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Peru: Long-Term Development Issues

Volume I

Postscript — Summary and Conclusions

April 13, 1979

Country Programs Department
Latin America and Caribbean Regional Office

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CURRENCY EQUIVALENTS

The exchange rate is being adjusted daily roughly in line with the difference between domestic and international inflation. The exchange rate and currency equivalents in effect on March 29, 1979, were as follows:

Currency Unit = Sol (S/.)

| | <u>Calendar 1978</u> | <u>March 29, 1979</u> |
|---------|----------------------|-----------------------|
| US\$1 = | S/. 160 | S/. 210 |
| S/. 1 = | US\$0.0062 | US\$0.0047 |

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This report was prepared by Elkyn A. Chaparro based on two missions that visited Peru in March/April 1976 and September, 1977. The report was discussed with the Peruvian Government in March 1979.

The following persons participated in the 1976 mission and made substantial contributions to the report:

| | |
|---------------------------------|---|
| Fred Levy (IBRD) | Industry |
| Juan Carlos Gomez-Sabaini (OAS) | Taxation |
| Gregory Lazarev (FAO) | Land Reform |
| Vicente Galbis (IMF) | Savings and Financial Intermediation |

Other mission members were: Cornelius Cacho, Nicholas Carter, Ines Garcia, Carole Seppala, Gerhard Thiebach, Dirk van der Sluijs, and Damian von Stauffenberg from the Bank and Ernesto Kritz and E. Riezebos, Consultants. Susana Hristodoulakis was the mission secretary.

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COUNTRY DATA - PERU

| AREA | POPULATION | DENSITY |
|-----------------------------------|--|---|
| 1285.2 km ² , thousand | 16.5 million (mid-1977) Rate of Growth: 2.9 (from 1970 to 1977) | 13 per km ² 54 per km ² of arable land |

POPULATION CHARACTERISTICS (1977)

| | |
|--|------|
| Crude Birth Rate (per 1,000) | 41.0 |
| Crude Death Rate (per 1,000) | 11.9 |
| Infant Mortality (per 1,000 live births) | 65.1 |

HEALTH (1977)

| | |
|-----------------------------|-------------------|
| Population per physician | 1760 |
| Population per hospital bed | 500 ^{3/} |

INCOME DISTRIBUTION (1971-72)

| | |
|--|------|
| % of national income, highest quintile | 58.6 |
| lowest quintile | 3.1 |

DISTRIBUTION OF LAND OWNERSHIP

| | |
|-----------------------------------|----|
| % owned by top 10% of owners | .. |
| % owned by smallest 10% of owners | .. |

ACCESS TO PIPED WATER (1975)

| | |
|-------------------------|------|
| % of population - urban | 72.0 |
| - rural | 15.0 |

ACCESS TO ELECTRICITY (1972)

| | |
|-------------------------|--------|
| % of population - urban | } 34.9 |
| - rural | |

NUTRITION (1974)

| | |
|-------------------------------------|-------|
| Calorie intake as % of requirements | 100.0 |
| Per capita protein intake | 61.7 |

EDUCATION (1976)

| | |
|-----------------------------|-------|
| Adult literacy rate % | 72.0 |
| Primary school enrollment % | 111.0 |

^{1/}
GNP PER CAPITA in 1977 : US \$ 830

GROSS NATIONAL PRODUCT IN 1977

| | US \$ Mln. | % |
|---------------------------|------------|-------|
| GNP at Market Prices | 12422.1 | 100.0 |
| Gross Domestic Investment | 1933.6 | 15.6 |
| Gross National Saving | 1007.4 | 8.1 |
| Current Account Balance | -926.2 | -7.5 |
| Exports of Goods, NPS | 1725.6 | 13.9 |
| Imports of Goods, NPS | 2164.0 | 17.4 |

ANNUAL RATE OF GROWTH (% constant prices)

| | 1965-70 | 1970-75 | 1975-77 | 1978 |
|---------------------------|---------|---------|---------|-------|
| GNP at Market Prices | 5.4 | 5.6 | 0.0 | 0.1 |
| Gross Domestic Investment | -1.5 | 15.8 | -17.4 | -15.4 |
| Gross National Saving | 10.3 | 9.8 | -4.9 | 44.5 |
| Current Account Balance | .. | .. | .. | .. |
| Exports of Goods, NPS | 2.9 | -7.1 | 7.7 | 17.0 |
| Imports of Goods, NPS | -1.0 | 10.0 | -9.6 | -32.1 |

OUTPUT, LABOR FORCE AND
PRODUCTIVITY IN 1976
(at 1970 prices)

| | Value Added | | Labor Force ^{2/} | | V. A. Per Worker | |
|---------------------|-------------|-------|---------------------------|-------|------------------|-------|
| | US \$ Mln. | % | Thous. | % | US \$ | % |
| Agriculture | 1138.9 | 13.6 | 2109.4 | 43.4 | 539.9 | 31.5 |
| Industry and Mining | 3167.7 | 38.0 | 1019.1 | 21.0 | 3108.3 | 181.2 |
| Services | 4030.9 | 48.4 | 1731.6 | 35.6 | 2327.8 | 135.7 |
| Unallocated | .. | .. | .. | .. | .. | .. |
| Total/Average | 8337.5 | 100.0 | 4860.1 | 100.0 | 1715.5 | 100.0 |

GOVERNMENT FINANCE

| | General Government | | | Central Government | | |
|---------------------------|--------------------|------|----------|--------------------|------|----------|
| | Soles Bln.) | | % of GDP | Soles Bln.) | | % of GDP |
| | 1977 | 1977 | 1972 | 1978 | 1978 | 1975-78 |
| Current Receipts | 190.1 | 18.1 | 19.1 | 264.2 | 15.8 | 15.2 |
| Current Expenditure | 219.7 | 20.9 | 17.4 | 208.7 | 17.3 | 17.0 |
| Current Surplus | -29.6 | -2.8 | 1.7 | -24.5 | -1.5 | -1.5 |
| Capital Expenditures | 44.9 | 4.3 | 4.9 | 57.6 | 3.4 | 4.3 |
| External Assistance (net) | .. | .. | .. | 14.9 | 0.9 | 2.3 |

^{1/} The Per Capita GNP estimate is at 1977 market prices, calculated by the same conversion technique as the 1978 World Atlas. All other conversions to dollars in this table are at the average exchange rate prevailing during the period covered.

^{2/} Total labor force; unemployed are allocated to sector of their normal occupation. Unemployed are mainly of unemployed workers seeking their first job.

^{3/} 1975 estimate.

.. not available
.. not applicable

COUNTRY DATA - PERU

| MONEY, CREDIT and PRICES | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 |
|-----------------------------------|-------|-----------|-------------------------|--------|--------|--------|
| | | (Million) | outstanding end period) | | | |
| Money and Quasi Money | 87506 | 107012 | 126174 | 151062 | 198800 | 320900 |
| Bank Credit to Public Sector | 20811 | 19773 | 43567 | 104900 | 198900 | 289800 |
| Bank Credit to Private Sector | 60361 | 73152 | 95788 | 134900 | 173800 | 238200 |
| (Percentages or Index Numbers) | | | | | | |
| Money and Quasi Money as % of GDP | 24.4 | 23.9 | 22.8 | 19.7 | 18.9 | 19.2 |
| General Price Index (1977 = 100) | 37.8 | 44.1 | 53.4 | 71.9 | 100.0 | 157.5 |
| Annual percentage changes in: | | | | | | |
| General Price Index | 14.2 | 16.7 | 21.1 | 34.6 | 39.1 | 57.5 |
| Bank credit to Public Sector | 77.0 | -5.0 | 120.3 | 106.9 | 69.0 | 45.7 |
| Bank credit to Private Sector | 18.0 | 21.2 | 30.9 | 37.2 | 49.4 | 17.1 |

BALANCE OF PAYMENTS

| | 1976 | 1977 | 1978 |
|-----------------------------|------------------|--------|--------|
| | (Millions US \$) | | |
| Exports of Goods, NFS | 1744.6 | 2137.8 | 2399.9 |
| Imports of Goods, NFS | 2628.0 | 2694.4 | 2070.1 |
| Resource Gap (deficit = -) | -883.4 | -556.6 | 329.8 |
| Interest Payments (net) | -324.0 | -371.9 | -493.2 |
| Workers' Remittances | - | - | - |
| Other Factor Payments (net) | -42.4 | -54.5 | -84.5 |
| Net Transfers | 57.2 | 56.8 | 56.0 |
| Balance on Current Account | -1191.9 | -926.2 | -191.0 |
| Direct Foreign Investment | 170.8 | 54.1 | 25.0 |
| Net MLI Borrowing 2/ | | | |
| Disbursement | 1144.4 | 1026.4 | 866.5 |
| Amortization | -305.4 | -406.4 | -478.9 |
| Subtotal | 839.0 | 620.0 | 387.6 |
| Capital Grants | - | - | - |
| Other Capital (net) | -338.3 | -97.6 | -86.7 |
| Other items n.e.i | 0. | 0. | -52.0 |
| Increase in Reserves 2/ | 520.4 | 349.7 | -82.0 |
| Net Reserves (end year) 2/ | -355.3 | -705.0 | -623.0 |

MERCHANDISE EXPORTS (AVERAGE 1976-78)

| | US\$ Miln | % |
|-------------------------------|-----------|-------|
| Fish meal | 182.8 | 10.9 |
| Coffee | 155.2 | 9.3 |
| Other Agricultural goods | 179.7 | 10.7 |
| Copper | 342.6 | 20.5 |
| Silver | 174.8 | 10.4 |
| Other Minerals | 317.0 | 18.9 |
| Petroleum, Crude and products | 95.1 | 5.7 |
| All other commodities | 228.0 | 13.6 |
| Total | 1675.2 | 100.0 |

EXTERNAL DEBT, DECEMBER 31, 1978

| | US \$ Miln |
|--------------------------------|------------|
| Public Debt, incl. guaranteed | 5046.8 |
| Non-Guaranteed Private Debt | 378.2 |
| Total outstanding & Disbursed | 5425.0 |
| DEBT SERVICE RATIO for 1978 1/ | |
| | % |
| Public Debt, incl. guaranteed | 33.3 |
| Non-Guaranteed Private Debt | 3.3 |
| Total outstanding & Disbursed | 36.6 |

RATE OF EXCHANGE

| | |
|-----------------|---------------|
| Averages - 1977 | |
| US \$ 1.00 = | 81.97 Soles |
| Soles 1.00 = | US \$ 0.01220 |
| Average - 1978 | |
| US \$ 1.00 = | 160.00 Soles |
| Soles 1.00 = | US \$ 0.00620 |

IBRD/IDA LENDING, (Dec. 1978) (Million US \$):

| | IBRD | IDA |
|-------------------------------|-------|-----|
| Outstanding & Disbursed | 185.6 | - |
| Undisbursed | 234.5 | - |
| Outstanding incl. Undisbursed | 420.1 | - |

1/ Ratio of Debt Service to Exports of Goods and Non-Factor Services.

2/ Adjusted for Balance of Payments support loan.

