

The peruvian economy: overview, prospects, and proposals

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The Peruvian economy has developed favourably in recent years, as shown by several economic indicators. Positive GDP growth rates over a relatively long period (more than forty consecutive months) and an annual inflation of less than 10 percent have endowed the Peruvian economy with great stability and predictability for decision-making.

Peru has a considerable stock of liquid international reserves for the size of its economy. Reserves equivalent to more than fifteen months of regular imports give the exchange market great tranquillity, along with rising exports of goods and services, and a significantly positive current accounts balance. The management of a declining public sector deficit and some recent measures aimed at transparency and fiscal accountability, such as the constitutional reform of the national pension system, also provide international analysts and potential investors with positive indications.

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This notwithstanding, the main problem faced by the Peruvian economy is the fact that the fruits of this growth and the good indicators do not as yet translate into tangible improvement of the standards of living of the population, 54 percent of which live in poverty, according to World Bank indicators. In other words, the economy seems to go well but people feel otherwise, and this causes deep concern and great scepticism in the population, which in turn creates social conflicts and problems for democratic governance. As Ambassador Allan Wagner, secretary-general of the Andean Community, has rightly pointed out, the strategic project the subregion has adopted should promote “globalisation with integration, integration with social inclusion, and social inclusion with democratic governance¹”

In Peru, only 40 percent of the labour force have adequate jobs. The country’s major problem is growing underemployment (the unemployment rate is about 10 percent). This is associated with the phenomenon of informal economic activities, which is growing apace (it is now estimated at about 65 percent of productive activity). Under these circumstances, the economic growth achieved is insufficient to create an adequate number of productive jobs and the economic policy measures adopted have not yielded the expected results, as they have been designed for a formal economy, which is shrinking in Peru.

Moreover, economy and politics seem to go their separate ways. Economic stability contrasts with the difficulties encountered by President Toledo and, in general, the entire political class (Congress, political parties, etc.) in being attuned to the population’s major concerns. Daily the media devote considerable space to a series of political attacks and scandals, while the major issues on the development agenda do not seem to have the same importance. As an analyst who had arrived recently in Peru put it, “*the Peruvian economy seems to be on automatic pilot*”,² despite a quite hot political environment (general presidential and congressional elections are scheduled for April 2006, and the electoral campaign is already starting).

¹See pertinent documents on the Andean Community website: www.comunidadandina.org.

²This comment was made by a high-ranking officer of the Inter-American Development Bank-IADB on the occasion of the Bank’s Board of Governors’ meeting held in Lima in the summer of 2004.

In our view, the explanation of what happens to the Peruvian economy requires a more thorough analysis, which this article will attempt to do.

The peruvian economy's situation and prospects according to the main macroeconomic indicators: 2004 and 2005

As was mentioned previously, the main macroeconomic indicators show a considerably favourable development, which is conducive to stability and helps create an appropriate climate for investments. Table 1 shows estimates at the close of 2004 and the forecasts for 2005 concerning some of these indicators, according to official sources, such as the Ministry of Economy and Finance and Peru's Central Reserve Bank, as well as our own estimates.

Table 1 - Major macroeconomic indicators: 2005 projections

<u>Indicator/Institution</u>	BCR	MEF	New Economy ³
GDP (growth rate %)	4.5	4.5	3.5-4.0
Inflation (annual rate %)	2.3	2.5	3.0
Exchange rate (S\$/ per US\$1)	3.40	3.48	3.35
Goods exports (US\$ million)	12,000	11,912	12,000
Goods imports (US\$ million)	10,500	9,898	10,000
Public Sector Deficit (GDP %)	1.0	1.0	1.1

Source: Author's data based on official projections for February 2005 by Peru's Central Bank (BCR), by the Ministry of Economy and Finance (MEF – see www.mef.gob.pe), and estimates by *Nueva Economía* (see www.nueva-economía.org).

³Enrique Cornejo is President of the *Nueva Economía* Association, a Peruvian nonprofit institution devoted to studying development with social justice in developing countries, particularly of Latin America. It gives special emphasis to the analysis of the characteristics of the various economies that coexist in our countries.

