unfolded, authorities expanded the programmes in an ad-hoc way (Table 3.2), targeting different vulnerable groups and eventually reaching 8.4 million households (63% of total households in Peru). Despite implementing the most significant mitigation measures in 2020, the government sustained its efforts in 2021, particularly through the *Bono Yanapay* programme, which extended coverage to 67% of households (World Bank, 2023^[4]). Without these benefits, the poverty rate would have been 2 percentage points higher in 2021, as 84.1% of poor households had access to COVID-19 pandemic cash transfers.

The delay in pandemic-related cash transfer programmes can be, at least partly, attributed to the lack of a comprehensive and up-to-date social registry of households. Several databases had to be merged and even created between mid-March and the beginning of June to identify the vulnerable households including workers with volatile or low incomes, many of whom are informal workers. In response, the

government allowed excluded households to register or update their socioeconomic status on the platform of the National Registry of Households and become eligible for the transfer, adding 3.8 million households to the beneficiary database.

Figure 3.15. Emergency cash transfers helped ease COVID-19's impact on poverty and income loss



Note: Panel A. Countries covered include those with questions in the household survey that make it possible to identify the emergency transfers implemented in response to the COVID-19 pandemic. Panel B: The rate of change compares the median income in 2020 to that of 2019 and expresses the difference as a percentage. The interpretation of the graph is additive: the first bar represents the average household income per person from wages and salaries paid by a third-party employer; the second bar adds income from self-employment; the third bar adds income from transfers and the last bar adds in all other sources of income.

Source: Economic Commission for Latin America and the Caribbean (ECLAC), based on Household Survey Data Bank (BADEHOG).


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Table 3.2. Peru's emergency transfers in response to the COVID-19 pandemic

	Started operating	Target	Coverage (million households)	Benefit
Bono Yo Me Quedo en Casa (I stay at home)	March 2020	Poor and extremely poor.	2.7	PEN 760 (USD 218) in 2 payments
Bono Trabajo Independiente (Self-employment)	March 2020	Non-poor self-employed workers living in households with incomes up to PEN 1200 (USD 343).	0.78	
Bono Rural	April 2020	Poor and extremely poor in rural areas.	1.1	
Bono Familiar Universal	May 2020	Rural and urban areas, not beneficiaries of previous cash transfers.	3.8	
Increased benefit in existing programmes (Bono 600, and Yanapay)	2020 – 2022	Poor or extremely poor or already covered by existing social programmes.		PEN 350 (USD 92)

Source: (Gálvez Vargas, 2021^[52]).

Implementation issues due to low financial inclusion had also to be addressed during the pandemic, and significant progress was made to enable cash transfers to reach all those in need. Initially, delivery was made through bank windows, instead of digital mechanisms, leading to agglomerations and an increased spread of COVID-19. As the beneficiary registry grew, more modality payments were established, such as deposits in a bank accounts, ATM or agents' withdrawals using mobile banking, and securities transporting companies to reach households located in hard-to-reach areas. The implementation of the "Cuenta DNI" in late-2021, as highlighted in chapter 2 of this survey, gave a boost to financial inclusion. This digital savings' bank account allows families to receive cash transfers or any other state benefit.

To better support the poorest, it is crucial to expand the reach and benefits of cash transfer programmes. One option is to extend the coverage of *Juntos* to include all individuals living in poverty and provide them a benefit equivalent to the extreme poverty line. This would cost around 2.4% of GDP in 2021. Another option to better consider the household characteristics and to contain fiscal costs is to transform *Juntos* into a guaranteed-minimum-income scheme for the population below 65. This would involve a periodic cash transfer to supplement household incomes. This programme could build on *Juntos* and be financed from general tax revenues, with options to raise tax revenues discussed in Chapter 1. By setting the guaranteed minimum income to the poverty line, an illustrative calculation using household surveys, indicates that such programme would cost 1.1% of GDP in 2021 (Ñopo, forthcoming) or 1% net of the expenditure in *Juntos*. The benefit of choosing the national poverty line calculated by the National Statistics Institute, is that the minimum income would adjust automatically to changes in prices in the basic food basket. When children are part of the household, the cash transfer could be conditional on human capital accumulation and desired health behaviours, as in *Juntos*, to generate incentives for investing in education and health. The size of the benefit can also consider children's age and educational level. Finally, it could eventually also be adapted to the costs of living of the different territories in Peru.

To maintain incentives for formal work and avoid that beneficiaries are reluctant to take up formal work for fear of losing their benefit, a graduation phase, in which the value of the transfer forgone is smaller than any additional income made should also be considered. For those already working, more hours worked, or better jobs could be encouraged, by reducing by a smaller amount the benefit for the extra income they earn. Ex-ante and ex-post impact assessments should be systematically conducted to evaluate the effects on formal labour force participation and adjust the design if necessary. Cash transfers could be also ideally tied to individual behaviour that promotes future employment outcomes such as school completion, training, and participation in public employment services to help families overcome poverty.

An alternative to the proposed guaranteed-minimum-income scheme is a negative income tax or earned income tax credit, which has shown positive effects on labour force participation, poverty reduction and reduction of informality in United States and some developing countries (Hoynes and Patel, 2017^[53]; Gunter, 2013^[54]). The main difference between the proposed scheme and the negative income tax is that the latter is financed directly through a progressive income tax that could offset social security contributions incentivising labour formality (Acosta, Pienknagura and Pizzinelli, 2022^[55]). The advantage of the conditional cash transfer programmes is that it provides more flexibility to condition the transfer on positive educational and health behaviours.

Regardless of the approach followed, the social information system could still be improved by collecting relevant and frequent data to properly detect vulnerable households and be more agile to respond efficiently to household shocks, such as the COVID-19 pandemic or natural hazards. The significant efforts done recently to update the social registry should continue, especially for collecting data to accurately identify minority groups and vulnerable households. The current method of updating the registry primarily involves conducting in-person interviews. However, conducting high-frequency phone surveys would enable more frequent monitoring of households. Additional methods, such as on-demand inclusion of households have been shown internationally to improve targeting along various dimensions, including programme satisfaction and more flexibility in the timing of identification (Hanna, Khan and Olken, 2018^[56]). For example, if local communities verify the final list of beneficiaries, excluded households can be added. Eligible households could enrol at an office; and only those close to the eligibility threshold would need home verification.

The targeting system (*Sistema de Focalización de Hogares*, SISFOH) also needs to be adapted to effectively reach the poor and vulnerable households. Eligibility is based on household material conditions and characteristics of the head of the household, such as type of housing, water supply, employment status, and ownership of household appliances. However, the system's criterion of not paying contributions to the health system generates incentives against formal employment, creating a significant implicit tax. In

the long term, the targeting system could also aim to capture temporary poverty to enhance its responsiveness and resilience.

Boosting protection against job loss

Peru does not have an unemployment insurance system and only very few workers have some income protection against job loss. The main protection mechanisms are the end-of-service severance pay and the individual unemployment savings accounts. The individual unemployment savings accounts (*Compensación por Tiempo de Servicios*) are financed by the employer and are compulsory for medium and large firms, but not for micro and small firms. As a result these instruments are typically only available to permanent workers, who constitute 5% of the total workforce and belong mainly to the highest deciles of the income distribution (de la Cruz, Manzano and Loterszpil, 2020^[1]). During 2021, only 40% of private salaried workers was covered by this mechanism. This leaves a significant proportion of the population vulnerable to job loss. Moreover, the ability to withdraw funds from the individual accounts for non-unemployment-related purposes suggests that this mechanism does not effectively function as a protection against job loss. Instead, it operates more like a mandatory savings system.