. . . not available

. . . not applicable

POSTSCRIPT

i. This report studies various issues influencing Peru's long-term development and assesses Government policies addressing these issues up to mid-1978. Since then, the issues have not changed, but the orientation and decisiveness of Government policies have changed in various important positive ways. This postscript outlines briefly the principal policy changes and their possible impact on Peru's development prospects.

ii. During 1978, Government officials made a bold and critical diagnosis of the basic problems causing the present serious financial difficulties and constraining balanced long-term development. The Government's analysis reached conclusions similar to those in this report, which highlight the need to reduce the domestic resource gap; stabilize the economy; improve efficiency of resource use; and stimulate export volume growth and diversify exports away from a few primary commodities.

iii. Based on this diagnosis, the Government started implementing during the second half of 1978, an economic recovery program that aims at:

a. Closing the Financial Gap

Short-term financial stabilization. A number of measures have been adopted to reduce the resource gap, slow down the inflation rate, and to stop the loss of international reserves. The sol was devalued from S/. 130 to the US dollar in May to almost S/. 200 to the US dollar by year-end 1978. Public sector savings, as a share of GDP, are aimed to rise from -1 percent in 1978 to 5.6 percent in 1979, by adopting far-reaching measures. Effective real interest rates are to become positive before the end of 1979. Finally, the bulk of the external debt due in 1979 and 1980 was renegotiated.

Stimulating public savings. The Government has already adopted and continues to design and introduce a number of tax measures aimed at broadening the tax base and improving the equity and allocative effectiveness of the tax system. At the same time, a major effort is being made to strengthen and expand tax administration and enforcement. On the expenditure side, most subsidies on food and petroleum products have been eliminated, military purchases have been reduced and a severe austerity program is being enforced.

b. Solving Structural Distortions

Efficiency in resource use. The decontrolling of prices and the movement towards realistic exchange rate and interest rate policies are major components of the Government efforts to increase economic efficiency throughout the economy. In addition to stimulating industrial efficiency, the National Registry of Manufactures -- prohibiting the import of goods in the registry -- will be dismantled during the next two years, and the level of import tariff protection will be substantially reduced during the next three years. Finally, a 1978-1982 Medium-Term Public Investment Program that concentrates on projects with high expected returns was prepared. The greater emphasis on efficient resource allocation in the public and private sectors, and on development of Peru's comparative advantages is expected to lead to higher levels of employment.

Export promotion. Central to this objective will be a realistic exchange rate. However, special priority will be given to stimulating non-traditional exports. The measures to promote industrial efficiency are being complemented by fiscal incentives and by streamlined export procedures.

Improving public sector management. Initial steps are being taken to make state-owned enterprises more financially independent and responsive to efficiency considerations. Their investment decisions are to be based on economic priorities.

Rapid growth of agriculture and mining. Public investment in both these sectors will be reoriented towards projects of high pay-off and quick gestation. In agriculture, measures will be taken to promote intensive land-use and the creation of small- and medium-sized agroindustries. In mining, the Government intends to promote the participation of foreign and domestic private capital in the creation of large, medium, and small mines and expand the level of public investment in the sector.

c. Evaluation

Because these policies are being launched at a time when Peru is still faced with formidable stabilization efforts, they constitute an extraordinary and unusual task. As soon as the fiscal and external gaps are narrowed, and inflation is brought under control, the system of policies recently initiated should continue to be applied as the normal Government program. The principle of efficiency should then reach all sectors, but in particular agriculture, where much remains to be achieved. This should help to avoid returning to the strong disequilibria of the past. The present report analyzes the sources and causes of these disequilibria.

SUMMARY AND CONCLUSIONS

I. INTRODUCTION

1. This report aims at providing a long-term perspective for understanding Peru's past development and for suggesting the elements of a strategy for rapid and balanced development in the future. The report is not encyclopedic. Instead, through macroeconomic and sectorial analysis it reviews some basic issues of long-term consequence. The report does not judge government objectives which is a domestic political issue; instead the report takes objectives as given and studies effectiveness of policy in attaining objectives. This summary and conclusions brings together the different issues studied in Volume II, the Main Report, into an overview. The first part of this summary reviews the present economic structure and the policies that created it, focussing mainly on the adequacy of government policies. In the second half, this summary looks at the policies that could improve the present structure and put Peru into a path of sustained development.

2. Although the focus is long-term, the issues treated in this report have a major relevance for Peru's short-term policy making. In fact, the long-term analysis of the past shows that the chain of events that brought to the present economic difficulties were present at various times in Peruvian economic history and that emergency remedies that provide temporary solution without changing the underlying trends, will only postpone and magnify the problems.

II. THE PAST DEVELOPMENT ISSUES

A. LONG-TERM TRENDS IN ECONOMIC HISTORY

3. The most salient feature of Peru's socioeconomic development is the contrast between regions, between groups of population and between periods in its history. The Andes Mountains divide the country into three regions with distinct geographic and climatic features, ranging from desertic coastal plains, to cold Andean highlands and to tropical humid jungle lowlands. From the contrasting topography flow sharp differences in natural resource endowment. Peru has abundant deposits of minerals and rich fishing grounds, but, besides small fertile areas in the coast, most of Peru's land has poor agricultural potential.

4. The economic strategy and the social structure developed during the colonial period and the 19th Century (1530-1820) superimposed additional segmentations to the basic topographic contrasts. The economic strategy aimed at a concentrated exploitation and export of one or two primary products. The social structure imposed was one of the most rigid in Latin America, with a small rentier class at the narrow top who benefited from landownership and the export booms, but did not evolve into an entrepreneurial class. Chronologically, growth fluctuated violently from periods of boom to periods of stagnation and decline when the product was exhausted or its world demand collapsed. The economic structure became increasingly divided between the export sectors, which introduced modern technology in periods of boom, and the rest of the economy, where technology changed little and output growth

was slow. The periods of bonanza did not result in either linkages being developed between the primary export sectors and the rest of the economy, nor in much permanent development progress. A large share of the rents was transferred abroad; little productive use was made of the rest, both because of the elite's little entrepreneurial interest and talent, and because of the Government's limited execution and management capacity. Most of the windfalls not transferred ended up paying for imports of luxury goods or for unproductive Government expenditures. Moreover, excessive domestic spending in periods of boom and the lag in adjusting expenditure to the financial constraints imposed by the decline, further accentuated the depressions and mortgaged a substantial share of the benefits during the subsequent boom many years later.

5. Compared to the previous centuries of meager development achievements, the first half of the 20th Century was a period of remarkable progress although the basic constraints to sustained and balanced development did not change. The export base diversified with the expansion of copper, lead, zinc, cotton, sugar and fishmeal production. Nonetheless, since all major exports remained primary products subject to violent fluctuations of world markets, the economy's development continued to follow a pattern of boom-bust cycles. The productive linkages between the primary export sectors and the rest of the economy developed little. A small manufacturing sector emerged behind large protective walls, but it became increasingly dependent on the primary export sectors for financing its investment and foreign exchange requirements. Finally, the segmentation of the economy became increasingly acute. The distance between the modern sectors (exports and manufacturing) and the rest of the economy, and between the Coast and the rest of the country continued to grow rapidly. With the massive migration from rural to urban areas and from the Sierra to the coast, an increasingly powerful urban middle class emerged that started changing the upper strata of the socioeconomic pyramid and intensified the focus of government policies on promoting urban growth in the coast. However, the Sierra's agriculture and rural population -- which included the bulk of Peru's poorest half -- benefitted little from development and from government policies.

6. In the 1950s, the political pressures to modify the development pattern became very large, particularly in the rural areas. In 1962, a new government made a wider distribution of development benefits a major policy objective. Progress was made in strengthening the public sector's execution capacity and in implementing large programs in education and road construction. However, the reformist strategy ran into serious political and financial problems. By 1968 Peru was again into another of its recurrent deep financial crises and at the end of 1968 a military government took power.

B. RECENT GOVERNMENT STRATEGY: AN OVERVIEW

7. The 1968 Military Government announced plans for basic changes in the development strategy. It saw three principal problems: unequal distribution of wealth and development benefits, inefficient use of resources and excessive foreign dependence. Therefore, the new government strategy was to focus on:

(i) expanding the role of the state; (ii) changing the patterns of asset ownership; (iii) curtailing foreign dependence by reducing foreign ownership and orienting industry and agriculture towards essential goods in the domestic market; (iv) stimulating the deconcentration of economic activity out of Lima; and (v) reforming the educational system.

8. The Government was successful in overcoming the 1968 financial crisis -- with a tough emergency program of austere fiscal and monetary policies and helped by a buoyant demand for Peru's primary exports -- and in carrying out many of its objectives. The State became the principal agent of the economy. Through nationalization and creation of new enterprises, the State took direct control of well over 150 enterprises in key economic sectors, and, through copious and intricate legislation, it imposed strict operating controls on the non-public sectors. The State's share in total capital formation rose from less than one-fourth in 1968-70 to over one-half in 1974-74. The patterns of asset ownership in the economy changed drastically: the share of assets foreign owned fell sharply; the best farm lands were converted into cooperatives; and the permanent workers in manufacturing gained a share of the sector's assets. The Government also gave a strong autarchic bias to agricultural and industrial policies, increased the incentives for industry to establish outside of Lima, and laid the groundwork for a major industrial reform. Finally, probably one of the most significant achievements was in the promotion of the cultural and political integration of the country. Particularly through the land reform, the rural population has become better organized to articulate its priorities.

9. Against these notable achievements, the Government's strategy ran into serious problems. Since there were no blueprints when the process began, a large number of decisions had to be improvised when problems arose. The strategy followed had a major impact in changing the sociopolitical and economic structure of Peru, but did not succeed in resolving basic problems that for centuries have constrained balanced and sustained development in Peru. The conditions and the prospects of the poorest half of the population improved little, in spite of the massive reforms of ownership and the large State intervention. The financial improvement of 1968-70 was shortlived and did not break the long-term trends towards macroeconomic disequilibrium. In fact, efficiency of resource use fell so much, that the basic economic structure noticeably weakened. Finally, the vulnerability and dependence of the economy to foreign events and decisions increased. The following pages analyze in more detail these issues.

C. IMPACT ON THE POOR OF GOVERNMENT POLICIES

10. Focusing almost exclusively on a redistribution of ownership, the government's poverty strategy ran into three basic constraints:

- (i) Peru has very limited productive assets. Land is not sufficient to provide an adequate income to all the rural population with the level of technology now used.

- (ii) The differences in productivity are very large between sectors (e.g. industry and agriculture) and within sectors (e.g. modern coastal farms and traditional Sierra haciendas).
- (iii) The regular workers in the higher productivity farms or firms are a minority, most already in the richest quartile of the population.

11. Thus, the large reforms of ownership redistributed income flows and wealth within the top quartile of the population--which is remarkable--but the poorest 50 percent benefitted little, if at all. The land reform redistributed almost 45 percent of farmlands to the regular workers in the farms expropriated but these direct beneficiaries account for only 15 percent of the rural families. To try to spread out benefits somewhat more widely, the Government decreed that in some cooperatives the surrounding peasant communities share in the profits for use in community improvement programs; these indirect beneficiaries total an additional 10-15 percent of rural families. The remaining 70-75 percent who did not benefit from the land reform were the farmers with a smaller medium-sized commercially viable farm (2-50 ha), the minifundistas (farms less than 2 ha) and the seasonal landless workers. The two latter account for one-half of the rural families and are the rural poorest. They would benefit from the land reform only with increased labor demand in the larger farms. However, this appears unlikely, since to ensure that membership does not grow, many cooperatives are mechanizing their operations. Even within the 15 percent who directly benefitted, there are sharp differences in income gains. Those in the modern and technified farms in the Costa (around 3 percent of rural families) saw their incomes multiplied; those in the low productivity Sierra "haciendas" did not increase much their incomes. The profit-sharing schemes in the industrial and mining sectors noticeably increased incomes of the workers there, but they account for less than one-twentieth of the labor force.

12. The Government's poverty strategy gave much less attention to macroeconomic policies. Their thrust remained heavily biased against the poor and transfer programs directly benefitting specific poverty target groups remained very small.