Peru's GDP at the end of 2004 was estimated at 248.3 billion new soles or US\$ 70 billion). It has been growing at an annual rate of approximately 4.5 percent, which, although quite positive, is insufficient, as it should grow at 7 percent to absorb the incoming labour force and to give a definitive solution to underemployment. To achieve this, the current investment levels should be at least doubled; this does not sound like a simple task in the context described above but the potential is there.

At the close of 2004, inflation was 3.4 percent (higher than the initial 2.4 percent official target) and the national currency had appreciated by 5 percent. This phenomenon of the strengthening of Peru's new sol is due to three factors: (a) the considerable increase in revenue from goods and services exports and remittances from Peruvians abroad; (b) the structural US-dollar surplus on the local market (reinforced by US dollars from the drug traffic); and (c) the weakening of the US dollar vis-à-vis the euro and other hard currencies.

A few factors explain the growth of foreign trade (exports plus imports), which exceeded US\$ 20 billion in goods exports alone. There are the advantages provided by the Andean Trade Promotion and Drug Eradication Agreement-Aptdea, particularly as regards textiles and apparel, as well as agro-industrial products. Moreover, high international prices for the main export commodities (particularly metals) have been stable, owing to the performance of the industrial economies, and especially of China's.

The Peruvian population in 2004 is estimated at 28 million and the average per capita income at US\$ 2,400. But this figure should be taken with caution, as it does not reflect the sharp disparities that exist in the country, where income distribution is the region's most unequal after Haiti.

Despite an ongoing process of regionalisation that seeks to enhance the management capacity of regions and municipalities, there is great economic concentration in Lima and a few major cities. Lima, the capital, concentrates over 80 percent of active and passive financial transactions. It is also home to 70 percent of registered industrial establishments in the country and it is where a third of the Peruvian population lives. Nine out of ten cardiologists work in Lima and the inflation in the country is measured by the behaviour of consumer prices in Greater Lima.

The State handles an annual budget of about US\$12 billion, but owing to the lack of an appropriate State reform, these resources are spent inefficiently

and with little transparency. The State is the country's major purchaser of goods and services but does not make full use of its procurement capacity, with the consequent negative effects. The country's low tax revenue is associated with the extensive informal economy. Only 1.8 percent of major taxpaying firms account for 84 percent of tax collections and there is much tax evasion and many tax breaks. The tax burden barely reaches 13 percent.

To meet public financing requirements, the various administrations have increasingly resorted to increasing public indebtedness, which already totals about US\$ 30 billion (equivalent to 42 percent of GDP). The foreign public debt is slightly over US\$ 24 billion (34 percent of GDP), and over the last four years the domestic public debt has grown considerably (basically through the issuing of sovereign bonds) and now approaches US\$ 6 billion (about 8 percent of GDP).

The public foreign debt is contracted mainly with multilateral organisations and foreign governments, while one fifth of it is owed to holders of Brady bonds and other types of bonds. The problem of the public debt in the next few years will be not so much stock but flow. It will be necessary to restructure debt servicing through various market mechanisms, so as to make it more manageable, particularly as concerns the public sector budget.

In 2005, as Table 1 shows, a 3.5-4.5 percent growth is expected, as well as lower inflation as compared with 2004. No major changes are expected in the rate of exchange so that, in our view, the US dollar's weakening trend should continue and the Peruvian currency should appreciate further. As regards the management of public finances—although we are now in an election period—, it is expected that the objective of reducing the public sector deficit to one percent of GDP will be achieved.

With respect to the foreign sector, an equally favourable behaviour of international prices is expected. Moreover, the ratification of several free trade agreements — especially with the United States — could give a considerable boost to investments and exports, particularly as regards textile and agro-industrial products. It is estimated that the exports and imports of goods will exceed US\$ 22 billion. An extremely important project slated to begin in 2005 is the third phase of construction of distribution infrastructure for the exploitation of the Camisea natural gas field, which will make it possible to export gas to markets in North America.

Accordingly, it seems that 2005 will be another year of good economic indicators and of a “political heating-up,” while the social issues will continue to be on hold, awaiting the next Administration, to be elected in 2006. Whoever assumes the helm will face a mighty challenge, have little elbowroom, and meet great social expectations. Statesmanship, great prudence, and fiscal transparency will thus be necessary.