Cash transfer programmes, such as the guaranteed-minimum income discussed above, could provide protection to workers during unemployment. For example, for workers earning the minimum wage, a cash benefit equivalent to the poverty line would imply a non-negligible 40% replacement rate. This would cost an additional 0.1% of GDP if all unemployed workers were to be covered for three months (the average duration of unemployment). For workers above the minimum wage, a contributory pillar could supplement the guaranteed-minimum-income and provide top-up benefits to achieve a replacement rate more in line with other OECD countries (60% on average). This contributory pillar could be primarily based on the existing individual unemployment accounts, or be mixed, as in Chile, where individual savings are supplemented by a solidarity fund financed by employer's contributions and general taxation. The advantage of individual unemployment savings accounts is that they limit the risk of moral hazard and incentivize workers to prevent job loss and return to work quickly (ILO, 2019^[57]; OECD, 2018^[26]). However, individual unemployment accounts do not provide risk sharing. Individuals with lower contributory capacity are at higher risk of unemployment and have weaker protection, which is why the cash transfer programmes such as the guaranteed minimum income could serve as a minimum protection floor. Another option proposed by the ILO is to introduce an unemployment benefit system based on individual contributions of 1.16% of wages of all salaried workers with permanent or temporary contracts to a common unemployment fund (ILO, 2022^[58]).

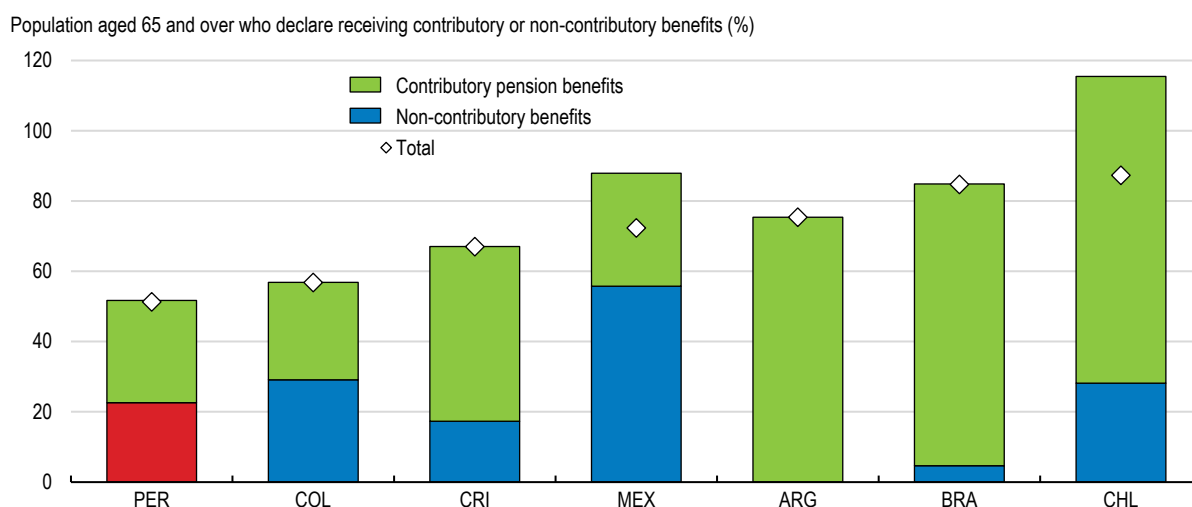
Strengthening protection via cash transfers would ensure all workers against unemployment, including the self-employed who usually do not contribute to unemployment insurance schemes. It would also have the added benefit of reducing labour costs for employers and encourage the creation of formal jobs. Currently, employers are mandated to contribute around 9.8% of wages to the individual unemployment savings accounts, which is high compared to a median of 2.8% for advanced countries or 1.5% for emerging economies (ILO, 2019^[57]). For example, in Chile workers' and employer's contributions amount to a maximum 3% of wages in a very similar setup. Additionally, restricting withdrawals from the individual savings accounts to job dismissals and crediting any surplus contributions as pension entitlements upon retirement would help achieve the system's original objective of protection during unemployment. Contributions can also be limited to a maximum number of years to accumulate sufficient resources to cover unemployment eventualities, such as 11 years in Chile.

All unemployed workers, with previous informal or formal jobs, should register with the labour market intermediation services (*Centros de Empleo*) to support their employment and training search. For that there is a need to strengthen labour orientation and intermediation services, including training, to help the unemployed enrol in cash transfer or unemployment benefits programmes while receiving support in their job search. Currently, the Public Employment Services are understaffed and there is a need to strengthen recruitment and training programmes for caseworkers (OECD, 2019^[14]) to provide effective support.


Providing adequate pensions for all

A consequence of widespread informality is that very few people have old-age pensions in Peru (Figure 3.16). The Peruvian pension system consists of two parallel contributory schemes and a small non-contributory scheme called *Pension 65*. Special regimes also exist for the armed forces, police, and public servants. In 2019, less than half of the elderly population in Peru received pensions (Figure 3.16), with 26.1% receiving contributory pensions and 21.1% non-contributory pensions. The two parallel contributory schemes, one public and one private, have different rules and lack coordination and integration among the overseeing institutions (Table 3.3). Formal workers are free to choose to which system they contribute, but very few workers do. In 2021, 18% of workers contributed to the private scheme and 8% contributed to the public one, mostly upper-income workers.

Figure 3.16. The pension system has low coverage



Note : 2021 or latest.
Source : IADB SIMS.

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The low coverage of pensions in Peru is largely due to high informality and low frequency of contributions. Approximately 50% of working-age men in Peru have never contributed to the pension system, and for women, this number is even higher at around 75%. Those who contribute do not do so systematically because of frequent job rotation into the informal sector (Jaramillo and Campos, 2021_[17]). Indeed, on average workers contribute during 36% of their active lives, while those in the lowest income quintile only 28% in the private pension system (Bernal, 2020_[59]). The pandemic has worsened this situation because of the six extraordinary withdrawals from private pension funds in 2020-2022, equivalent to 10% of GDP, that have left 80% of affiliates (2.3 million workers) with no pensions. While withdrawals early in the pandemic could be justified because of the sharp slowdown in economic activity, later withdrawals continued to deplete the private pension scheme, where assets have declined from 22% of GDP in 2020 to around 12% in 2022.

Not all workers who contribute to the public system are able to get a pension. The system requires at least 20 years of contributions and only one in five workers meet these criteria, usually those belonging to the highest income quintile (Ñopo, 2021_[12]). A reform in 2021 facilitated access for those with at least 10 years of contributions, but very few contributors meet this minimum requirement. Those who do not meet the requirements do not receive any benefits or refunds, implying a redistribution from low to high income workers.