13. Fiscal policies have not been progressive. On the revenue side, the tax system continued to rely heavily on indirect taxes on consumption as a source of revenues. Corporate income taxes were eroded by generous tax holidays. Since the corporate income tax schedule is highly progressive and the tax exemptions are proportional, the benefits from the tax holidays increase rapidly with size, discriminating against the small enterprise. Personal income taxes are low because of extremely high personal exemptions, generous legal loopholes and weak tax administration. The bulk of income taxes is paid by the top 1 percent of the population, the rest of the top quartile contributes little although they were the main beneficiaries of the ownership reform.

14. The redistributive impact of government expenditures was also limited. Between 1971 and 1975 expenditures on social sectors (education and health mainly) grew little in real terms and fell as a share of total expenditures. Most of the government's investment expenditures went for capital

intensive projects, while little was spent on programs directly focused on the poor. Infrastructure in poor areas did not improve much and a large share of what was done was financed by the poor themselves. Little effort was made at developing rural development programs focused on increasing the productive capacity of the poor, or at more massively providing assistance to artisan industry. Moreover, what little was done was not cost effective (high cost per beneficiary when cheaper alternatives existed) or went to projects that gave little prospects for a sustained improvement of the income of the poor, without permanent outside subsidies.

15. The large build-up of Government controls on prices and on general economic activity -- many imposed with social objectives in mind --, ended up helping the poor little as consumers but penalizing them as producers. Price controls were imposed on a large number of domestically produced goods, and the prices of imported petroleum and foodstuffs (mainly wheat, meat and vegetable oils) were heavily subsidized. However, most of these items were not important in the consumption basket of the rural groups and of the poorest of the urban groups. Some of the consumer subsidies (such as for some wheat products) benefitted some of the urban poor, but they were not cost-effective since they favored the upper income groups more than the poor. However, the profit squeeze resulting from the controls was more easily absorbed by the larger modern enterprises than by the small artisanal producers and small farmers. In some cases the price controls had more devastating consequences on the poor. For example, the artificially low price of wheat drove out of the market quinoa, the only crop that could be produced at altitudes above 3,000 meters. Subsidies on fertilizer imports and artificially low interest rates on the formal financial system also reduced the competitive position of the artisanal producer and the small farmer, since they had no access either to formal credit nor to fertilizer use. To the extent that, without directly benefitting the poor, the price controls resulted in an inefficient allocation of investment resources lowering overall output and employment growth, the poor also suffered. Finally, the build-up of Government controls on most aspects of economic activity (including agricultural production and marketing, industrial investment and operation, and price and import controls) were difficult to comprehend by the small entrepreneur and required a costly administrative infrastructure that the large enterprises could more easily absorb than the small enterprises.

16. Macroeconomic policies also discouraged labor use in the economy. Cheap interest rates, an overvalued exchange rate, and large tax incentives to investment on imported equipment, all contributed to artificially lower the cost of capital. On the other hand, various measures aimed at improving the working conditions of those already employed sharply increased the cost of labor. Unfortunately, the high level of underemployment and large disparities in productivity between sectors cause direct trade-offs between measures that improve the working conditions of the minority with permanent jobs and measures to stimulate labor absorption. Thus, minimum wage legislation, profit-sharing schemes, social security and the labor stability law (which puts barriers on firms dismissing personnel) have improved working conditions markedly, but also have strongly contributed to a lowering of the labor component in production.

17. Finally, the negative consequences of the violent cyclical fluctuations of the Peruvian economy are mainly absorbed by the poor. An analysis of the behavior of the economy through the four cycles of the 1950-70 period shows that the main adjustments are absorbed by the construction sector and tertiary activities. A large share of the output classified in the tertiary sector are artisans, informal small-scale industry and the self-employed. Since institutional rigidities in the labor market constrain industrial enterprises from reducing the labor force when demand falls, the larger industrial firms satisfy the peaks of demand by sub-contracting production to artisan and other self-employed. When demand collapses these are therefore the first to suffer. This link between the formal and informal sectors (where most of the urban poor are employed) is an important reason for trying to minimize the violent fluctuations of the economy.

D. MACROECONOMIC ISSUES: SAVINGS, EFFICIENCY AND CYCLES

18. The emergency austerity measures imposed by the government in 1968-70 did not provide a lasting improvement, since starting in 1971 Peru's macro-financial trends once again deteriorated sharply (see table below). The resource gap (gross domestic investment minus gross national savings) increased from less than 1 percent to over 11 percent of GNP between 1971 and 1975. National savings fell sharply and import dependence increased, deepening the dependence of the economy on a few primary exports. Since export volume declined, the fate of the economy depended on the world prices of the exported commodities and on foreign borrowing. Up to 1974, prices were favorable but not sufficiently high to finance the exploding resource gap and heavy foreign borrowing was incurred. Since 1975, prices collapsed and external borrowing continued skyrocketing. By now, the external borrowing capacity has been exhausted and the country is once again in a deep depression. An aggravating factor to the present scenario is that efficiency of resource use in the economy has fallen sharply.

MACROECONOMIC INDICATORS, 1970-75
(Calculated at Constant 1963 Prices)

| | Resource Use <u>1/</u> | GDP | Export Volume | Import Volume | Investment <u>2/</u> | Savings <u>3/</u> |
|------|---------------------------|-----|------------------|------------------|----------------------|-------------------|
| 1970 | 100 | 100 | 100 | 100 | 100 | 100 |
| 1975 | 148 | 134 | 78 | 158 | 202 | 84 |

1/ Consumption plus investment.

2/ Gross domestic investment.

3/ Gross national savings adjusted for effects in terms of trade.

Source: Volume III, Table 2.25.

19. The large magnitude of the present crisis, the short-lived effect of emergency remedial measures in previous crises, and the widening amplitude of the resource gaps are evidence that only measures that go to the roots of the macro-economic problems can be expected to put Peru into a path of sustained growth. The discussion below summarizes the analysis in the Main Report on some of the key problems.

1. The Fall in National Savings

a. Long-Term Trends

20. During the 1960s and 1970s the savings performance of Peru has fallen sharply. During the 1950s, the savings ratio (gross national savings as percent of GNP) and its components -- personal, business and government savings -- fluctuated with the economic cycles, but the long-term trend remained a horizontal line around 20 percent of GNP. Since 1961, the savings ratio has continued to gyrate, but the long-term trend has become a sharply falling diagonal from over 22 percent of GNP in 1960-62 to a very low 8 percent in 1975-76. During the 1960s, the long-term decline was principally caused by personal savings which collapsed from a high 8-10 percent of GNP in the 1950s to a negligible level in 1968. Government savings, which had traditionally been low -- albeit consistently positive in the 1950s -- also became negative. Business savings, on the other hand, continued rising vigorously up to the mid-1960s, when they peaked at about 16 percent of GNP. Following the cyclical recovery of 1970-71, both personal and government savings have remained at critically low or negative levels, but business savings contracted sharply.

b. Determinants of Savings

21. Personal savings. Although the data on personal savings are particularly weak and there is little conclusive research in Peru or elsewhere on its determinants, various hypotheses can be made on why they collapsed. The first hypothesis is that the rapid fall in real interest rates in an increasingly uncertain environment induced either a shift from personal savings to consumption or (more likely) a shift from financial assets to "inflation hedges" (such as real estate or foreign exchange). The second hypothesis is that the large price subsidies on some consumer goods stimulated private consumption. The third hypothesis is that the redistributive policies of the Government affected personal savings in two ways. On the one hand, the "rentier" class of traditional landowners viewing the land reform as inevitable decapitalized their haciendas and consumed the proceeds. On the other hand, the few who benefitted from the redistributed income flows had a high propensity to consume. Whatever the validity of these hypotheses, what is certain is that the Government took no measures to stimulate personal savings.

22. Business savings. The inadequate financial policies of the state enterprises were the principal cause for the fall in business savings performance during the 1970s. The rapid transfer of some of the largest private enterprises to the public sector and the rapid proliferation of new state enterprises (all classified under "business savings"), strained the State's management capacity which in turn negatively affected the enterprises'

performance. However, the most detrimental policy on the state enterprises' finances and management was price controls. The two largest losers were the petroleum company (PETROPERU) and the agricultural marketing company (EPSA), but practically all state enterprises suffered losses or a major profit squeeze. This in turn eroded financial management and cost consciousness, further reducing operational efficiency and profits.

23. Government savings. the single major cause for low government savings in 1971-76 was the unsatisfactory performance of Central Government tax revenue. During the period, total Central Government expenditures grew in real terms about 6.5 percent yearly (not much faster than GDP), while revenues grew only 2.1 percent yearly. Given the sluggish revenue growth, expenditure growth was excessive. However, if the elasticity of revenues with respect to changes in GDP had been equal or somewhat above one (as is the case in many other developing countries), the level of expenditures could have been financed without incurring an unmanageable deficit. Unfortunately, this was not the case. By international standards the tax burden in Peru is low (around 13 percent of GDP) and the buoyance of tax revenues with respect to changes in GDP has fallen from about 1.18 in 1950-65 to only 0.93 in 1968-76. The built-in elasticity is much lower. The main cause for this low elasticity has been the massive erosion of the base of practically all taxes with generous tax holidays and exemptions. At the same time, little use has been made of excises on gasoline and non-essential consumer goods. These have a high revenue potential and would help rationalize energy use and increase the progressivity of the tax system. Because of the low performance of taxes on domestic transactions, the tax system has remained excessively dependent on foreign trade movements. Thus, in the recurring balance of payments difficulties (like since 1975), the collapse of the Central Government revenues deepens the financial difficulties. Finally, tax administration is weak mainly because of the complexity of the tax system and because insufficient resources have impeded its efficient operation.

24. The only public sector institution that consistently generated a growing amount of savings was the Social Security Administration (SSA). These increased from 0.5 to 1.5 percent of GDP between 1968 and 1974, mainly because of the lag between the growth of contributions to the pension fund and actual retirement of workers. This surplus has been achieved in spite of the inadequate financial policies that the Government has imposed on the SSA. Since it is required to maintain the bulk of its funds in fixed-term deposits at very negative real interest rates, it is rapidly being decapitalized. Already in 1976, the SSA's savings fell sharply to 1 percent of GDP and, according to SSA estimates, the surplus is bound to become a rapidly growing deficit in the coming decade.

25. In conclusion, two complementary hypotheses can be made on the determinants of national savings in Peru during the last 15 years. The first is that the ultimate major determinants of the deterioration was the transition towards a mixed economy and the strains created by change in ownership structures and in the socioeconomic constellation of power. The second hypothesis, corollary to the first one, is that in its zeal to do much in a short period of time and to satisfy the demands of the new middle class,

the Government did not attach sufficient attention to the problem of resource mobilization. Nevertheless, a larger effort towards tax reform, more realistic pricing policies and stimulus of personal savings was feasible and would have made possible for the Government to continue its reforms. In fact, more savings generating efforts would have been much more conducive than present policies to attain the development and distributive objectives of the Government and would have reduced foreign dependence.

26. If the conclusion was that political realities made the larger savings effort impossible, then the problem with the policies followed was to make a high level of investment an objective itself. The realistic approach would have been to reduce investment to the national savings realities, and focus the attention on increasing the efficiency and productivity of the resources invested. In fact, the efficiency of resource use was so low that more growth and development benefits could have been achieved with a much lower level of investment. This is discussed below.

2. The Low Efficiency of Resource Use

a. Efficiency of Public Investment

27. Since 1968 the Government has massively increased the importance of public investment in the economy. Through this tool the State can now influence the direction and momentum of the development process. Therefore, successes and failures in the public investment strategy and the degree of its efficiency of resource use have crucial implications for the financial, economic and social prospects of the country. However, although some important projects have been completed, the productivity of public investment has been low. From an analysis of the largest projects in execution or completed since 1971, the Main Report concludes that at least one-half of public investment expenditures may yield low or negative returns to the economy. The productivity of the investment expenditures, of course, has a direct implication on the future returns from the large external debt contracted. Since the economic rate of return of many projects is well below the average interest paid for financing it, these projects end up causing a further negative transfer of resources out of the country.