As previously mentioned, there are no reliable data on poverty but every indication suggests that poverty has increased, particularly in towns other than Lima and around the countryside. What we see daily on the streets and around the country shows that there is greater inequality and that economic concentration has increased. Informal economic activity, which has also increased, is a decisive factor in explaining what is happening in the Peruvian economy.

We will try to explain what is happening by resorting to two working hypotheses: according to the first, the economic policy prescribed the country assumes that there is only one economy, whereas in practice different types of economy coexist, each one with its own dynamics. The second hypothesis asserts that there is one formal, legal State, which nevertheless reaches only a minority of the population, whereas an informal State or perhaps other States exist, which work in parallel to the formal State and in which there is indeed a sense of popular empowerment and recognised duties and rights.

The peruvian economy or the economy of diversity and its implications for economic policy

The effectiveness of the economic policies that are usually implemented in our countries is often questioned. Economic growth, when it occurs, is not adequately accompanied by productive employment growth. Stabilisation policies favour combating inflation but neglect productive growth and the promotion of investment. The pursuit of competitiveness is usually based on reducing labour costs and benefits but neglects to increase the productivity of capital or to improve basic infrastructure. The economy is usually evaluated on the basis of the performance of a few macroeconomic indicators but no consideration is given to social indicators, which would reflect the population’s living standards and which, after all, are the *raison d’être* of economic policy.

This is an old discussion. Given the scarcity of resources and the growing needs to be met, economic policy decisions always imply high opportunity costs. Achieving growth with stability; reaching a competitive integration into the world economy; pursuing development with social justice; achieving social inclusion through democratic governance: these are some of the objectives which, though in principle conflictive, we should challenge economic policy to achieve.

The situation just described is not peculiar to poor, small countries. This problem also exists in industrial economies, although on a different scale and for different reasons. In our view, in poor countries such as Peru the problem is not that the proposed economic policies are not applicable (Milton Friedman had already discussed this issue in the last century, making a distinction between the “realism of assumptions” and the “predictive power of hypotheses”); rather, they are applied under the mistaken assumption that the economy has already attained an advanced stage of development or that it at least shows a “normal” pattern of competitiveness, transparency, and free mobility of factors.

This problem has been studied from different angles. Víctor Raúl Haya de la Torre asserted that economies such as the Peruvian economy “have two speeds,”⁴ a high speed associated with the modern sectors of the economy, and a slower speed, associated with the poor, technologically backward sectors; and a car with different simultaneous speeds cannot run normally.

In the 1970s, authors such as McKinnon, Shaw, and Galbis introduced the “financial repression”⁵ thesis as an attempt to explain the performance of small enterprises as a function of their means of access to formal credit channels. Development theories have also raised hypotheses such as structural dualism. Some authors, including Adolfo Figueroa,⁶ criticise the neo-classic growth model (the foundation of the so-called neoliberal policies) for not taking into consideration either the “starting point” of the various countries at the time policies were applied or noneconomic factors, such as culture, that could be extremely useful to explain the relative effectiveness of such policies.

⁴See Haya de la Torre, Víctor Raúl. “El Plan Económico del Aprismo”, speech given in Lima on October 9, 1945. In: *Obras Completas*. Tome V, p. 369.

⁵ See Ramírez Cornejo; Enrique. *Tasas de Interés: teoría y política*. Lima: Universidad de Lima, 1978.

⁶See Figueroa, Adolfo. “Sobre la Desigualdad de las Naciones”. In: *Libro Memoria de la XIV Conferencia de la Asociación de Facultades, Escuelas e Institutos de Economía de América Latina - AFEIEAL 2000*. Tegucigalpa, Honduras, 2000, p. 255-272.

As we see it, at least four types of economy coexist in Peru: (a) a subsistence economy, associated mainly with the extremely poor rural sectors, nearly non-existent technological development, and the prevalence of a barter system; (b) an informal, urban economy, with low productivity levels but heavy absorption of labour, which pays no taxes; (c) a modern, industrial economy, basically connected to agro-industry and other manufacturing sectors geared to exports, which understands international markets and employs competitive strategies; and (d) a post-modern economy of knowledge and services, in which transnational information and sundry services companies coexist, which adopts state-of-the-art technologies and maintains thousands of public Internet cabins – a Peruvian invention – as well as some small software exporting enterprises.