Table 3.3. The parallel contributory pension systems in Peru

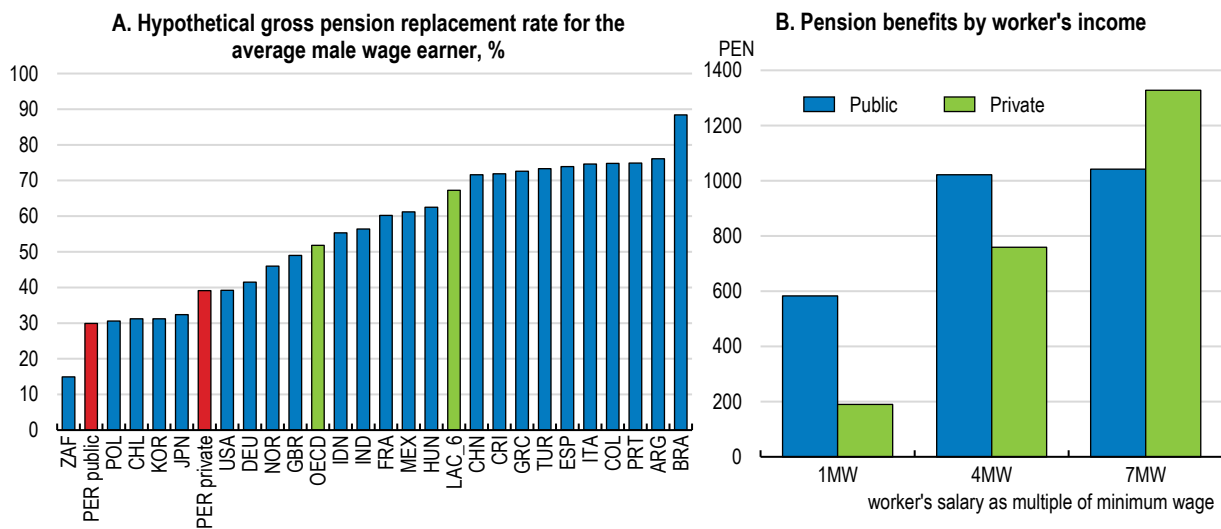
	Public Pension System (SNP)	Private Pension System (SPP)
Ownership of contributions	Common fund.	The contributor is the sole owner of the funds through his/her individual accounts.
Pension calculation	The benefits are determined based on the average of the last 60 monthly wages. The specific replacement rate varies depending on the individual's age.	The pension will result from accumulated savings, which will grow according to the value of the contributions and the return obtained on them.
Maximum pension	Limited. Up to 100% of the reference remuneration and currently up to a maximum amount of 893 PEN or USD 236 (subject to at least 20 years of contributions).	
Minimum pension	Starting at age 65 and only if you have contributed for at least 20 years, it is 500 PEN per month, equivalent to 50% of the minimum wage or 20% higher than the poverty line.	Those born before December 1945 are entitled to a complement to achieve the same minimum pension as the SNP. In 2023, a minimum pension was created that allows the affiliate to voluntarily set a pension savings goal to achieve a minimum pension, and its amount cannot be less than the basic consumption basket.
Minimum time of contributions for retirement	20 years to get a full pension. Proportional pensions available for those with at least 10 years (PEN 250) 15 years (PEN 350).	There is no minimum time of contributions to receive a retirement pension.
Obligatory contributions	13% of the monthly remuneration.	10% of the monthly remuneration, plus the insurance Premium (1.74%) and the AFP's Commission paid as percentage of wages or of assets under management (between 1.47 and 1.69 depending on the AFP).
Pension modalities and withdrawals	Single pre-established.	Workers can choose the pension mode that best suits their needs: programmed withdrawal, family life annuity, temporary annuity with deferred life annuity. Since 2016, there is the possibility of withdrawing up to 95.5% of the accumulated fund at the time of retirement, which is usually the preferred option. Withdrawals of up to 25% are allowed prior to retirement for mortgage down payments and to pay down mortgage debt.
Administrative or overseeing institution	ONP – decentralised public institution of the Ministry of Economy and Finance.	SBS – Superintendency of Banks, Insurance and AFPs.

Source: OECD Secretariat based on Ñopo (forthcoming).

Both public and private contributory systems in Peru give low benefits (Figure 3.17, Panel A). Moreover, workers with similar career paths can receive different pensions under the two schemes (Figure 3.17, Panel B). In the public system, the minimum and maximum pensions have been updated only once in 2019, resulting in large losses of purchasing power and extremely low replacement rates. In the private system, low replacement rates of less than 30% (Freudenberg and Toscani, 2019_[60]) are driven by low mandatory contributions compared to international standards (OECD average of 18.2% against 13% in Peru), low labour incomes and low frequency of contributions due to informality. Because pensions are capped in the public system, high-income workers tend to affiliate in the private system. While low-income workers would prefer to stay in the public system to get access to the minimum pension, stringent requirements access dissuade them. Early withdrawals from the private system are possible under numerous situations (OECD, 2019_[61]). Most people (95%) withdraw most of their accumulated savings (up to 95.5%) when they reach the retirement age (Ñopo, 2021_[12]), as this is allowed. As a result, the private system has become a way to save up to the retirement age, undermining one of the main purposes of a pension system which is to insure people in old age beyond retirement.


The non-contributory pension programme, *Pension 65*, mainly covers the poorest workers, leaving many vulnerable workers without any pension benefits. Although successful in alleviating extreme poverty in old age, benefits and coverage remain low (monthly PEN 125 or USD 32, 36% of the poverty line or 13% of the minimum wage in 2021). While coverage has increased since the programme's inception eleven years ago, it only reached 24% of the elderly (627 924 beneficiaries) by the end of 2022. Benefits remain the same since the programme inception, even though the monthly cost of the food basket per person at the extreme poverty line has increased by over 38%. Despite increasing resources, spending remains low, with a budget of 0.1% of GDP (0.45% of the public budget) in 2021.

Figure 3.17. The pension system's generosity is low



Note: Panel A: Year 2019. It shows the hypothetical gross replacement rates based on current pension system characteristics and rules. They are calculated for someone entering the labour market at age 20 and working a full career until the normal retirement age. Price inflation is assumed to be 2.5%, real earnings growth is 2% and the real rate of return is 3.5%. Panel B, is a calculated example of a worker that affiliated to the system between 1994 and 2019 with 20 years of contributions and contribution density of 77%. It compares the benefits the workers would receive in the public pension system or the private pension system with a profitability from AFP Integra (annuity interest=3%). LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX.

Source: OECD Pension models and (Nopo, 2021^[12]).

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A comprehensive reform of the pension system is necessary to improve coverage, increase benefits and address informality. There is a need to expand coverage and benefits of the non-contributory pension. One option is to deliver a universal non-contributory minimum pension to all residents aged 65 and above. For example, providing a universal minimum pension equivalent to the poverty line to all Peruvians aged 65 and over – around 3 million people – would cost 1.6% of GDP (1.5% of GDP net of current expenditure in *Pension 65*), raising to 1.8% of GDP by 2050. Such benefit would provide a replacement rate of 40% to minimum wage earners. To encourage formal job creation, this minimum pension would be financed from general taxation, which would require mobilizing additional tax revenues. Options for raising more revenues are discussed in Chapter 1. Implementing such a universal minimum pension scheme offers the advantage of reducing contribution rates within the contributory system for low-income workers, thereby promoting formal employment.

To top up the non-contributory pension workers would contribute to the pension system, for which enrolment would become automatic and mandatory for all workers. To preserve incentives for formalisation, mandatory contributory rates could be made progressive, with lower contributions for wage earners below the minimum wage, where incentives for informality matter the most, and increasing gradually for higher wages. The contribution rates could be calibrated to achieve replacement rates of at least 50% of pre-retirement earnings, close to the average OECD replacement rate for men (59%), to ensure adequate pensions and fiscal sustainability. This could imply very low contributions for the lowest-income workers, and higher than current contributions for the higher-income workers. Finally, a third tier of individual voluntary savings could complement the other two pillars.

An alternative to address informality and reduce labour costs instead of progressive contribution rates is subsidising the social security contributions of low- and middle-income workers (OECD, 2019^[61]), with the subsidy decreasing with income. Evidence from Chile shows that subsidizing social contributions has

increased formal employment for vulnerable groups (OECD, 2022^[62]). The risk is creating an incentive to remain informal or to under declare income, so it must be designed very carefully.

The fragmentation of the contributory public and private pension systems also needs a deep reform to address complexity, inefficiencies, and inequities, as analysed in the OECD Pension Review (OECD, 2019^[61]). Aware of these challenges, in July 2022, a Multisectoral Commission, composed by the ministries of Labour, Economy and Finance, the Council of Ministers, the Central Bank and the Superintendency of Banking, Insurance and AFPs, was tasked with preparing technical reports evaluating the pension system and preparing a proposal for reform.