28. There are various causes for the low productivity of public investment. In the first place, the State spread out too thinly into too many sectors and tried to achieve spectacular results in too little time. The emphasis was on promotion of projects with too little attention given to the execution capacity of the agencies. The predilection for very large projects and the push for quick involvement in the full detailed management responsibility of the projects further compounded the execution capacity problem. Of course, the decision of the Government to concentrate investment in a few huge projects meant that risks were high for errors in one project to have major consequences on the productivity of total public investment and on the economy as a whole.

29. Another major cause of the low efficiency was the little attention given to economic criteria in project decision-making process. Foremost were physical considerations of exploiting natural resources or satisfying a domestic need. The main objective was to increase units of output rather than minimizing the benefits of the economy per unit invested. The economics

of projects also suffered from the general lack of cost-consciousness. The policies of price controls and subsidies, the strong pressure to achieve visible results and the heavy state interference in management, strongly eroded the accountability and financial management of public enterprises. As financial deficits became chronic, the incentives of the enterprises to control costs lessened since the Treasury was expected to cover the deficits.

30. These problems did not arise because of a lack of formal controlling mechanisms. On paper, an intricate and complicated mechanism exists for processing, approving and monitoring execution of projects, involving many ministries, agencies, committees and commissions. The problem is that it does not work properly. Most of the large projects tended to gain an irresistible momentum of their own after having been broadly identified. In some cases, the Government exerted its political weight behind the projects by passing legislation declaring them of national priority before studies establishing feasibility had been concluded. In other cases, the National Planning Office (INP) had little chance of influencing the project effectively since by the time it received the completed feasibility study, the institutions involved in the project had already committed large quantities of human resources to it and millions of dollars had been spent. In both cases the sectors found ways of bypassing the planning system, thus making the screening process irrelevant in practice. Moreover, INP lacks the appraisal capacity to conduct a thorough evaluation. In 1976, its Projects Department had only 14 technicians and since the processing system is extremely complex, they spent a large amount of their time doing administrative functions.

31. On the other hand, the ineffective controlling mechanism has created serious problems in project execution. The long series of authorizations and clearances -- most of which are formalities more than a review of substance -- tied up an important share of the already weak administrative capacity of the executing agencies and led to delays in project execution.

b. Efficiency of Government Controls

32. Starting from the assumption that the free operation of market forces was a principal cause for the unbalanced development and skewed income distribution in Peru, the State decided not only to acquire directly a large share of the strategic resources in the economy but to also closely monitor and restrict activities outside the public sector. Controls have been imposed on practically all aspects of economic activity and the procedures enforcing the controls have become ever more voluminous and complex.

33. Unfortunately, the benefits derived from the controls were small or negative. Some examples illustrate this:

- a. The complex controls on industrial investment have not changed much the structure of industry away from consumer goods, but may have encouraged concentration in a few large firms and in the Lima-Callao Area.

- b. Controls imposed on agricultural marketing have not worked. The consumers are not paying less and producers are not getting better prices. On the other hand, the fluidity of the marketing process has diminished and administrative costs increased, damaging producers, middlemen and consumers.
- c. Foreign exchange and import controls have failed to stop capital flight and to keep imports within planned limits. A complex machinery to control foreign borrowing has not been successful in curbing the expansion of external debt, but has contributed to costly delays in loan approvals.
- d. Price controls have not been conducive to an efficient allocation of resources nor have they contributed to reduce inflation in the longer run. The increasingly overvalued exchange rate during 1968-76 penalized exports and subsidized upper income groups. Increasingly negative real interest rates repressed financial development and distorted resource allocation by subsidizing investment and encouraging capital intensive activities. Unrealistically low public utility tariffs held back the expansion of basic public services. Price controls on petroleum and foodstuffs stimulated energy consumption and discouraged agricultural production. As discussed earlier, price controls did not favor a more equitable income distribution.

34. On the other hand, the costs to the economy of the controls have been very high. Implementing the controls has mushroomed the bureaucracy in the Government to enforce them and in the rest of the economy to comply with them. The controls also have tied up the scarce management and administrative knowhow in the economy, diverting it from other more essential tasks. Finally, the decision-making process has lost fluidity; costly delays are incurred while important decisions are pending.

c. Efficiency in Agriculture

35. Agriculture has concentrated the largest contrasts in Peru's development pattern. With the best lands, with favorable government policies, and with large injections of foreign capital and technology, the Costa has concentrated practically all modern Peruvian agriculture. The Costa is the backbone of agricultural exports and provides a large share of the crops domestically consumed. The regular workers of the large coastal estates succeeded in increasing considerably their wages during this century; to keep costs down the estates had been cutting jobs drastically and by the mid-1960s employed less than 4.5 percent of rural families. Conversely in the Sierra -- where most of the rural population lives -- the agrarian economy has stagnated throughout the centuries. Besides a poor resource base, the Sierra was penalized by adverse government policies and a semi-feudal agrarian structure. Around 40 percent of the Sierra's farmlands were large rentier haciendas, most of them worked by tenants with primitive technologies and extremely low productivity. The physical environment makes uneconomic large-scale crop production, so the few haciendas that modernized and acquired wage-labor moved into extensive sheep raising. But in doing so, they also

were cutting employment. At the bottom of the agrarian structure were the minifundistas and the landless workers not permanently employed in the large estates. Most of them in the Sierra, they had in 1971-72 per capita annual incomes of less than \$86 and accounted for 70 percent of the poorest 40 percent of Peru's population. With poor and small plots of land and with no access to Government assistance and services, they depended on off-farm employment to finance over 40 percent of their expenditures.

36. In this scenario of inadequate agrarian structure and rural poverty, the agricultural sector has been for many years in crisis. Peasant unrest and land invasions led to the first agrarian reform law in 1964. The law was not effectively implemented but it accelerated the change of expectations in rural areas. Fearing the inevitability of effective land reform, landlords decapitalized the estates, while labor management conflicts sharpened and farm profits fell. The uncertainty, the peasant unrest and the pro-urban government policies all fed each other to lower investment and reduce growth of output. At least since the early 1960s, agricultural output growth has remained below that of population and agricultural imports have risen rapidly, surpassing exports in 1975-76.

37. In 1968, the Government made important policy changes vis-a-vis agricultural and rural areas. The objectives became to increase the growth of food output, and to improve wealth distribution and the conditions of the rural poor. To achieve this the Government's strategy had three main components: a massive agrarian reform, higher public investment, and an increased intervention of the State in all aspects of agrobusiness. The Government has taken forceful action in all three aspects: 40 percent of the best farmlands were redistributed; public investment in agriculture increased almost fourfold in real terms; and the influence of the State on the sector has become pervasive. Nevertheless, the results have not been positive. As discussed above, the lot of the rural poor has not changed much. The efficiency of resource use in the sector has declined.

38. One problem seriously affecting efficiency is the functioning of the cooperatives created with the agrarian reform (Agrarian Reform Enterprises - AREs). Although production did not collapse with the land reform -- a remarkable achievement -- all AREs are facing in varying degrees operational problems. The more that cooperativization changed the pre-reform patterns of production and the smaller the initial distributable profits, the lower the willingness of members to participate in the AREs goals. Member rejection has been particularly large in the poor tenant-based haciendas of the Sierra, where cooperativization meant the elimination of individual plots/herds. The rigid size criteria imposed on all cooperatives have made many of the Sierra AREs uneconomic. Basic conflicts of set interest have arisen between members of the cooperative (who want to maximize wages and reduce employment) and members of the surrounding peasant communities (who want to reduce wages and maximize seasonal employment). At the same time, since the individual profit sharing is small and the member has little control on the allocation of the reinvested profits, he pushes for high wages and low profits, but since the wage and the job are both guaranteed, there are no incentives towards labor effort and discipline. Finally, all of the above organizational problems have constrained and made exceedingly difficult the management of the AREs. In

turn, this results in bad investment decisions and a deterioration of the AREs' prospects. Unless rapid action is taken, many AREs will go bankrupt in the near future. Many are surviving only with ever growing amounts of subsidized short term credits from the Agricultural Development Bank. The Government has been forced to intervene by fixing maximum wages, but has not been able to find solutions to the other basic problems.

39. Other Government policies have not stimulated efficient production. The Government concluded that market forces were not allocating sufficient resources to the production of food, and the monopolistic practices resulted in excessive profit margins and inefficiencies in marketing. To force growth of food production the Government first decreed that 40% of all arable lands be dedicated to crops, and since 1975 it has been setting up a complicated central planning system to partially replace the market on production and pricing decisions. In marketing, the Government imposed controls on prices and marketing margins; took over all marketing of exports, imports and some domestically produced foodstuffs; and established controls regulating the physical movement of agricultural goods. The farm area in food production has increased, but gross value of output per ha has declined, and net foreign exchange savings have been negative. Price subsidies on fertilizers helped more the richest farmers and often resulted in excessive use of fertilizers with little impact on production. The Government lacked manpower, money and storage facilities, wholesale markets and other marketing infrastructure which remains extremely inadequate. The centralized production planning has not been in operation long enough to evaluate its results, but it is so complicated that it has little chances of success. Negative real interest rates and inadequate water charges have also distorted resource allocation, encouraged overmechanization, and because of excessive water use increased the salinity and drainage problems in some areas.

d. Efficiency in Industry

40. Efficiency of production in industry remained low principally because of the increased orientation of policies towards forced import substitution since 1968. The 1971-75 National Development Plan cogent analysis of the problems in the industrial sector concluded that in most cases the industrial plant was "inefficient, disjointed, highly protected and incapable of competing in external markets". The Government opted for a highly autarkic model of industrial development, since it deemed necessary to produce domestically all goods considered essential. The policies that ensued were not much different from earlier ones. Significant greater emphasis was given to public sector planning and investment, and restrictions were placed on foreign investment, but the basic structure of incentives to the private sector was retained and even expanded: high protective tariffs, import prohibitions, and generous fiscal and credit incentives on the other.

41. The result of this strategy is that the problems diagnosed in 1971 have become worse. The share of domestic producers in the national market for manufactured goods has increased, but the foreign dependence of the sector has not declined: the fall in imports of finished goods has been offset by an increase in imports of capital goods and other inputs, while industrial exports have increased little. The rate of growth of industrial employment

was slightly lower since 1968 than in 1960-68, in spite of the faster growth of production. Moreover, the growth of industry has continued to be at a high economic cost. The combination of the highest average nominal tariffs in the Andean Pact (particularly high for consumer goods industries), tariff exemptions for imported inputs and absolute import prohibitions, resulted in extremely high levels of protection for consumer goods industries. This and the very generous fiscal incentives, assures a high profitability to Peruvian enterprises even at very low level of efficiency.

42. Trying to achieve economic independence through autarky in a country of Peru's size, may be both costly and self-defeating. Early growth quickly runs up against the limits of the domestic market and small-scale holds production costs above international prices. The improvement of real incomes is thus constrained, and the transfer of resources to industry -- whether through subsidies or higher prices -- represent a drain away from other more efficient sectors, limiting the growth of both output and employment. The resulting inefficiencies keep industrial exports from growing, but, unless it is to stagnate, industry will need foreign exchange for the raw materials and capital goods it requires. As industrialization proceeds in such a framework, and as incomes and employment become more dependent on the level and growth of industrial output, the economy as a whole becomes more dependent on the vagaries of international commodity markets and on the availability of foreign capital to finance the balance of payments current account shortfalls.