Table 2 - The four coexisting types of economy in Peru

(a) Subsistence economy: it includes extremely poor rural sectors, the majority of which have no access to the market; rudimentary technologies; low educational and nutritional levels; barter system.
(b) Informal, urban economy: encompasses about 70 percent of productive activity; intense absorption of labour with low productivity levels; subject to high financing costs on the parallel market; as a rule, it does not pay direct taxes and is oriented to the domestic market.
(c) Modern, industrial economy: agro-industry, manufacturing sectors geared to exports such as apparel or metal-mechanic items; understands international markets; has modern organisation, adopts competitive strategies, and pays attention to productivity; pays taxes and is normally subject to higher costs because of its formalised legal standing.
(d) Knowledge and services economy: although still relatively small, it is growing fast. It comprises transnational IT companies, thousands of public Internet cabins — a Peruvian invention —, and some small software exporting enterprises. New knowledge is being created, such as in the area of biodiversity, and the tourist sector shows great dynamism in different segments (nature, adventure, history, culture, gastronomy, etc.)

The problem is that the four types coexist. In terms of the population involved and poverty levels, (a) and (b) constitute the majority; in terms of contribution to GDP, tax collection, and contact with the modern world, (c) and (d) are more important, although they involve far less people. Given this picture, the following questions may be posed: Which economic policy should be applied? How to incorporate the mestizo or to include compensatory elements when policy decisions are made? Which priorities should be adopted and when?

These are essential questions that should be seriously and thoroughly discussed. The economic policies that are usually proposed do not take into consideration the coexistence of different economic — and social — realities. However, to begin with it is necessary to create the conditions for the economy to become more homogenous and for reducing social inequality.

The legal State and the parallel State

Is the Peruvian State large or small? A State whose public sector budget is US\$ 12 billion (or 17 percent of GDP) does not seem to be overly large (it is actually average for Latin America), but resources are spent poorly and in an excessively centralised fashion, with little transparency. Resources thus do not always adequately benefit the target population.

A drastic reform of the State is needed so that it can reach out to the people, increasing its representative character and its legitimacy. This reform should also aim at the modernising public management, increasing the transparency of government action and its accountability – including its monitoring by organised sectors of society –, and decentralising government activities, all of which would result in greater efficiency and less corruption. Also needed is a restructuring of the public sector's budget, 64 percent of which are spent on payroll, pensions, goods and services, 25 percent on paying the public debt, and only 11 percent on public investment projects. Restructuring should also transfer resources from current expenditure to social programs and investment expenditures, particularly on basic infrastructure.

As we speak of reforming the State and its institutions, questions arise. Which State do we want to reform? The first question, though, is: Is it necessary to reform the State? The answer is yes. Various circumstances show that the

current State has collapsed and must be drastically changed. The State's absence or lack of capabilities is seen, for instance, in areas such as security, citizenship, intelligence, health, social security, basic education, tax collection, infrastructure, territorial management, corruption, etc.

But the problem is much more serious than it seems. It is not a question, as some neoliberal thinkers pretend, of downsizing the State and transferring the greatest number of functions and institutions to the private sector. In a country such as Peru, with so much poverty and inequality, the size of the State is really a relative matter. Even though some sectors may be somewhat oversized or have an excess of bureaucracy, the main problem are the scarce public resources, which are spent poorly, ineffectively, without transparency, and in a centralised manner. But even if we could correct all of that, it would still be too little.

The biggest problem we must acknowledge and understand is that what we recognise as the State, with its institutions, laws, and public servants, represents only 10 percent of Peruvians. In other words, *nine out of ten Peruvians do not feel that they are represented by the current State, and those feelings are not unwarranted, for the Current State does not take them into consideration!*

A few simple observations and questions that may explain this “exclusion situation” are the following:

- (a) Upwards of 80 percent of economic units in the country are micro or small businesses (MYPEs) and most of them are informal. Who in the State apparatus bothers about understanding and assisting microbusinesses with their main needs and concerns?
- (b) About 90 percent of agricultural producers in Peru are small farmers with less than 10 hectares each. Who or which institution in the agricultural sector worries about the particular reality of these small producers?
- (c) Thousands of boys and youths in Peru have quit school and those who do attend have serious problems in learning the educational contents that are of no use to them; there is a lack of teachers in the villages of the interior; our university students do no research and thousands of young people spend hours chatting on the Internet,

wasting precious time and even “unlearning” the proper use of their own language. Given this situation, what does the State do in the area of education?