A priority should be removing the existing competition between the public and private systems and making benefits complementary. The contributory system could rely on public or private provision, on both or establishing notional accounts as done in other OECD countries. Maintaining private provision as the main system has the benefit of contributing to the development of local financial markets, and of establishing a clear link between contributions and benefits, incentivising workers to contribute regularly. The minimum pension discussed above could also be designed to provide both proper incentives to contribute to the pension system and higher pension benefits as the number of years of contributions increases.

To enhance pension coverage for the self-employed, mandatory contributions, as done in other Latin American countries and several OECD countries, could be implemented in a gradual manner. Improving incentives to increase voluntary contributions could also be considered. For example, by making automatic enrolment to a voluntary pension account. Financial incentives for voluntary contributions could also be improved. This should be accompanied by progressive contribution schedules, as discussed above, and innovative collection mechanisms using advanced technology, such as smartphones, to make it easy to contribute, or through utility bills (e.g. mobile phone, water, electricity). Encouraging long-term savings opens the door to saving smaller amounts which often does not occur, due to high transaction costs (Bosch et al., 2019^[63]). Technological innovations can also help reach those disconnected from traditional savings systems. Some examples from OECD countries include a platform called “Retirement Miles” in Mexico encourages pension savings among low-income and independent workers. In Chile, the U-Zave platform allocates savings to a personal mutual fund through purchases in associated stores. Similarly, a Spanish start-up developed a mobile app called “*Pensumo*” or “Pensions by Consumption”, which enables members to save through purchases in associated businesses, and by participating in socially responsible activities (for example, recycling and road safety initiatives).

Other reforms to the design of the private pension system are needed as discussed in the OECD Pension Review (OECD, 2019^[61]). A priority would be to limit early withdrawals from individual accounts to improve pension benefits. Early withdrawals could be limited to voluntary contributions or to extreme cases such as terminal illness. Other key priorities include optimizing the asset accumulation period by adjusting the default investment strategy to adopt a more optimal lifecycle approach. It is also important to align costs and fees and foster competition through improved disclosure and reporting on the costs and fees associated with pension funds. Moreover, placing limits on the frequency of changing funds and providers can help prevent cost increases resulting from unnecessary switching. Overall, the pension reform would also benefit from parametric changes including limiting early retirement, closing the 5-year gender gap for early retirement, and linking the retirement age to life expectancy.

Ensuring universal access to high quality health care services

Peru has made significant progress towards universal health coverage during the past decades (Figure 3.18, Panel A). Health coverage has increased from 37% in 2004 to 95% in 2019, according to the register of the universal health insurance, but socio-economic and geographic inequalities persist, (Figure 3.18, Panels B and C). Hospital services are highly concentrated in urban areas, with some regions having poorer access to healthcare than others (OECD, 2017^[64]). Peru has a low density of healthcare workers per capita, 16.8 per 10 000 habitants in 2021, much lower than Latin America (23) and the OECD (30) (World Bank, 2021^[65]) and unequally distributed across the country (Figure 3.18, Panel D).

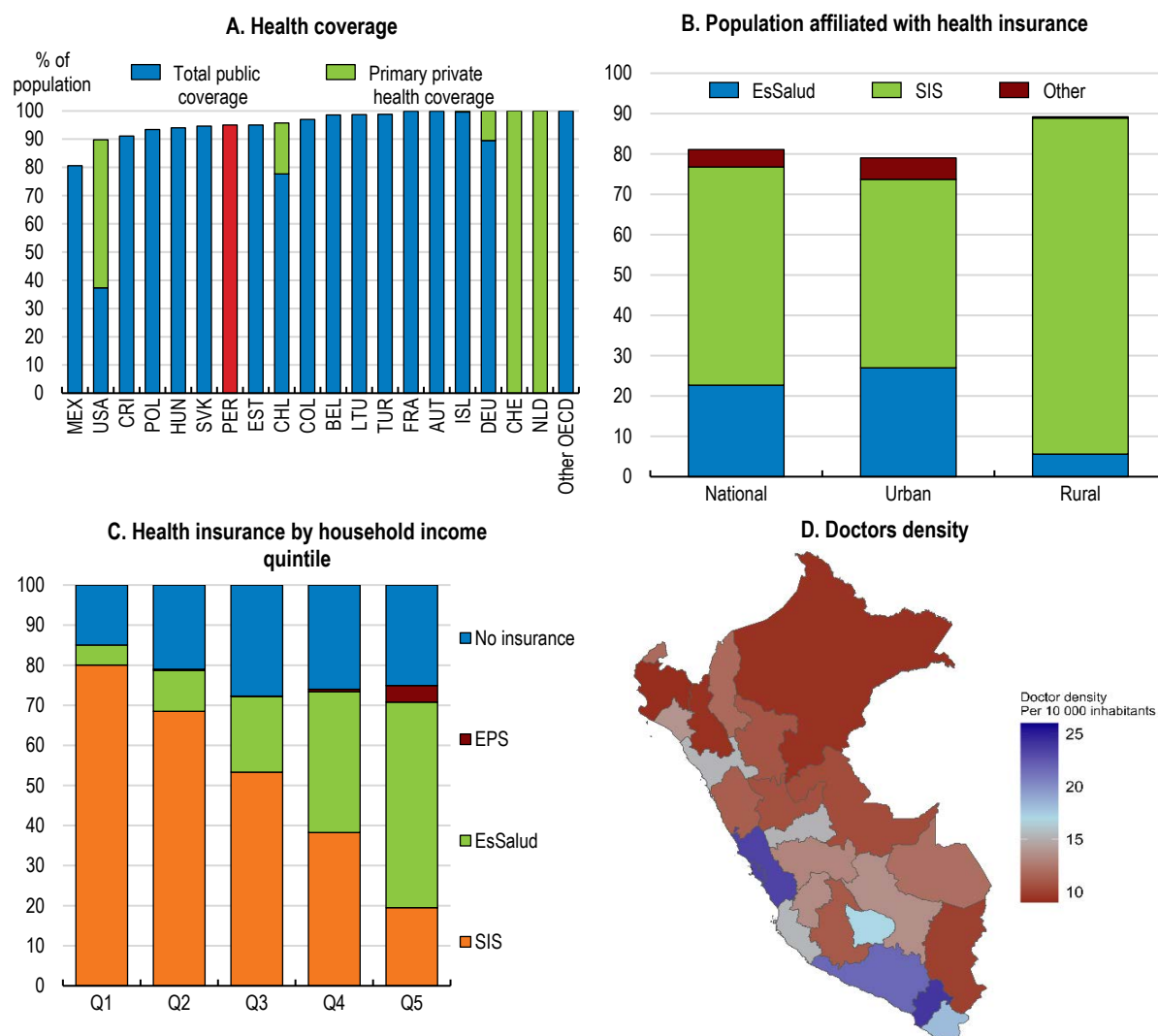
The COVID-19 pandemic has revealed the health system is overwhelmed. Peru stands out in the international context as the country with the highest number of deaths per population worldwide, with over 6 000 people per million (according to Our World in Data). Age and the region of residence have been the main determinants of the probability of dying from COVID-19, while mortality rates were homogeneous throughout the income distribution (World Bank, 2023^[4]). Poor infrastructure at primary care and hospitals, lack of specialised personnel, and governance problems are part of the explanations (Schwalb and Seas, 2021^[66]). During the pandemic, visits to healthcare centers declined significantly because the system became overwhelmed by COVID-19 cases and did not recover pre-pandemic levels in 2021 (World Bank, 2023^[4]). Even before the pandemic, many people were relying on pharmacies to meet health care needs instead of visiting recognized health care providers, as 45% of the population that required care had not visited a health center, and the number climbed to 55% by 2021.