3. Import Dependence, Export Dependence, and Cyclical Fluctuations

43. During the last quarter century, the economy has become more dependent on imported goods to satisfy its demand. In the 1950-76 period, the average annual growth rate of import volume was over 7 percent, that of total domestic demand (consumption plus investment) almost 6 percent while that of GDY (GDP plus income effect of terms of trade) was less than 5.5 percent.

44. There are various causes for the increased import dependence. The decline in domestic food output per capita resulted in rapidly growing food imports. The decline of domestic petroleum output against an energy demand growing in excess of 7 percent annually (stimulated by unrealistically low controlled prices), mushroomed the volume of petroleum imports during the 1970s. The manufacturing sector remains heavily dependent on imported inputs and since it has been almost totally oriented towards the domestic market, it generates little foreign exchange. Finally, the heavy emphasis on capital intensive projects in public investment and the higher imported component of defense expenditures have made public expenditures more import-intensive.

45. The growth in import dependence would not have been a problem had export volume kept pace; however, since 1968 the opposite occurred. Between 1968 and 1976 export volume shrunk almost 25 percent; in all years after 1972, export volume has been below what it had been in the early 1960s. The virtual disappearance of anchovies in 1973 (which kept fishmeal export volume in 1973-76 at about one-third of the 1968-72 level) and the nationalization of the iron industry in 1975 were important causes of the fall in

export volume. However, even if fishmeal and iron exports are excluded, the volume of other exports was in 1976 only 6 percent above what it had been eight years earlier. Agricultural exports shrunk by about one-fifth during 1968-75 mainly because cotton production fell and domestic consumption of sugar grew briskly. Even excluding iron, the total volume of mining exports stagnated during 1968-75.

46. The concentration of exports in primary commodities (manufacturing still accounts for less than 6-7 percent of total exports) and violent cyclical fluctuations have remained major features of Peru's economic structure. However, the characteristics of the cycles have been changing since 1950 and the magnitude of the recurring disequilibria has become progressively larger. In the 1950s, the timing of the fluctuations of import capacity and economic activity was closely linked. The bulk of investment was by the private sector and most of the financing of the resource gaps came from private foreign direct investment. Starting in the mid-1960s, however, public consumption and investment became important exogenous factors that lengthened the periods of expansion. By the 1960-66 period, although import capacity expanded rapidly, the Government's expansionary policies fueled resource use to grow faster than GDY (gross domestic income) and financed the resource gap with heavy foreign borrowing. Then, in 1967 although import capacity stagnated and GNS fell by 12%, the Government was able to maintain a GDP growth of 4 percent with continued deficit financing. As the investment-savings gap expanded to almost 6 percent of GNP the financial situation collapsed in 1968. In the 1970s, the public sector stepped up the use of foreign borrowing to counteract the fall of export earnings and of national savings. In the 1971-75 period both import capacity and gross national savings contracted 25 percent, but the Government stimulated the economy with massive consumption subsidies, the income redistribution measures and a 25 percent yearly increase of public investment. The resource gap exploded from 0.4 to 11.4 percent of GNP between 1971 and 1975, and the external public debt more than tripled. Since then the country has been on the verge of financial collapse.

47. An interesting question is whether savings or foreign exchange have been the dominant constraint in Peru's development. The evidence in this report suggests that the dominant gap changes during the cycle (savings gap being dominant in periods of high commodity prices and vice versa) and that in the long term the principal constraint has been the domestic savings gap. However, because of the long periods of inadequate price policies -- particularly exchange rate -- penalizing exports, the external gap has dominated during certain periods.

48. In sum, with a rapidly deteriorating national savings performance and a growing import dependence, economic activity has become more dependent on the behavior of exports. However, since the exports have remained concentrated in a few primary commodities and export volume has not grown, economic activity has become more dependent on the behavior of world primary commodity prices. In turn, since world primary commodity prices have continued to fluctuate violently economic activity has become more vulnerable to violent cyclical movements and more dependent on foreign savings.

III. THE FUTURE DEVELOPMENT ISSUES

A. NATURAL RESOURCES, POPULATION DYNAMICS AND URBANIZATION

1. Natural Resources

49. The natural resource base holds both major opportunities and major constraints to Peru's future development. The largest asset is mining, which will remain the backbone of the economy as a source of savings and foreign exchange, although it provides little direct employment and may have, for a long time, few linkages with the rest of the economy. Fishing resources appear to be abundant and could provide foreign exchange, protein rich food for domestic consumption, and some employment. However, their long-term growth potential is still uncertain and supply fluctuating so sharply from year to year that they cannot be considered a base for sustained long term growth. The largest resource constraint is the scarcity and poor quality of agricultural lands. The population pressure on the cultivated lands is high, particularly in the Sierra, and (aside from some valleys in the Costa) yields are low. Since the soils in the low Selva plains appear to have limited long-term agricultural potential, the only new lands that could be brought into production are limited areas in the upper Selva (Ceja de Selva) and, with expensive irrigation and drainage, some valleys in the Costa. Much can be done to increase land productivity with known technologies, but even then, the long-term average growth of food production may not be above 2-3 percent yearly (barring unlikely major technological breakthroughs). Energy is the second major potential constraint. Peru's dependence on imported energy resources will increase in the future, even taking into account the hydroelectric potential and the proven coal reserves, unless a major breakthrough is made in the petroleum explorations. The third potential natural resource problem is water. Although the country as a whole has abundant water resources, to satisfy the long term needs west of the Andes, water will have to be transferred from the eastern side of the mountains at a very high cost.

2. Population Dynamics

50. Since the early 1960s, birth ratios seem to have started to gradually decline. This is a major demographic change with enormous long-term consequences on Peru's development. In the 1930-60 period, a rapid fall in mortality rates almost doubled the rate of natural increase of the population to almost 3 percent yearly. The fall in birth rates seems to have been principally caused by education and urbanization.

51. However, the rate of decline of birth rates has been too small to offset the continued fall in death rates and the population growth rate has not declined. Moreover, since death rates are still high and can be expected to continue falling in coming years, population growth would still average 2.9 percent p.a. in 1976-2000, if the fertility decline continues at the same slow pace as in recent years; total population would then double to 32 million by the year 2000.

52. The consequences of such a rapid population growth are dramatic. In the first place, it will exacerbate the food and energy gaps and worsen the population pressure on the already scarce cultivable areas. Secondly, it will neutralize efforts to raise incomes in rural areas and increase pressure on job creation in urban areas. Finally, a rapid population growth will further strain the country's capacity to provide basic services and social infrastructure to a larger share of the population. Aware of these negative consequences, the Government is now studying the population issue, although the details of what concrete action it intends to take, are not yet known.

53. Peru is now feeling the expansionary impact on working age population of the 1930-60 acceleration of population growth. This increase has not yet been fully translated into the growth of the economically active population because of sharp falls in labor participation rates, principally for the younger age groups (because of the expansion of education) for the older urban age groups (because of expansion in social security), and for women in rural areas (because of emigration). Since there is a 15-25 year lag between the change in birth rates and the growth of working age population, the labor force will be growing at an accelerating and unprecedented rate for at least 15 years to come. How rapidly the labor force grows will probably depend on labor participation rates of urban women, which have been increasing rapidly in recent years. After 1990, the growth of the labor force will crucially depend on the speed at which birth rates decline in the coming decade. The slower fertility falls, the longer will the time be postponed when the labor force growth starts declining.

3. Urbanization

54. Accompanying the acceleration of population growth came a massive migration to the Costa and to the urban areas. Between 1940 and 1972 the share of population living in the Costa rose from 28 to 46 percent and the share living in urban areas doubled to 53 percent. Urbanization has been an inevitable result of the modernization of the economy, although the better resource endowment of the Costa plus the concentration of political power in urban areas (biasing government policies in their favor) also contributed. The latter further widened the interregional disparities (in output per worker, education and basic services) further encouraging migration.

55. The migrants -- who tended to be the better educated, more entrepreneurial and not the poorest in the area of origin -- appear to have benefitted substantially, improving their standards of living and merging rapidly with the recipient urban areas. The social returns of the urbanization process also seem to have been substantial. Economic growth was boosted by shifting labor from poor regions to regions of low economic opportunity and high labor productivity. Underemployment is high in urban areas but much lower than in rural areas. The underemployment problem in urban areas is not a result of migration, but of the inability of Peru as a whole to provide sufficient adequate jobs to a population growing too rapidly. Urbanization has also contributed to lowering fertility and to reducing the cost of providing services to a larger share of the population.

56. Projections of spatial distribution of the population, fortunately suggest that the overall growth of urban areas may fall in the next quarter century. The possible decline will mainly depend on the fall of the urban birth rate, since the relative importance of migration will be smaller in the future, even if rural population shrinks somewhat in absolute terms.

57. While urbanization as a whole may have been inevitable and beneficial, the Government has been increasingly concerned with the pattern of urbanization: an ever-growing concentration in the larger cities and the overwhelming primacy of Lima. Research on the adequacy of different patterns of distribution of urban population is still fragmentary and somewhat inconclusive, both in Peru and abroad. However, various studies have found that the emergence of primate cities and the concentration of urban population are common features of most developing countries. In Peru, however, these trends may have been accelerated by the sharp regional differences in resource endowment, the highly centralized government decision-making and administration, and the pro-urban bias of policies. On the other hand, there is little evidence to show that the past pattern of urbanization in Peru has been grossly inadequate and there is little knowledge on how to determine a better one. Large cities provide the economies of scale and agglomeration necessary for rapid industrialization and substantially lower the costs of infrastructure and social services. It is undeniable that the interregional geographical distribution of income and economic activity has worsened, but it is also difficult to argue on existing evidence that more geographical equity would necessarily have resulted in a faster improvement in the living conditions of a larger share of the poor. Aside from its costs or benefits, the tools used by the Government in promoting decentralization have been large in number, but small in impact and effectiveness. Changes in macroeconomic and sectoral policies that now favor large urban centers (such as reducing the protection and subsidy of the capital-intensive import substitution industry, more realistic exchange rate policies, more adequate agricultural price policies, etc.) would be a more potent set of tools to encourage decentralization in a way consistent with other crucial long-term goals of the Peruvian economy: more domestically produced food, more exports and more production efficiency. In recent years, the Government has been gearing up towards a regionalization of its administration. The strengthening of local administrations would lay the basis for implementing programs involving the local population and may be an incentive for industrial relocation. However, the experience of other countries has not been very successful because of political resistance and the shortage of administrators and technical manpower to staff the regional offices.

4. Conclusion

58. In sum, from the review of natural resources and population dynamics various conclusions can be drawn to serve as inputs in the design of a future development strategy. Unless the fall in birth rates and population growth accelerates, it will be almost impossible to provide a rapid growth of income per capita. However, even if a population policy was adopted, the growth of the labor force during the next decades will be higher than at any time before. Since underemployment is already very high -- and it is the principal cause of poverty -- the growth rate of job creation will have to

accelerate in the future and should become a major focus of Government policies. However, the bulk of the new job creation probably will have to come mainly from manufacturing and services (including tourism). Mining creates few jobs even if the plentiful resources were exploited massively. Fishing is labor-intensive, but highly unpredictable. The farm area can be increased only marginally; there is much room to increase yields but not at a rate sufficient for both increasing incomes and number of jobs. In the best of circumstances, farm employment will not decline.