- (d) Owing to increasing corruption, inefficiency and impunity are the only features one notices in the administration of justice. What is the State doing instead of promoting a real reform of the Judiciary?
- (e) Lack of security on city streets and in the country is on the rise. In many city districts and in villages in the interior, the people, tired of the abuse and inaction on the part of the State, has decided to make justice with their own hands and to provide themselves with the security the State fails to provide. Are not the recent events in Andahuaylas a demonstration of the absolute ineffectiveness of the State?
- (f) Microbusinesses need the credit and technical assistance provided by Edpymes, Cajas Rurales, and Cajas Municipales financial institutions, but the State, represented by the Banking and Insurance Superintendence, seems to be prepared only to regulate and support the activity of the big banks (the banking sector and other financial institutions).

We could go on citing examples of the State’s absence or poor management. The main objective of a thorough reform of the State should be such that it would include and represent most or all citizens. In Peru today there is a *legal, formal, Constitutional State* that is inefficient and that, unfortunately, is only concerned with or has influence over 10 percent of Peruvians. At the same time, there is also a *parallel, informal State* that works and which encompasses 90 percent of Peruvians. It is in this parallel State that millions of microenterprises, small producers, self-employed, informal workers, taxi drivers, communities, nongovernmental organisations, different associations, and so on, work and establish their own rules of the game.

This parallel State does work; its participants define their own rules and procedures and abide by them, have values, goals, objectives, and commitments. They feel they belong to this informal State; there is trust in their leaders, so that there is participation, commitment, and even sacrifices. In the meantime, we that find ourselves in the legal, formal State do not understand what is happening and go on talking to and legislating for 10 percent of the population.

Ten proposals for a consensual agenda

To approximate the parallel State to the formal State, we propose an agenda with ten items to be made into consensus objectives:

- (1) Investing to promote employment and dignity. This requires efforts to raise the levels of investment to generate growth and create productive jobs. A priority should be to grow at a yearly rate of 7-8 percent during an extended period in labour-intensive sectors.
- (2) Social justice with fiscal responsibility. There is no development without social justice. The State's foremost responsibility is to ensure social justice and this should be achieved through the transparent, responsible use of the public sector's scarce resources.
- (3) Social engineering to achieve consensus. This requires multidisciplinary efforts to bring closer together the interests of investors and those of the population living in the area of influence of the investment project. It requires a search for co-ordination mechanisms and an effort to understand the concerns of the communities and to ensure a socially responsible management on the part of the enterprises.
- (4) Decentralisation of production. This requires moving from the current regionalisation based on the official bureaucracy to decentralising production, so as to establish macro-regions and create the conditions to make investment and the generation of local jobs in the interior more attractive.
- (5) Profitable agriculture with food security. This requires transforming and modernising the agricultural sector, organising producers, providing credit and technical assistance, facilitating the establishment of productive chains, developing the irrigation infrastructure, and opening marketing channels. It also implies ensuring food and proper nutrition, particularly for mothers and children.
- (6) Quality education and education for work. This is needed to raise the schooling level from the sixth grade to higher education and the quality of educational contents to instil in students the values of solidarity, productivity, and competitiveness.

- (7) Science and technology for change. It is recognised that without scientific research and technological change there is no development or adequate participation in the global, competitive context.
- (8) Associating for exporting. This is required so that thousands of micro- and small businesses may achieve economies of scale, obtain access to credit, and benefit from technical and financial co-operation, directing their efforts to both the domestic and the foreign market.
- (9) Managing to promote social justice. This requires the training of civil servants for the different tasks of the State so that they may attain a level of excellence and dedication to the job, keeping always in mind that the final objective is to meet the requirements of the citizens and to be efficient and transparent in their work.
- (10) Competitive integration. This presupposes the reaffirmation of our integrationist calling in its various forms: subregional, regional, and hemispheric, seeking in integration a way of working together to achieve competitiveness and the attendant improvement of the living standards of the population.