The health system in Peru is highly fragmented, with multiple regimes and different rules. It is composed of three regimes: a non-contributory mechanism, called the Integral Health System (SIS); a contributory system called the Social Security in Health (EsSalud); and private supplementary healthcare providers (EPS). The non-contributory mechanism (SIS) covers around 60% of the population, mostly belonging to the lowest income percentiles and informal workers, and is primarily financed by general taxation. Part of this system is also semi-contributory, although it makes up a minority of SIS affiliates, as non-poor self-employed and microentrepreneurs can contribute a small amount and enroll. The contributory system, EsSalud, covers 26% of the population, mostly higher-wage workers, and is financed exclusively by labour charges. The private health insurance is only held by 3% of the highest-income population. Each system provides the same services to its affiliated population with its own budget, working in parallel with no coordination of functions and are managed by different ministries with limited effective stewardship of the health ministry.

The health regimes provide services that differ significantly, resulting in inequities. SIS offers a large primary coverage, but with inadequate infrastructure and equipment (Phillips, 2022^[67]). For example, while SIS has 40 primary care facilities for every 100,000 affiliated, EsSalud has only four leading to longer waiting times for appointments. On the other side, EsSalud has a better provision of more complex health care interventions (Ñopo, 2021^[12]) and better cost coverage (Seinfeld et al., 2021^[68]). As a result, out-of-pocket expenses can differ significantly depending on the health scheme and typically higher for households affiliated to SIS for complex illnesses.

The financing of the health system incentivizes informality (Torres, 2021^[69]). While the non-contributory system SIS provides free access, formal workers need to contribute 9% of the monthly salary to EsSalud at the minimum wage. However, users' satisfaction with both systems is similar (Ñopo, 2021^[12]). This leads to formal workers paying for what informal workers receive for free or at a very low cost, and leads to contributions to the health system viewed as a tax on formality by workers and employers. The health system creates other complexities that result in awkward incentives. For instance, there are semi-contributory regimes that require self-employed and microentrepreneurs to pay for identical coverage as the free schemes.

Figure 3.18. Access to health coverage is almost universal but unequal



Note: Year 2021 for Peru. Panel A shows 2019, data for Peru is 2021 from the register of the universal health insurance. Panels B and C show data from Household Surveys. SIS is the non-contributory health system, EsSalud is the contributory system and EPS are private institutions. Source: INEI-Encuesta Nacional de Hogares; OECD Health Statistics 2021.

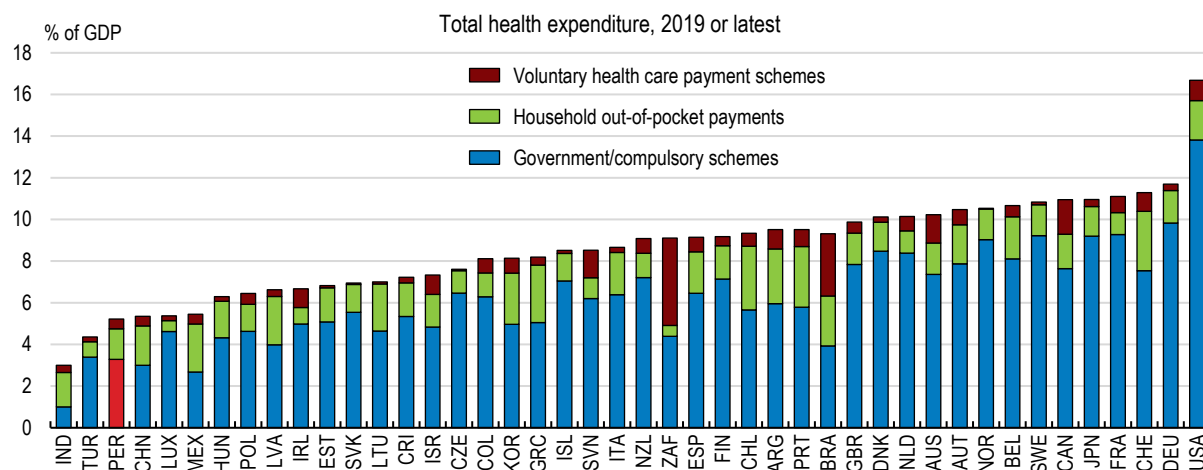
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Public healthcare in Peru is also underfunded and resources are fragmented over the different subsystems, creating inequalities for access. While public health expenditures rose to 3.3% of GDP in 2019 (Figure 3.19), spending has not kept pace with the expansion of the coverage. For a comparison, per capita spending in EsSalud is 40% higher than per capita spending in SIS (World Bank, 2021_[65]). While technical inefficiencies, including low capacities as highlighted in Chapter 2, may partially explain low public expenditure, underfunding remains a clear issue that leads to high out-of-pocket spending. At 30% of total health expenditure, out-of-pocket spending in healthcare is among the highest in the OECD. Out-of-pocket spending is primarily borne by the wealthiest households, but only because they can afford such expenses, meaning that poorer households lack access to certain services.


To achieve universal access to high-quality healthcare services and reduce inequities and incentives for informality, increasing public healthcare spending is necessary. According to the World Bank, an additional 1.2% of GDP is required to achieve universalisation and increase the quality of health services (World Bank, 2021_[65]). Since health financing through labour charges creates disincentives for formal job creation,

increasing the financing from general taxation would help. Options to increasing general taxation are discussed in Chapter 1. To boost formalisation incentives, health contributions for low-income workers could be lower, particularly around the minimum wage where formality incentives matter the most. A gradual schedule of health contributions could be based on workers' income, shifting more of the burden into higher income ranges, away from the vicinity of the minimum wage, by starting at zero for poor workers and increasing for higher-income groups (World Bank, 2021^[65]).

Figure 3.19. The healthcare system lacks sufficient funding



Source: OECD, Health Expenditure and Financing database.

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To address current inefficiencies and inequities, it is necessary to strengthen coordination between the multiple public insurers and gradually integrate these systems. This could be achieved through greater use of service-exchange agreements between SIS and EsSalud, standardising typologies of care providers across subsystems and establishing minimum quality standards (OECD, 2017^[64]). In June 2019, guidelines for service exchanges were approved, and a few institutions have started implementing them. However, challenges regarding the definition of services and their scope hinder widespread adoption. Amid the COVID-19 pandemic, there was a push for health service exchanges, which should be continued moving forward. Legislation could better define the levels of coordination to guide joint actions of public insurers. Further integration would require pooling all existing resources and distributing them to existing insurance schemes based on a pre-defined per affiliate value adjusted by health risks and sanitary outcomes, and developing a common tariff for general benefits to facilitate the mobility of insured persons between different provider networks. A unified public healthcare system with universal access and a common set of high-quality healthcare benefits could be supplemented by regulated voluntary private insurance, an approach followed in some OECD countries such as France.