B. ELEMENTS OF A DEVELOPMENT STRATEGY: THE LONG-TERM APPROACH

59. The next 4-5 years will be extremely difficult for the Peruvian economy. Since external debt and its servicing are already extremely high, foreign savings can hardly be expected to keep flowing in at the excessive rates of the early and mid-1970s. With little room to maneuver, the huge resource gap will have to be converted into a resource surplus in a very short period. Therefore, barring a sensational increase in world commodity prices or the sudden discovery of a new valuable export product, economic policies inevitably will have to be characterized by austerity.

60. In this scenario the Government's strategy could take two different directions. The first could be called the emergency approach and would follow the lines of stabilization programs implemented during previous years. It would focus primarily on measures that at the least possible political cost, cut demand massively and encourage quick increases in supply. In the public sector, expenditures would be cut trying to minimize short-term reductions in employment and avoiding to damage powerful political groups, even if the cuts curtailed programs with a high long-term rate of return and left untouched programs requiring chronic Government subsidies. Tax and price measures would be taken with the sole objective of giving a sufficient quick short-term boost to revenues to a level compatible with an acceptable public sector deficit. At the same time, measures would be taken to channel more cheap public sector financing from the banking system and to obtain more non-project foreign financing. To encourage supply, more financial incentives (through tax holidays, negative real interest rates, direct subsidies, etc) would be superimposed on the existing ones and high protective walls would be maintained to isolate domestic industry and stop imports. Selective price increases would be authorized to encourage output of goods considered strategic but general price controls would be maintained to repress inflation. Financial recovery would be achieved and output growth would resume during the next rapid upswing in world prices of primary commodity prices. However, as the new bonanza relaxes the compression measures, the basic weaknesses of the system would again lead to the same problems of the previous cycles. In the public sector, the revenue bonanza would lead to large increases in expenditures, but since project preparation would have slackened during the depression years, and since the institutional and policy infrastructure for taking decisions would have remained unchanged from the previous crisis, the efficiency of resource use would be low. The same would occur in the private sector, since the emergency measures introduced during the previous

crisis to stimulate supply would have further distorted the resource allocation function of the price system. Then as the low built-in elasticity of the tax system slackens the growth of government revenues at a time when the growth of expenditures is accelerating, the public sector deficit would widen. However, since net international reserves are high and export value is still expanding healthily, the Government would have little problem in financing the deficit with foreign borrowing. The widening of the resource gap would lead to inflationary pressures, and the country would again fall into a deep depression during the following fall of world prices of primary commodities. Throughout the whole cycle, the lot of the poor would have at best not improved much. As discussed above, during the compression period of the emergency approach, the poor carry the largest burden of the compression. During the expansion period, the poor would be at a disadvantage given the strong biases of the system in favor of the established and the large enterprises.

61. Clearly the emergency approach, which has been implemented so often in the past, would not be conducive towards sustained and balanced development.

62. The second alternative Government strategy could be called the long-term approach. The strategy would build upon the realities imposed by natural resources and population and would focus on:

- (a) eliminating the distortions in the economic system that prevent from making maximum use of resources, that lower output and income growth potential, and that discriminate against the poor;
- (b) reducing the economy's dependence on the vagaries of world demand of a few primary commodities;
- (c) reducing the gap (in efficiency, incomes and technology) between the small export sectors and the rest of the economy; and
- (d) providing basic needs to the poor.

63. Within the long-term approach, Peru would still have to go through a compression phase before resuming growth, but the guiding light of the measures taken to face the present crises would be long-term improvement and not short-term temporary remedy.

64. The thrust of the key policies within the long-term approach can be grouped into four sets of interrelated issues; diversification of exports, efficiency of resource use, mobilization of national savings, and poverty focused policies. These sets of issues are discussed below.

1. Diversification of Exports and Industrial Policy

65. Central to a long-term development strategy of Peru will be the rapid growth of exports and their diversification away from primary commodities and into manufacturing and agroindustry. The low growth of export volume and its expansion in short spurts has been a major restraint to sustained development in the past.

66. Mining will remain the backbone of Peru's exports in the medium run, but the long-term approach would aim at diminishing their preponderance in the export structure. The medium- and long-term mining sector prospects will not be constrained by the lack of identified deposits. The Government should move rapidly to establish a realistic development strategy and investment priorities for the sector as a whole. The key issues are project implementation capacity and financing, and long-term growth of foreign demand. There is a trade-off between the rate of expansion of output and the rate of domestic involvement on the sector. The still limited management and implementation capacity and the more limited financial capacity of the country means that if foreign involvement is minimized, the growth of the sector would be slow and perhaps costly errors would be made. This is what has occurred in the last decade. In the other extreme, exclusive foreign involvement as in the pre-1968 period, would prevent Peru to benefit from the managerial and technological expertise that can be gained in the mining sector and used in general industrial development. The latter is important for Peru's long-term development. Pragmatic strategy, through which Peru would benefit the most, would be more balanced. The three State-owned companies would orient their investment primarily towards new projects of a size and complexity that they can manage efficiently and the country can finance. Foreign equity capital would be attracted to the extent that world demand allowed for a faster growth of the sector. Given the strong institutional structure that it has established in the mining sector, the State is in a good position to guarantee that adequate economic and technological benefits are reaped by the Peruvian economy from foreign investment.

67. However, the thrust of policies should go towards diversifying into industrial exports for various reasons:

- Employment: To expand employment sufficiently rapidly to absorb the rapidly growing labor force and to reduce underemployment will depend mainly on job creation in the manufacturing sector.
- Economic Integration: Expanding industrial exports will increase the domestic value added of exports as well as the linkages between the export sectors and the rest of the economy.
- Foreign Dependence and Cycles: Expanding industrial exports would reduce the vulnerability of the economy to foreign arbitrary decisions and to the capriciousness of the markets of one or two commodities by diluting the concentration of exports. This would reduce the violent cyclical fluctuations and allow for a smoother growth pattern.

68. The success of so many developing countries in increasing their industrial exports to developed countries since the mid-1960s, and the success that some Peruvian industrialists have had in penetrating foreign markets should dispel any skepticism on Peru's ability to export manufactured goods. However, timing is of the essence in determining the prospects of Peru's participation on a large scale in the expanding market for manufactured goods from developing countries. Already most Latin American countries are forcefully promoting aggressive industrial policies. Unless Peru moves quickly

to improve efficiency, strengthen the competitiveness of its industrial structure and establish itself in the world markets, by the mid-1980s it may find itself out-competed not so much by the industrialized countries of today but by other countries in Latin America.

69. An export-oriented strategy will call for important changes in industrial policies. In the first place, it is crucial to ensure that the exchange rate does not become overvalued. At the same time, the present system of industrial incentives is both unnecessarily costly and unsatisfactory in pursuing the Government's development objectives. The high level of protection assures adequate profits at normal levels of aggregate demand, regardless of productive efficiency and regardless of the level of priority accorded their product or the location of their plant. Although the tax and other incentives greatly enhance the profitability of investment, there is little net differentiation among the priority categories or among locations. While the incentives may have raised the rate of investment overall, available investment data suggest that the differential provided has not been sufficient to overcome the uncertainties of investing in sectors other than where profits were earned. At the same time, the loss of tax revenues to the Treasury has contributed importantly to the Government's budget difficulties. There is also reason to believe that the substantial subsidization of capital provided by the incentive system has resulted in the creation of idle capacity in some industrial subsectors, while generally biasing production processes in favor of capital intensity to the detriment of employment. At the same time, tax incentive to reinvestment probably reduces the mobility of capital, favors the major firms and investors in the higher tax brackets, and contributes to the concentration of market power.

70. In sum, the incentive system could be simplified, its administrative costs substantially cut, and the incentives themselves reduced, particularly in view of recent Government actions to reduce private investor uncertainties. We specifically recommend: (i) that the profits distributed to labor be taxed as ordinary income; (ii) that tax incentives to investment be sharply reduced in size and converted to a tax credit applying to investment from all sources (not only profit reinvestments); and (iii) that incentives be equalized across industrial subsectors, with exceptions strictly limited to cases of clear social interest. Most tariff exceptions should be reduced or eliminated in the context of a general reduction of trade barriers. Exceptions might be limited to imported inputs for export products.

71. Peru's import regime consisting of a complex combination of tariffs, exchange controls, absolute import prohibitions, and exceptions to each, results in an extremely high level of protection, one of the highest in Latin America. This strongly biases the economy in favor of production for the local market and represents a serious disincentive to the development of manufactured exports. Moreover, some of the highest levels of effective protection are provided to the traditional consumer goods industries and so raise and assure profit levels in those industries (at the expense of consumers) as to make largely ineffective the incentives for priority industries, for nontraditional exports, and for location outside Lima-Callao. In addition to retarding the growth of exports, the high level of protection

raises costs in the short run and dampens the incentives to improve product quality and productive efficiency, thereby reducing the real incomes of Peruvians generally. Finally, the preferential treatment accorded capital goods imports reinforces the bias of other incentive policies in the direction of promoting capital-intensive production processes.

72. In addition, a successful industrial export drive will require more Government action to: (a) promote export industries domestically and export products abroad; (b) increase the availability of export financing and reduce the unnecessary administrative procedures for export licensing; and (c) give special attention to the export potential of the labor intensive small-scale industries.

2. Efficiency of Resource Use

a. Overall Economic Management

73. An efficient management of the economy requires a solid planning system providing the Government decision-makers with: a long-term framework on which to base strategies and programs; an adequate analysis of the economy-wide consequences of decisions; and a timely advice on necessary policy adjustments to short-term realities. During the past 15 years, Peru has built a highly structured planning framework and experience has been gained in preparing and implementing various development programs. However, there are various areas for urgent improvement in the planning system.

74. In the first place, little long-term planning is done at present. A fairly clear vision of the organization of the economy and society to be attained in the long run exists; much less is known on the constraints that the resource base and the weight of present decisions will create in attaining this vision. As said before population, energy and water will pose serious development constraints in the long run; detailed policy oriented studies on how to face these constraints are urgently needed. Equally important are master plans for establishing priorities in mining development and for improving knowledge of the farmland potential.

75. Secondly, more realism and less institutional compartmentalization should be introduced to the planning process. In the past, the planning process gave little attention to the actual resource balance of the country: it was unrealistically optimistic on supply of some resources (particularly financial resources to finance the plans and human resources to manage them) and gave little emphasis to other resources underutilized (particularly labor). The planning system did not react to the widening of the resource gap after 1971, and by continuing to accelerate expenditures in fact helped to widen it further. Part of the problem is institutional. The emphasis of the Planning Office is on how resources should be spent, not on how they should be mobilized to finance the plans which are the responsibility of the Central Bank and the Ministry of Economy and Finance.