Is it possible to achieve social justice with fiscal responsibility?

In our view, the human being should be the fundamental priority of a development strategy. We should thus pay attention both to the economic indicators that help stability and to the social indicators that ensure social inclusion and democratic governance.

In this connection, the State's main task should be to promote development with social justice. This requires the understanding that job creation and the reduction of poverty and inequality can be ensured by sustained economic development, which in turn requires private and public investment. How to invest at the required, sustainable rate? How to ensure that such investment and the ensuing growth are sustainable? How to ensure that growth is accompanied by the generation of productive employment? How to ensure that growth is equitable? How to improve the effectiveness of public investment so as to take better advantage of the scarce budgetary resources?

These are some of the questions that must be answered in a straightforward and responsible way.

Job creation will then come basically from the participation of private investment in new development projects. The State's task will be to create the appropriate climate so that this investment may have the proper conditions to ensure profitability and stability. The State should also provide a basic infrastructure that is conducive to the country's integration and the achievement of competitiveness.

Important sectors for job creation and the fight against poverty, such as agriculture, must be given priority. The agricultural sector must be profitable and this requires the management of costs and prices. The compensation of agricultural producers for subsidised food imports through price bands is an appropriate measure. Another important task is the planning and zoning of crops to prevent overproduction. Also important is an ad hoc tax policy for agriculture as well as reducing the excessive costs that affect farmers. The agricultural sector thus needs promotion and technical assistance, credit, and support for the organisation of producers, among other measures. Just as for the agricultural sector, it is also necessary to establish sectoral policies for manufacturing, construction, tourism, etc.

But growth is not enough, even if it generates employment. The task of furthering social justice implies working for quality education that favours scientific research and the development of new technologies as well as striving for universal social security coverage and for the entire population's access to basic health services. Social justice also implies fighting poverty and inequality and pursuing the decentralisation of production.

This effort to achieve social justice requires sound financing, which will not come from further indebtedness and still less from merely printing money or increasing the public deficit. Resources must come from the restructuring of public expenditure so that, in a modern, transparent, and decentralised manner, they are redirected from the current expenditure on the bureaucracy to investment and the funding of social programs. This will require a genuine tax reform based on few taxes which all must pay to ensure an effective broadening of the tax base.

The tax reform we need: citizenship and taxation

If it is the State's main task to ensure social justice, then public expenditure should be responsibly financed. In recent decades, successive Administrations have covered up the fiscal deficit by borrowing. This is no longer an option. The public debt already takes up more than half the annual GDP.

Servicing such debt gobbles up four of each ten dollars earned from exports, or 25 percent of the public sector's budget and this situation will worsen unless debt servicing is restructured or reprogrammed. During President Toledo's administration alone the public debt (domestic and foreign) has risen by about US\$5 billion.

The only way of financing public expenditure (which is fundamental for ensuring social justice) is by raising tax collections or by cutting public expenditure. This must be understood and accepted. The era of debt is over.

Revenue from various types of tax in Peru totals about US\$70 billion a year. This is not sufficient for the requirements of the public sector budget (which, as mentioned, requires about US\$12 billion a year) nor is this revenue very high, if one considers the high levels of tax evasion and tax avoidance, contraband, undervaluation, piracy, and tax breaks. How, then, should one go about increasing tax collection?

A *genuine tax reform* is imperative. The expression "tax reform" has lost prestige lately owing to the haphazard creation of new taxes such as the tax on financial transactions – ITF, pre-emptive tax collection, and the emphasis on auditing those who already pay their taxes instead of identifying and punishing those that do not.

A serious tax reform should aim at four fundamental objectives: (a) broadening of the tax base; (b) adoption of a progressive tax structure; (c) simplification and neutrality of taxation; and (d) arousing the Peruvian citizenry's awareness of taxes.