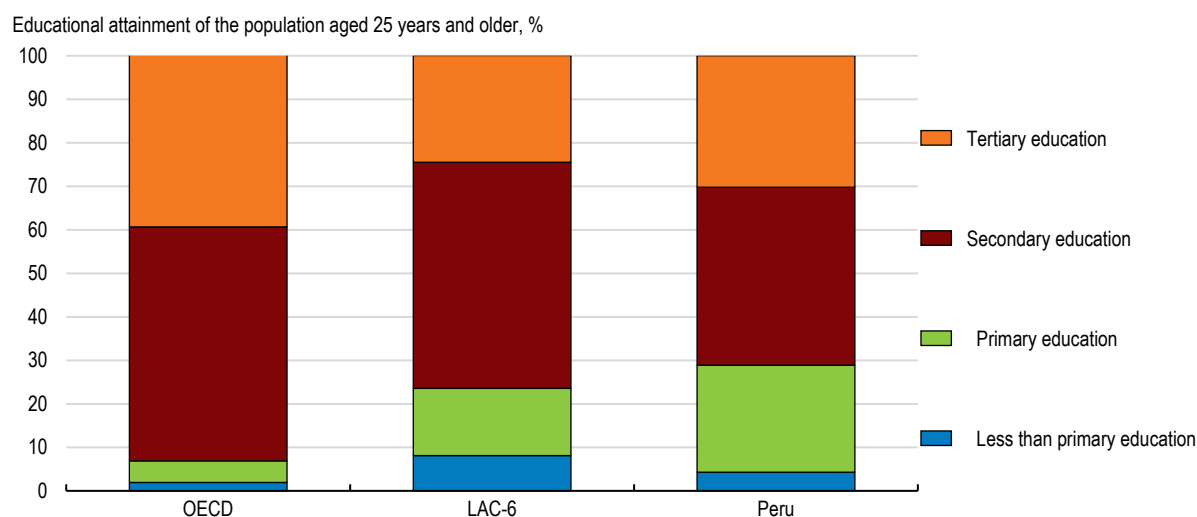
Achieving universal health coverage cannot be done without improving the quality of healthcare provision. Effective stewardship by the Health Ministry will be essential to set health priorities and establish a standard methodology for tariff calculation to improve the purchase and sale of services (OECD, 2017^[64]; World Bank, 2021^[65]). Strengthening coordination and coherence of services delivered among public insurers would allow for economies of scale and reduced inequities and inefficiencies in access to healthcare. A regulatory framework that establishes a common service plan and fee schedule should be implemented, with mechanisms to ensure compliance by insurers and providers. A transparent data infrastructure that ensures compliance with quality and outcome standards, reduces payment delays, and monitors costs is also needed. Improving healthcare infrastructure and the density of the health workforce and better distribute it across Peru's geographical areas is crucial.

Better access to high quality education and training is key for equity and productivity

Addressing unequal educational attainment

High quality education is crucial for raising productivity and reducing inequalities. A well-educated workforce can help decrease labour informality, as higher labour productivity affords paying for higher labour costs. Despite low public education spending (2.7% of GDP in 2018, compared to an OECD average of 4.4%), Peru has made notable strides in providing universal basic education, with at least 96% of adults completing primary education in 2020, surpassing Latin American countries (Figure 3.20). The impact of the COVID-19 pandemic on educational attainment in Peru has been significant. World Bank estimates indicate that 1.7 years were lost in learning-adjusted years of schooling, one of the highest rates in the region (World Bank, 2023^[4]).

Figure 3.20. Educational attainment is relatively high



Note: 2020 or latest available year.: LAC-6 is the unweighted average of ARG, BRA, CHL, COL, CRI, and MEX. Source: OECD and INEI.

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Prioritizing universal access to high-quality early childhood education is crucial for improving educational outcomes later in life, particularly for children from low-income households (Alcázar, 2020^[70]; Karoly, 2005^[71]). Early childhood education and care is also essential to develop future children's skills and facilitate both parents' labour market engagement (OECD, 2023^[72]), especially for women. By 2022, 6.4% of 0- to 2-year-old children were enrolled in *Cuna Más*, a large-scale early childhood development intervention that has shown good results in terms of educational outcomes (OECD, 2019^[14]). While coverage for children aged 3 to 5-years-olds improved significantly to 94% in 2019 from 81.5% in 2013 (INEI, 2022^[73]), pandemic-related school closures led to a drop in enrolment rates to around 85% in 2020 and 2021, with a slight recovery in 2022 (90%). There are high disparities in access to high-quality early childhood education with rural and remote areas lagging. A non-school-based early education programme (PRONOEI) has improved access for children from disadvantaged backgrounds, but it has not been effective in providing the same quality of education as formal schools (Box 3.3). Access to formal early education schools remains low for lower-income families in remote rural zones as formal schools are mainly located in urban areas and there is limited transport connectivity. Improving children's access to early education and care requires an expansion of education services for 0-to 2-year-olds, including *Cuna*

Más day-care. Furthermore, improving access to formal public early schools for 3-5 years olds would imply higher investment to expand capacity and formal schools across the country. While PRONOEI programme has helped to increase access of children from vulnerable backgrounds, improving the funding of the institutions would likely deliver better outcomes, with a view towards transforming these into formal schools in the future. These reforms would reduce poverty, increase social mobility and integration (OECD, 2018^[74]), and help reduce dropouts (Heckman and Masterov, 2007^[75]; OECD, 2016^[76]). Additionally, mothers, for whom affordability of early childhood education is the main barrier to the labour market, would feel encouraged to search for a job.

Box 3.3. Early-childhood education for students from vulnerable backgrounds in Peru

In Peru, early education is mandatory for children aged 3-5 years. The Ministry of Education oversees the early-childhood education programmes, which are implemented through a combination of public and private schools, and community-based organizations. Non-School-Based Early Childhood Education Programme (PRONOEI) is a public early childhood education programme that aims to provide comprehensive care and education to children in rural and remote areas where access to formal education is limited. In these centres, teachers are typically community members who are trained to provide early childhood education and care to children in their local communities, many times mothers from the community. PRONOEI community educators work closely with parents to promote children's development, and they are often responsible for organizing and leading learning activities, and preparing nutritious meals.

The programme has been instrumental in promoting early childhood education in remote and rural areas of Peru, providing access to education for children who would otherwise lack childcare. Evidence suggests that the PRONOEI programme has positive effects on education results, children's cognitive and socio-emotional development, relative to those not participating in education, particularly for children who come from disadvantaged backgrounds and have limited access to education. However, PRONOEI students tend to obtain worse outcomes than students from school-based background (Cueto and Díaz, 1999^[77]; Cueto et al., 2016^[78]). This is at least partly explained by PRONOEI educators lacking formal education beyond the secondary level, and their training may not be as extensive or rigorous as that of teachers in formal schools. Other challenges are related to the retention of trained educators in the PRONOEI programme, particularly in areas where opportunities for career advancement and professional development are limited. Inadequate infrastructure, and low financial resources for programme implementation contribute to poor educational outcomes.

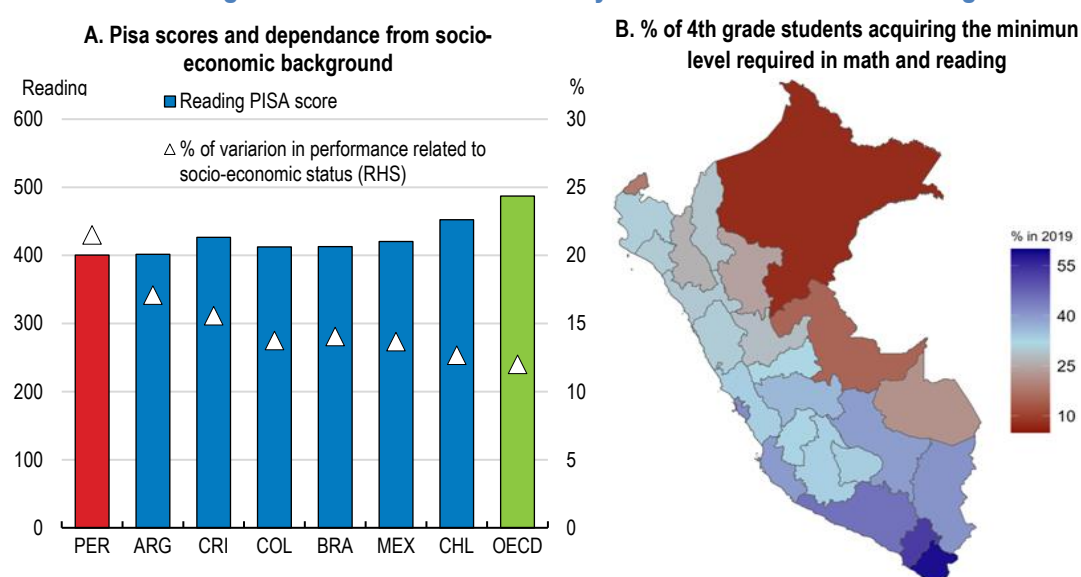
Access to secondary education has improved, with 41% of the population aged 25 years and older attaining secondary education in 2021 from 36% in 2010 (INEI, 2022^[73]), above some Latin American countries and close to the OECD average. However, educational exclusion remains a concern. Gender gaps in educational attainment remain relatively high, as 34% of women compared to 42% of men aged 25 years and older achieve secondary education (INEI, 2022^[73]). Work obligations of female teenagers outside of school and teenage pregnancies are the main factors explaining school female dropouts, especially in rural areas (OECD, 2022^[11]). In rural areas only 32% of the population completes secondary education and 8% completes higher education. While conditional cash transfer and scholarship programmes like *Juntos* and PRONABEC (scholarships and educational loans to talented students from poor backgrounds), have reduced exclusion, disparities still exist between regions and ethnic groups. For example, students in Lima attain a higher level of education than students from vulnerable regions (INEI, 2022^[73]), and individuals from indigenous backgrounds study an average of four years less than those who speak Spanish. These inequalities have been aggravated by the pandemic. According to the Ministry of Education, the average attendance rate for secondary education in 2020 was 56%, compared to 90% in 2019, with the impact being larger for those from vulnerable backgrounds. Targeted academic support could reduce educational exclusion. For example, expanding the bilingual education programme for indigenous children to