76. Finally, more efforts should be made to improve the statistical data base and to introduce more economic considerations into planning and decision making. Even if practical or social objectives are considered paramount, economic criteria should be used to determine the cheapest way of attaining them.

b. Government Controls, Subsidies and the Price System

77. One of the principal causes for the past low efficiency of resource use has been the distortions in resource allocation created by the pyramiding of government controls and subsidies. There is little doubt that in the present legal framework and with the sharp disparities in opportunities that prevail in the economy, the forces of the free market will not tend toward an equitable distribution of income nor a rational allocation of resources. However, the present pattern of government interventions instead of equalizing opportunities and allocating resources to the attainment of the desired objectives at the lowest costs, are having the opposite effect. Controls and subsidies have become so complex, interlocked and widespread that a partial analysis of specific groups of controls may not be sufficient. In reviewing the present system of controls, the Government should consider two questions: (a) taking into account the ramifications throughout the economy, is the control or subsidy, the least costly instrument (to the economy and to Government resources) to obtain the objective; and (b) does the Government have the financial and human resources to execute the control or subsidy efficiently? The following paragraphs discuss some of the key areas where revisions should be considered.

i. Exchange Rate Policy

78. Peru has a long history of fixed exchange rate policies. Only in times of crisis when the balance of payments gap had reached untenable levels -- such as in 1968 and since 1975 -- have the authorities decided to move the exchange rate. Therefore, since Peruvian inflation has consistently been above the average of its main trading partners, the exchange rate has been overvalued for long periods. This has required excessive protection and subsidies to industry; discouraged the use of local raw materials and labor; prevented the growth of exports; and subsidized the upper urban income groups (to the extent that these have a higher import component in expenditures). A more realistic exchange rate policy would help increase efficiency and savings, would be crucial for the successful diversification of exports, would help reduce the gap in real incomes between the rich and the poor, and would obviate the need for permanent import and foreign exchange controls.

ii. Interest Rate Policy and Financial Intermediation

79. Past interest rate policy in Peru has been characterized by almost complete inactivity, despite substantial variations in price changes. In fact, at least since the early 1960s, the rate of inflation has been higher than the interest rate paid on deposits by the financial system. This has had various negative consequences. The growth of the financial system has been repressed. While there is no definite evidence in Peru or abroad of the impact on personal savings, what is certain is that in periods of inflation the low interest rates have caused private savings to flow away from the formal financial system and into "inflation hedges" and capital flight, reducing the volume of savings available to finance investment. By not reflecting the real costs of capital in the economy, negative real interest rates have also helped distort resource allocation into less than optimal use and have encouraged capital intensive activities. Finally, negative real

interest rates in the formal financial system have subsidized the upper income groups and penalized the poor in two ways. On the one hand, the repression of the financial system has limited its capacity to increase its coverage and forced it to ration credit, favoring the prime established borrowers. The rest, who are the majority of Peruvians, have to turn to the informal financial markets for their credit needs at extremely high interest rates. Therefore, the poor end up paying more than the rich, reducing their competitive position. On the other hand, the poor do not have access to "inflation hedges" and to external placements to protect them against inflation. Therefore, the financial assets of the poor remain in the financial system subsidizing the credit that goes to the established prime borrowers. In 1976 and 1977 interest rates were raised, but the adjustments were insufficient to stop the widening of the negative real level of interest rates.

80. Therefore, adopting a policy of realistic and flexible interest rates is essential on efficiency, equity and savings generation points of view. Based on the assumption that the public reacts to expected inflation and not to a posteriori inflation, the Main Report develops a small model for fixing minimum interest rates. A realistic measure of expected inflation would be the simple moving average of the actual inflation rate in the past few years and the rate projected for the current year. This would allow interest rates to fluctuate over the cycle -- although by much less than the actual rate of inflation -- and would ensure on average a positive real yield on financial instruments. The pivotal rate -- the rate on savings deposits -- would be adjusted exactly to the expected rate of inflation (all the other rates would be above this one).

iii. Agricultural Policy

81. The resources available in the agricultural sector are so limited that unless their most efficient use is made, there is little hope of accelerating the growth of output and of rural incomes. There are six key areas: production planning, prices, marketing, ARE's operation, credit and public investment.

82. Government intervention to promote a faster growth of agricultural output is clearly justified. The bias in favor of food crops for the domestic market has some justification, given the vagaries of world food prices and the occasional nonexistence of supply in world markets, but if it is carried too far, it endangers lowering productive efficiency and incomes of farmers. Except for a very selected number of foodstuffs considered strategic, it would be more advisable to allow production to go towards high income products, even if they are for export: the farmers would benefit, the balance of payments burden would be lowered and the economy as a whole would gain. To the extent that the Government, nonetheless, considers it imperative to ensure the domestic supply of specific commodities, a simple price support mechanism combined with preferential access to services would have a higher chance of success and at a lower cost than the complicated production planning system now in use. Developing an efficient and well-planned system to deliver technology inputs and credit to as many farmers as possible clearly is important. But here again, this can be done in a more streamlined approach than at present.

83. The inefficiencies introduced by past Government intervention in the marketing system have become a serious bottleneck to agricultural development. This report endorses the view that the State should intervene to eliminate the possible monopolistic practices now exercised by middlemen and to ensure that marketing margins are as small as possible benefitting both producers and consumers. However, instead of trying to police the whole marketing system, the Government should consider implementing the much simpler and effective strategy that has been proposed by previous World Bank reports. EPSA, the State marketing agency, should operate in competition with private traders, breaking monopolies wherever they exist and forcing traders to become more efficient. To achieve this, it should be sufficient for EPSA to handle a small share of trade (say not more than 20-30 percent). Since it now lacks infrastructure and money, and has little experience, EPSA should concentrate at first on a small number of key commodities in key areas. It could afterwards gradually expand, although the range of products in which it intervenes should remain small. Of course, for the system to work, EPSA must be treated and managed like a private enterprise, subject to the same taxes and receiving no particular Government subsidies. At the same time, the growth of the private trading sector should be encouraged to foster competition, and assistance should be provided to improve their facilities and to cut costs. The Government should also invest in improving basic marketing infrastructure to facilitate the operations of EPSA and the private traders (storage facilities, wholesale markets, roads, etc.). In those very special crops the Government considers imperative to produce domestically -- for strategic or other reasons -- even at a cost above import prices, a dual approach of high support prices by EPSA combined with preferential supplies of credit, extension services and inputs, should be followed.

84. In the last few years the Government has started to relax its controls on prices and to reduce consumer subsidies. Low prices had been a chronic problem constraining growth in the past. Provided the Government has the financial and storage capacity to do it, a policy to stabilize prices seasonally would be beneficial for both producers and consumers. However, the Government should continue to phase out the permanent control on prices.

85. The survival of the Agrarian Reform Enterprises will depend on solving their present operational problems and increasing efficiency. The key issue will be how to increase the identification of the members with the fate of the cooperative to ensure a rational allocation of resources, to establish labor discipline, and to reduce conflicts between members. The Government should, however, reconsider both the organization of some of the cooperatives -- where the conflicts between types of members are inherent to the organization -- and the size of cooperatives -- where diseconomies of scale are important.

86. On credit, the policies of the Government should aim at increasing the number of farmers covered by the formal financial system, and at ensuring that credit goes to projects with a positive economic rate of return. More realistic interest rates would favor the expansion of coverage towards small farmers in two ways: the commercial banks would be encouraged to lend to the sector, thus freeing capacity of the Agricultural Bank (BAP) to concentrate

on the poorer farmers; the flow of financial resources towards BAP would increase. At the same time, however, BAP should strengthen its institutional capacity to handle more borrowers and shift the emphasis of its appraisal procedures from guarantees to the farmer's prospects and the return of projects.

87. Finally, public investment in agriculture should be reoriented. Consideration should be given to rephrasing or abandoning some of the large-scale irrigation projects with clearly negative rates of return. There are many alternative investment opportunities that offer a higher return to the Government objectives. Rehabilitation of irrigation systems in the Costa and development of marketing infrastructure are two examples. At the same time, a higher share of investment should be dedicated to the small farmers with productive potential.

iv. Public Sector Resource Use

88. The importance of public sector operations and the size of the public sector deficit have become so large, that their efficient management is of paramount importance. Two closely interrelated issues are involved: management and effectiveness of resource use.

89. Managerial problems affect most institutions in the public sector. A chronic problem of the past Central Government budgets was the unrealism of estimates at the time the budget was approved. The problem was particularly serious until 1977, since a two-year budget was used. But even under the present one-year budgets, to ensure a financial balance at the moment of approval, the spending units underestimate inevitable expenditures with the conviction that when a supplementary budget request is made during the year it will be granted. At the same time, there is no real system for establishing priorities during the fiscal year when expenditure cuts are necessary. Finally, the accuracy of revenue projections should be improved, and should be as conservative as possible, to avoid the frequent revenue shortfalls of the past.

90. The financial management and cost consciousness of public enterprises needs to be strengthened. The price controls, the monopoly position of most public sector companies and the generalized belief within public enterprises that the State will not allow them to collapse and will cover any deficits, have weakened their financial performance. Intricate controls were established in the past, doing little to effectively monitor performance, but curtailing excessively the company's autonomy for efficient management. The Government not only intervenes in the appointment of board members and top and middle level staff, but it also restricts the autonomy of boards to approve contracts, and screens all applications for business travel abroad of the enterprise's staff. Excessive Government intervention in such detailed internal affairs of the enterprises has also made it difficult to attract qualified staff to top managerial positions. On the other hand, efficiency criteria have been set for none of the firms, and there is a dearth of information needed to assess efficiency in terms of the objectives for which the enterprises have been established.

91. There is much that Peru could learn from the successes and failures in managing public enterprises in countries of Western and Eastern Europe. In general, this report recommends that a simple but more effective system of monitoring be established. The objectives of the enterprises and a set of criteria to judge the performance in achieving these objectives should be established. For the commodity-producing activities which substitute imports but have a monopoly in the domestic market, international prices should be used to judge the degree of efficiency. If the differences between local and foreign prices is substantial, the Government can decide whether the benefits pursued by the enterprise are worth the economic losses involved. If this were the case, the Government can set realistic performance targets for the enterprise to reduce costs; if these are not achieved, the Government would have valuable information in its hands (which it does not have now) to decide whether to allow higher prices, to reshuffle the composition of the Board and of management or to liquidate the public enterprise. Equally simple and effective performance criteria can be set for public enterprises in public utilities and marketing. Once efficiency criteria are set and the performance targets are agreed upon, boards and management should be given far greater freedom of action and responsibility. Control devices should be the periodical comparison of performance against the fixed efficiency criteria and targets, rather than the restrictive devices presently in use.

92. There is much room for cutting unproductive expenditures in the public sector. Most consumer subsidies have little justification; the Government has been cutting them in the last years, although a substantial amount still remains. The streamlining of unnecessary controls discussed before would also allow for a reduction or a better use of staff. Finally, if efficiency of public investment improves and public savings increase, the fall in borrowing will also reduce the burden of debt service payments. However, it is in public investment where more efficiency can be gained. Probably one of the most important lessons from the past public investment experience is that it is equally or more important to ensure that maximum benefits are obtained from each sol invested than raising the level of capital formation in the economy. The most practical and useful improvement would be to ensure that economic criteria are applied to each project. Projects with returns below the opportunity cost of capital in Peru should, in general, not be done. In the few special cases, where the Government considers a non-economic objective as paramount, then it should be demonstrated that the project is a least cost solution. The second line of improvement would consist in subjecting all executing agencies to a rigorous evaluation of implementation capacity. Overambitious programs, no matter how important, end up in costly delays and resource waste. A related aspect concerns the concentration of the investment program in huge projects. More manageable solutions and/or the break-up of the project into phases would involve less risks and less strains on implementation capacity. However, if large projects have to be done, these should be subjected to particularly rigorous efficiency and quality controls. Finally, any of the above improvements cannot operate without a better institutional framework managing overall public investment. Ideally, the best public investment screening institution should be one that will take a financial stake in the project and have a powerful group of independent analysts to appraise the projects and the implementing institutions.

The screening institution should become involved with the project from its earliest stages to ensure that the bad projects are stopped before irreversible commitments have been made and/or the project has mobilized a momentum of its own. At the same time, measures should be taken to avoid that projects are implemented just because a foreign supplier or financial institution offers particularly attractive terms. This has been a common occurrence in the past. Equally important, action should be taken to prevent political pressure from circumventing the decisions of the screening institution, particularly in large projects. It should be noted that more realistic interest rates and better financial management in public enterprises would be potent instruments helping to rationalize the public investment process.