Table 3 -The four objectives of tax reform

1.	Broadening the tax base;
2.	Adopting a progressive tax structure
3.	Simplifying the tax system and making it neutral
4.	Arousing Peruvians' awareness of taxes

What must be done to broaden the tax base is exactly the opposite of what the government is currently doing, i.e., those who do not pay—both small and big—should be identified and audited, instead of raising taxes or creating new taxes. It is not admissible that 84 percent of tax revenue should come from only 0.6 percent of taxpayers, called *PRICOS* [major taxpayers]. Nor is it admissible that the income tax should yield so little revenue.

The current tax structure is very regressive. Seventy-five percent of collections come from indirect taxes (all of us pay these taxes on what we consume, regardless of our income or of whether we are employed), while only 25 percent come from income or property taxes. This is unfair and must change. Our goal should be to raise direct taxes so that they will account for at least 50 percent of collections.

Taxation should be simplified. Three or four taxes should remain (income, IGV [sales tax], ISC [excise tax], and customs duties), while the other taxes should be gradually eliminated. Moreover, taxation should be neutral, i.e., it should not give rise to exceptions or privilege or curtail the enterprises' competitiveness. The current tax breaks of a sectoral or regional nature should be gradually and co-ordinately reduced. Lastly, we must make all Peruvians aware of the importance of paying their taxes properly and punctually; in this respect, schools have a key role to play.

If we handle expenditures in a responsible, transparent way, we shall regain credibility before Peruvians and be in a position to encourage them to comply with their tax obligations. In these globalisation times, when States cannot abandon their objective of ensuring social justice, the only way of obtaining sound revenue is through taxation. In a sense, to be able to fully realise their role as citizens, Peruvians must pay their taxes.

Pursuing a gradual, common-sense productive integration into the world

How should we interpret the major changes that are taking place in the world economy? How should we incorporate ourselves productively into the global, competitive economy? Does being modern imply giving up national objectives and lose our identity as a country? Which strategies should we adopt?

Some answers frequently given to these questions suggest that the most convenient thing to do is to throw open our national economies, even if unilaterally, without any negotiation, as the benefits will flow naturally and quickly. In our view, this is a simplistic interpretation of what is happening and the neoliberal ideological burden that normally accompanies it usually has a fundamentalist tone.

It is obvious that the changes that are occurring are substantial, but it is necessary to understand their nature to be able to adopt the appropriate strategies. From a strictly theoretical standpoint, a small economy such as the Peruvian must actively participate in the world economy precisely to offset the disadvantages of such a small share of the “world pie.”

With respect to tariffs, both industrialised and developing countries have substantially opened their economies in the last fifty years. In the case of the industrialised countries, the customs tariff dropped from 25 percent to less than 5 percent over that period. In addition, the proliferation of free trade agreements between countries or regional blocs has reduced a goodly portion of the tariff universe to zero, to the point that many think that tariffs will in time disappear.

Nevertheless, although there has been greater opening with respect to tariffs, there is also greater protectionism through the so-called “nontariff barriers” and the industrial countries are the ones that resort the most to unfair competition policies in international trade.

Thus, for instance, Europeans and Americans openly subsidise their farm exports, just as Australians and New Zealanders subsidise their dairy products or cattle exports. Also well-known are the “quotas” or “tariff quotas” allocated by the United States to its textile and apparel imports or the severe “administrative exigencies” established by industrialised countries for the entry of developing-country exports into their markets. Tied bids complete the picture with respect to services. In the case of developing countries, particularly Asian countries, subsidies, dumping (exports priced below cost), and undervaluation are consistently practised.

The argument so far indicates that although trade opening has advanced considerably with respect to tariffs, there has been marked back-pedalling as regards nontariff barriers. Free trade as such does not yet exist. This is a problem recognised world-wide, which is permanently under discussion at

the World Trade Organisation-WTO; developing countries led by India and Brazil have even formed the so-called Group of 21 to add to the negotiation agenda the need to dismantle nontariff barriers against exports from poor countries.