secondary education, prioritising the geographical areas characterised by the largest shares of children with a limited proficiency in Spanish, would help to reduce dropouts. Expanding the extended school-hours programme (*Jornada Escolar Completa*), prioritising students from vulnerable backgrounds, would also help by providing academic support and a safe environment. Particular attention should be paid to the quality of the teaching provided during these extended hours. Conditional cash transfers, such as *Juntos*, could be a powerful tool if the conditionality focuses on teenage girls' pregnancy prevention and regular attendance and school completion (OECD, 2019^[14]).

Improving the quality of education

While there has been substantial progress in education performance in the last decade, challenges related to quality and equity persist. Learning outcomes in Peru continue to lag the OECD average and other Latin American peers (Figure 3.21). Students' performance is highly influenced by their socioeconomic status, with primary education students from low socioeconomic backgrounds having 16% lower probability of meeting the minimal educational requirement in mathematics (Alcázar, 2020^[70]). Ethnic background and geographic location also significantly impact learning outcomes. Gender skill gaps are also significant. A greater proportion of 15-year-old girls perform below average in mathematics and science compared to their male counterparts, while girls perform better in reading than boys. This is reflected in the later education and occupation choices of women, with 25% of female tertiary graduates studying a STEM degree compared to more than 35% of male tertiary graduates in 2019 (OECD, 2022^[11]).

Figure 3.21. Low learning outcomes in Peru are closely tied to socioeconomic background



Source: OECD, PISA 2018 Database and INEI.

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The pandemic exacerbated inequality in education opportunities. The government promptly launched a distance learning programme (*Aprendo en Casa*) and distributed tablets with internet access to 24% of primary and secondary students (*Plan Cierre de Brecha Digital*) to address the long school-closures. However, less than 50% of primary education students had a computer at home and only 25% of households had internet access. Students from vulnerable backgrounds were particularly disadvantaged, with only 17% of them using digital tools to connect to classes compared to 59% of students from higher-income households (IPE, 2021^[79]). Even students participating in online classes have experienced a decline in learning outcomes, with an average drop of 14% in reading and mathematics performance between 2019 and 2021 (MINEDU, 2021^[80]). The proportion of students performing below the minimum

level in the PISA test increased by at least 22% from PISA 2018 (IPE, 2021^[79]). Closing these gaps will require targeted academic and tutoring support provided by well-trained teachers, prioritizing disadvantaged students. One example is through after-school or summer school remedial programmes, which have been shown to be effective in Finland, Portugal, France or India. Authorities could also expand coverage of the Digital Gap Closing programme (*Plan de Cierre de Brecha Digital*) to ensure that every student in the country has access to and actively engages with digital technologies.

Improving access to high-quality education requires enhancing teaching quality, learning materials and infrastructure. The welcome 2012 teacher reform aimed to improve educational quality by offering better labour conditions and merit-based career advancement (Box 3.4), while a monetary incentive programme (*Bono escuela*) launched in 2014 rewarded teachers for students' achievements. However, efforts to develop stronger professional pathways for teachers must continue, as only 64% of all teachers attain the minimum quality requirements in secondary education (UNESCO, 2023^[81]). Improving quality of teacher's initial training is key. Challenging working conditions, inadequate training, and lower salaries than for other professions limit the attractiveness of the teaching profession in Peru (UNESCO, 2017^[82]).

Box 3.4. The 2012 career teaching reform

In 2012, the government introduced a law (*Ley de Reforma Magisterial*) with the aim of improving the quality of teaching and the professional development of teachers. The reform introduced new evaluation criteria and professional development requirements for teachers, and a new system for promoting and rewarding good performance. The new system bases teacher selection and promotion on periodic mandatory performance evaluations. Based on these evaluations teachers can search for opportunities to move horizontally and vertically through the system. Contrary to the old law, teachers can be dismissed after three failures in performance evaluations to retain the most talented teachers. The new law expands the number of performance areas where teachers can be evaluated, including innovative pedagogical practises, institutional management, teacher training and research and innovation. The law also simplifies payroll management and establishes fixed pay rises linked to the performance evaluations. The reform has contributed to improve teacher quality and student performance while increasing incentive for professional development. However, implementation delays and salary raises not subject to meritocratic evaluations could hinder teacher motivation.

Source: (OECD, 2016^[83]; UNESCO, 2017^[82]; SOPLA, 2014^[84]).

There is also a need to better align the number of teacher candidates with the needs of the education system, particularly in rural areas where there is a large share of students of indigenous backgrounds. Too many teacher candidates apply for public positions in urban areas while in rural areas there are shortages with only 11% of available positions being filled in 2020 (World Bank, 2022^[85]). As a result, contract teachers, who lack necessary qualifications, tend to occupy positions that permanent teachers, with higher qualification, reject, usually in schools in disadvantaged backgrounds. Highly qualified teachers in pre-primary centres in Chile, Denmark, Turkey and Norway, are 11% more likely to teach students from disadvantaged backgrounds (OECD, 2019^[86]). Additionally, the number of multigrade schools in rural areas is large, as 78.3% of total primary schools have only one teacher for the whole primary education (CIES, 2021^[87]). Meeting the different needs of all students in multigrade schools requires highly qualified teachers specialized in many subjects. Reallocating high-qualified teachers to more disadvantaged schools, improving working conditions and reducing the number of grades a teacher must serve would reduce the gap in learning outcomes. Peru could draw from Korea's experience with mandatory allocation and rotation schemes for teachers according to the needs of each school to attract good teachers in disadvantaged schools via extra incentives, such as additional salary, smaller classes, less instructional time, additional credit towards future promotion to administrative positions, and the ability to choose the next school where one works (OECD, 2018^[88]; IDB, 2020^[89]).

Adequate school infrastructure is crucial for promoting engagement and enhancing learning outcomes. However, in Peru only 26.2% of total classrooms in pre-primary, primary and secondary public schools were in good condition in 2018, with even lower numbers in rural schools, at 24% (INEI, 2018^[90]). Around 60% of schools nationwide lack some basic services, of which 40% have no water, 36% have no drainage and 30% have no electricity, making the learning process challenging. In 2014, the Education Ministry implemented the National Programme of Educational Infrastructure (Pronied) with the aim of reducing educational infrastructure gaps. However, implementation has been weak driven by poor coordination between national and subnational governments and low implementation capacity. In 2021, 30% of the budget allocated to Pronied and the regional governments was not executed. Reforms to enhance procurement, reduce corruption and improve budget process and coordination, discussed in Chapter 2, are essential for this.