93. Finally, an efficient system to control public sector foreign borrowing should be urgently established. In the past, foreign borrowing decisions have been principally determined by supply factors: as long as foreign financing was available, public sector institutions borrowed. The easy availability of financing contributed to the low savings effort and the little attention to efficiency in investment of various public sector institutions. A complex network of commissions and committees now exist with the function of controlling foreign borrowing. However, the experience of the past five years shows their little effectiveness. Their role is mainly for processing and routine approvals with little analysis. On the other hand, the complexity of the routine procedures hampers the quick approval and disbursement of worthwhile loans. The control of foreign borrowing should be centralized into one institution that determines: (a) the country's overall borrowing capacity under realistic assumptions on future exports and giving due allowance to unexpected factors; (b) whether the debt service resulting from the proposed loan is within the limits of the total borrowing capacity; (c) whether better terms cannot be obtained in the market, possibly by combining various loan requests into one; and (d) whether it would not be more beneficial for Peru and the borrowing institution if it generated the resources from internal cash flow or it borrowed in domestic markets. The institution screening foreign borrowing could be the same as the one screening public investment, since in most cases foreign borrowing directly or indirectly finances public investment and the analysis required for both functions partially overlaps.

3. Mobilization of National Savings

94. Regardless of the strategy it follows, the Government will have to take urgent action to reduce the resource gap. Within the long-term development strategy proposed, many of the measures to improve efficiency and diversify exports would help attain this objective. Nevertheless, specific action will have to be taken to raise the level and the elasticity to changes in income of personal and public savings. This action would also help to encourage efficiency and increase equity in the economy.

95. Personal savings: As said before, little is known on the specific determinants of personal savings. It is plausible, however, that with uncertainty, inflation, and easy credit, potential savings flow to luxury consumption. It would therefore be advisable to restrict consumer credit for, and impose heavy consumption taxes on the purchase of luxury consumption goods. If these measures do not increase personal savings, they will at least

increase Government savings and the progressivity of the tax system. At the same time, action should be taken to encourage the flow of personal savings to the formal financial system. Of principal importance is a policy of realistic and flexible interest rates discussed above. The financial system should also be encouraged to be more aggressive in tapping personal savings by offering more efficient services and a wider range of savings instruments.

96. Public savings: There is ample room for rapidly and permanently increasing public savings 4-5 percent of GDP. Such a public savings target would imply that about 15 percent of revenues are saved, still well below the 19 percent of revenues saved in 1969-70. The three principal components for long-term improvement of public savings include public enterprise pricing policies, the tax system and the financial management of the Social Security Administration.

97. Allowing the public enterprises to adopt pricing policies that reflect their costs and the economic value of their goods and services could increase public sector savings by at least 3-4 percent of GDP. Realistic price policies are also essential to improve financial management and cost consciousness of public enterprises, and to rationalize resource use in the economy as a whole. Whatever specific objectives are pursued with price subsidies (income distribution, for example), they can be achieved more effectively and at a lower cost with direct subsidy programs that could be easily financed with the additional revenues generated by more adequate pricing policies. The Government has taken important action adjusting prices to more realistic levels since 1976, but the justification for allowing price increases is wrong in many cases, since it is based on the bottom line of the company's accounts and not on the economic value of the product. The most important case is petroleum. PETROPERU has been allowed to increase its prices so as not to incur a current account deficit. This means that PETROPERU has to finance practically all of its investment from borrowed funds. Equally important, the prices of petroleum products remain well below their economic value, stimulating growth of energy consumption -- while the widening energy deficit in Peru would call for the opposite -- and subsidizing urban upper income groups. Similar remarks can be made on controlled prices of imported foodstuffs and fertilizers. Another major problem of the present policy of delayed price adjustments is that when they are made price adjustments have to be very large. This has a major distabilizing force on inflationary expectations and on the economy, and is politically very costly. A more appropriate policy would be to free prices and to let them grow gradually in line with their economic value. If the argument for the continued discretionary control of prices is the fear that public enterprises will generate an excessive amount of profits and that they would not make an efficient use of them, it is more appropriate to use income taxes as an instrument to reduce the profits and to use the previously discussed performance criteria as a way to monitor efficiency.

98. An integral reform of the tax system is a necessary component of a long-term development strategy in Peru. The tax reform should aim at: (a) increasing the tax burden and the elasticity of yields to changes in GDP; (b) reducing the tax system's dependence on foreign trade; (c) increasing the progressivity of the tax system; and (d) reducing the

distortions in resource allocation created by the tax system. The Main Report provides suggestions for improvement of all the important taxes with these four objectives in mind. The most important suggestions are the following:

- Personal income taxes: The personal exemptions should be sharply reduced to expand the share of families liable to pay income tax from the richest 6 percent to at least the richest 25 percent. At the same time, the justification of a long series of allowable deductions should be studied and their level reduced. Minimum presumptive incomes for independent professionals should be introduced and the special treatment accorded to public sector employees should be eliminated. In spite of its high yields, the payroll tax should be abolished because of its regressivity and its undesirable impact on the cost of labor. Finally, consideration should be given to on the one hand, cutting the number of tax levels and the maximum rate, and on the other hand, to increasing the minimum rate to facilitate tax administration and tax more steeply the high middle income groups.
- Corporate income tax: The massive level of tax holidays should be drastically cut and converted from a tax deduction to a tax credit, thereby raising revenues by at least 1 percent of GDP and, increasing progressivity of the tax system. This change would also be consistent with the policy of increasing industrial sector efficiency. The present progressive rate should be replaced by a proportional rate and presumptive incomes per hectare should be established to tax the farm sector.
- Property taxes: The property values should be updated through completion of the ongoing cadastre and adjusted automatically yearly thereafter. The rates should be proportional and the large number of deductions reduced. Finally, the tax on automobiles should be steeper and more progressive.
- Sales taxes: Deductions and the top 27 percent rate should be eliminated. (Luxury consumer goods should be taxed with the normal 20 percent rate plus a hefty excise tax on consumption.)
- Excise taxes: Excise taxes should be used more widely to tax luxury consumption. The taxes on gasoline, cigarettes and liquor should be increased sharply.
- Tariffs: Tariff policy should be primarily an instrument of industrial policy, and should aim at reducing the presently excessive levels of effective protection.

- Tax administration: Tax administration should be centralized and the number, quality and salaries of staff improved. Tax data should be computerized to facilitate cross-checking, and simple mechanisms for automatic control of fiscal obligations and a master registry of taxpayers established. Fiscal arrears should be indexed to inflation and a stiff interest charged. The areas of largest tax evasion should be identified to focus tax enforcement.

99. Finally, urgent action should be taken to rescue the Social Security Administration from financial collapse within the next decade, by allowing it to obtain a real positive return on its assets and improving financial management.

4. Government Policies and the Poor

100. The long-term strategy proposed that aims primarily at increasing efficiency and savings, promoting industrial exports, reducing cyclical fluctuations and curtailing the biases of the present economic organization in favor of privileged groups will improve markedly the prospects of the poor for at least four reasons:

- The economy will grow faster and will suffer less frequent violent fluctuations. As said before, it is the poor who suffer the most in economic crises and the stabilization period that follows. What little they can save, rapidly disappears in the higher underemployment they suffer in depressions.
- Output will become more labor intensive and the linkages between sectors will increase. If the present price distortions cheapening labor and imports (low interest rates, overvalued exchange rates, tax holiday for capital investments, low petroleum and wheat prices, etc.) and increasing the cost of labor (payroll and social security taxes) are eliminated, resource use is oriented towards Peru's more abundant factors, and industrial exports expand rapidly, employment generation will certainly increase more rapidly than at present. This is probably the most important means of allowing the poor to integrate into the modern sectors and improve their incomes.
- The relative competitiveness of the poor and the opportunities for them to acquire assets will sharply improve. By eliminating the direct and indirect subsidies to which the poor do not have access (interest rates, tax holidays, subsidies, price controls, etc.) and concentrating Government action on breaking up monopolies and ensuring competition (agricultural marketing, industry, credit, etc.) the competitive position of the poor will sharply improve. By simplifying and reducing the procedures for business establishment -- which the poor cannot afford nor understand at present -- the biases against new small businesses will be reduced.

- The higher savings performance and faster growth of the formal financial system will increase the amount of resources available for giving the poor access to public services and to credit.

101. Moreover, the proposed development strategy would also improve the relative position of the poor. Through realistic prices, less subsidies and a more progressive and effective tax system, the real incomes of the upper income groups will fall relative to the poor.

102. However, a strategy that aims at rapidly improving the lot of the poor, and at more quickly integrating them into the modern economy, calls for massive Government action in various fields:

- Satisfying basic needs and increasing productive potential:
The Government will have to allocate a much larger share of the country's resources and the Government's revenues to increase the nutrition, education, health and housing standards of the poor. This is justified not only on equity grounds but as an investment in increasing the productive potential of the poor. In launching a basic needs strategy, however, the Government should take into account four factors. First, the programs should be focused on specific poverty target groups; generalized programs (such as nutritional objectives through price subsidies) are not cost-effective and inevitably end up favoring more the richer beneficiaries. Second, the views of the beneficiaries themselves should be the main determinant of the priority ranking of basic services. Third, maximum use of the resources of the beneficiaries (labor principally) should be made to maintain cohesion of social groups, stimulate participation and reduce costs/beneficiary to a minimum. Finally, the delivery system should be as decentralized and as simple as possible to minimize management requirements.
- Increasing Opportunities for Access to Assets and Knowhow:
A large share of the informal sector in urban areas are entrepreneurs with the capacity to develop into small efficient industrial or service enterprises if they are given access to credit to purchase simple machinery and are provided a minimum of managerial technical assistance, which at present they do not obtain. The Government should start a program -- small at first, but aiming at a massive scale -- to provide these inputs. To ensure efficiency and the survival of the program in the long run, subsidy elements should be kept to a minimum, if any. The problem of the poor entrepreneur is access to a formal financial system of credit, not cost. At the same time, efforts should go towards helping develop private marketing channels to develop and strengthen the market position of the small entrepreneur. Similarly in rural areas, there is sufficient information to conclude that even under rainfed conditions, there is room to increase production of the minifundista with improved cultural practices. Extensive sheep and alpaca grazing

also offer promising prospects under rational pasture management. Finally, with minor irrigation works, yields of irrigated crops, fruit trees and pastures could increase. Rural development programs focusing on production, but also including infrastructure and basic needs should be given priority. The first such project for the Puno area is now in preparation.

Labor subsidies: The possibility should be studied of granting labor subsidies to firms which hire and train labor, particularly the young school graduates. The labor subsidy program could be linked to the informal training programs of the Government.

103. Implementation of the proposed poverty oriented programs would depend on financial and institutional factors. If the efficiency and savings proposals discussed were implemented, the Government would have little problem in mobilizing sufficient resources to finance massively these programs. The more difficult problem to then overcome would be institutional. If the programs are to be implemented efficiently and with little waste, the pace of their implementation should be geared to a gradual strengthening of institutions.

IV. CONCLUSIONS

104. The unbalanced endowment, the rapidly growing population and the segmented economic structure inherited from the long-term past, pose a formidable challenge to the Peruvian Government in promoting a rapid and sustained development in which all Peruvians benefit. The governments of the past decade have made a correct diagnosis of Peru's problems and have made substantial progress in many fields. However, bright long-term prospects crucially depend on making important adjustments to economic structures and to the trends they have engendered. This report has sketched out some elements of a strategy that would aim at changing these trends. Implementing any development strategy that changes the economic structure will require much effort and will take time. The present moment of cyclical economic difficulties may be a unique occasion to start this process of change, since a program of austerity will in any event characterize the coming years. If the Peruvian Government embarks on this process of change and improvement, it deserves the large support from official and unofficial lenders, since the medium- and long-term prospects of the economy will improve dramatically.