Improving the transition from education to the labour market

Access to higher education has increased in Peru but it has come at the expense of quality. 30% of the Peruvian population aged 25 and above hold a tertiary degree, more than in many other Latin American countries. However, over 80% of the population aged 16-25 scores at the lowest levels of proficiency in literacy and numeracy according to the OECD PIAAC survey (OECD, 2023^[91]). Additionally, the number of active universities has almost doubled from 74 to 139 between 2000 and 2019 (OECD, 2016^[83]), many of them unregulated, resulting in relaxed admission requirements and low student skills (OECD, 2019^[14]). In 2020, the government launched the National Policy for Higher and Technical-Productive Education to 2030, with a focus on increasing access to higher education for at least 50% of the country's youth, emphasizing the access of youth from vulnerable backgrounds. A welcome 2014 higher education institutions law tried to improve regulation and quality across programmes and providers, creating an institution responsible for guaranteeing minimum quality standards. So far 92 universities and two graduate schools have met the minimum quality requirements in the initial stage of the higher education licensing process. However, only 73 vocational education institutes meet the quality criteria. It is crucial to further enhance the quality of these institutions by reinforcing quality assurance mechanisms and providing support for continuous improvement processes.

Peru needs to reinforce its vocational education and training (VET) system, which is currently not well aligned with the needs of the labour market (OECD, 2019^[14]). The demand for high skilled workers has been outpacing the supply. VET programmes could increase the supply of skills in high demand, such as IT technicians, personal care workers or health professionals. Peru's VET system is characterized by strong sectoral schools (e.g. in manufacturing, construction, and tourism) but enrol only around 15% of VET students. The remaining non-sectoral public and private schools are weaker providing low-skilled technicians with little work practice and offer too few opportunities to acquire advanced skills. Engaging firms in the co-design and running of non-sectoral schools' programmes and providing training could better align learning with labour market demands, while increasing work-based learning opportunities. Higher participation in work-based training would increase employability and reduce skill mismatches. Some OECD countries provide financial and fiscal incentives to provide apprenticeships in dual VET systems. For example, in France students receive financial aid and companies receive financial and fiscal incentives to hire apprentices, alleviating financial constraints and potentially promoting formal employment. Employers should also play a more active role in the design and implementation of active labour market policies, and university programmes to enhance the quality and relevance of skills.

Table 3.4. Main findings and recommendations

MAIN FINDINGS	RECOMMENDATIONS (Key recommendations are bolded)
Labour market reforms to reduce informality	
<p>Around 80% of workers are in informal jobs. This deprives them from access to many social security benefits, while reducing productivity and tax revenues.</p> <p>A reinstatement regulation that is uncommon in OECD and Latin American countries makes it difficult to recognise dismissals as justified, discouraging formal permanent contracts.</p> <p>A relatively high minimum wage reduces the prospects for low-income workers to obtain formal employment, particularly for women, young and rural workers.</p>	<p>Establish a comprehensive strategy to foster formalisation, including lower non-wage labour costs, particularly for low-income workers, more flexible employment regulation on permanent contracts, better skills, stronger legal enforcement, and improvements in tax administration.</p> <p>Reform the reinstatement regulation so that employers can plead for justified dismissals, including for economic reasons.</p> <p>Establish a permanent commission to guide future changes to the minimum wage based on objective mechanisms and its impact on informal employment.</p>
Expanding social protection coverage	
<p>Poverty at 26% is above pre-pandemic levels. The pandemic has highlighted significant gaps in social protection, particularly for informal workers. Income-support programmes are well established but coverage and benefits are low.</p> <p>There is a lack of timely statistics on vulnerable populations and monitories to properly identify these populations and their needs. The social household registry has improved during the pandemic, but often fails to reflect income changes in real time and leaves out some vulnerable households.</p> <p>The targeting system to select households eligible for social programmes incentivises informality by requiring not contributing to the health system.</p> <p>Pension coverage is low. The contributory pension system is complex and fragmented.</p> <p>Pension fund withdrawals reduce pension coverage and benefits and have left 80% of affiliates without savings for pensions. Most people withdraw 95.5% of savings at retirement age as lumpsum, leaving individuals with the full longevity risk.</p> <p>Access to the health system is highly fragmented. The underfunded public health system covers mostly the disadvantaged population for free while formal workers pay contributions for similar quality services.</p>	<p>Expand coverage and benefits of cash transfer programmes for the poor, based on the existing conditional cash-transfer programme <i>Juntos</i>.</p> <p>Collect systematically data on minority groups, households in remote areas, and vulnerable households. Continue improving the social household registry by merging in administrative databases, using real-time data and digital tools.</p> <p>Eliminate the requirement of not contributing to the health system to access social programmes.</p> <p>Expand coverage and benefits of the non-contributory pension scheme. Complement the non-contributory pension scheme with a contributory pension system that eliminates the overlap between existing contributory pension schemes. Restrict pension fund withdrawals to extreme cases, such as terminal illness, and to voluntary savings and replace lump-sum payouts at retirement age by regular pension payments.</p> <p>Improve access to quality healthcare services by integrating the multiple public insurers, with stronger recourse to general taxation revenues. Allow for voluntary private insurance contributions to top up health services.</p>
Improving access to high quality education	
<p>Early childhood education is key for improving learning outcomes later in school, especially for vulnerable children, but access to high-quality public early education is low and further decreased after the Covid-related schools' closures. This impacts also negatively female labour market outcomes.</p> <p>Better learning outcomes are mostly linked to advantaged students from urban areas and higher socioeconomic backgrounds.</p> <p>A large share of teachers does not attain the minimum quality requirements. Disadvantaged schools, from rural areas, struggle to attract qualified teachers.</p> <p>Low quality among postsecondary educational institutions is widespread, in particular in vocational education and training (VET), and programmes are not aligned with labour market needs.</p>	<p>Expand access to high-quality early childhood education, prioritising vulnerable children.</p> <p>Establish targeted support and tutoring programmes for students from vulnerable backgrounds provided by well-trained teachers.</p> <p>Continue improving teacher initial training, teacher recruitment and selection and promote merit-based promotions and rewards, including incentives for teacher's reallocation to disadvantaged schools. Strengthen the involvement of firms and social partners in defining the standards of dual vocational programmes, and boost participation in work-based learning.</p>

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PERU

Peru's solid macroeconomic framework has driven substantial economic growth and poverty reduction in the past two decades. While the economy swiftly rebounded from the pandemic due to strong policy support, it exposed structural weaknesses such as a large informal sector and stark regional disparities in accessing public services. More recently, growth has slowed, and inflation remains high but is on a declining trend. Looking ahead, main challenges for boosting productivity and investment include strengthening competition, improving regulations, diversifying exports, and enhancing infrastructure. Improvements in governance and the rule of law are essential pillars for achieving sustainable long-term growth and social cohesion. Expanding access to quality education, reducing social contributions, particularly for low-income workers, and providing a same basic level of universal social protection for all workers, formal and informal alike, would help reducing widespread informality and inequities. This will require raising additional tax revenues and improving spending efficiency. Environmental challenges and risks loom large, but also provide significant opportunities for the future. To tackle environmental challenges, Peru needs to curb deforestation while capitalizing on its renewable energy potential to reduce reliance on fossil fuels.

SPECIAL FEATURES: RAISING PRODUCTIVITY, EXPANDING SOCIAL PROTECTION, REDUCING LABOUR INFORMALITY

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