In the Peruvian case, the average nominal tariff is about 10 percent; raw material imports are subject to a 4 percent tariff, while a zero tariff holds for imports of capital goods. This means that we have made a significant effort toward trade opening—to a considerable extent without bargaining for anything in return. In our view, trade negotiations henceforth should aim at gradual opening and achieve a proper balance between the objectives of market access for our exports, investment promotion, and the requisite attention to our national production, when it is affected by subsidies or dumping. If subsidies are imposed against us, we must compensate our producers. As long as unfair competition practices prevail in international trade, we have to adopt trade defence policies as allowed by the WTO, i.e., we must act with much pragmatism and common sense.

Peru: a country of sharp contradictions but also of great opportunities

At times we have asked ourselves how to define Peru. Various authors have attempted an answer. In our view, it is a country of marked contradictions but also of immense opportunities. This ambivalence explains in great part what we have accomplished with respect to economic and social development.

Contradictions

We could write a whole book on Peru's contradictions, but we shall limit ourselves to only a few. It has abundant natural resources but low growth rates, with more than half the population living in poverty. In contrast, a country such as Japan, which has practically no natural resources, is a world power. Peru has one of the greatest water resources potential in the world but we only utilise 3 percent of it; in contrast, in the coastal valleys, which have little water, crops are still cultivated under extensive irrigation systems and to this day there has been no water legislation to regulate this scarce resource there.

Ancient Peruvians organised themselves territorially along the river valleys. Our current territorial organisation is chaotic. There are provinces of the same Department that cannot communicate with one another; their inhabitants must go down to the coast and climb the mountains again to reach the sister province. The ancient Peruvians bequeathed to mankind, among other things, the organisation and technology of agriculture on inclined terrain through the use of *andenes* or farming terraces; currently we no longer use this technology, while the *andenes* lay abandoned or merely provide a tourist attraction in some areas.

Maize and potatoes are produced, but the Peruvians' staple consists of bread and pasta made from imported wheat. In contrast, the Mexicans and Central-Americans of every social class consume tortilla made from maize produced on their lands. Peru is the world's top producer of fishmeal, but the per capita fish consumption in our population is extremely low. We have protein (fishmeal) and fibre (sugar cane) to produce good, balanced feed for animals, but have no cattle. In contrast, Cuba has no protein (it imports fishmeal from Peru) but sells us cattle.

The productivity of the best soils on the Peruvian coast is low. In contrast, Chile, with a territory no larger than Piura (a Department on Peru's northern coast) exports ten times more agricultural products. Taiwan, with a territory no larger than the Ica Department on the southern coast, exports 60 times more than Peru. Resources are available but are wasted for lack of planning. It is not a matter of land and natural or even financial resources; it is a matter of strategy, organisation, and mentality.

Opportunities

Nevertheless, while we experience such obvious contradictions, we have great opportunities, which present equally formidable challenges. The variety of microclimates and ecosystems should place us at the vanguard of the world with respect to fruit, natural dyes, and vegetable exports. Our country's geographical, social, and cultural diversity should mean strength instead of weakness. The United States, for instance, base their strength not on the uniformity of its territory but on the diversity of its population, mostly of immigrant origin.

Peruvians are used to living under scarcity situations, are ingenious, and have an enviable biological capacity to adapt themselves quickly to different

ecosystems. Instead of taking advantage of these capabilities, we export Peruvians, who go away and develop their abilities in other countries.

As we have seen, most of our firms, both in the countryside and in the cities, are micro- and small businesses. There is a great potential to organise producers into associations, get them together, and improve productivity levels. Although we are so small in the world context (we account for less than 0.2 percent of world trade), we can significantly grow through our exports, if we want. With the raw materials, the land, and the human resources we have, we can build very competitive productive chains.

Agreements similar to a Free Trade Agreement with the United States or the European Union could provide good opportunities. Andean integration and association with Mercosur can be quite beneficial; a closer economic relation with China and other Asian countries may be very profitable. To translate these opportunities into employment and income for our population, we must come to an agreement on what is basic, on a development strategy that is also geared to promote social justice. This is an issue we Peruvians must solve, the sooner the better.

Concluding thoughts

In this article we have pointed out the major characteristics of our economy toward the end of 2004 and the projections for 2005 in the face of the approaching electoral period, which will end in April 2006, when we Peruvians choose a new National Government and a new Congress. The most outstanding feature brought to light by this analysis is the existing contradiction between some economic indicators that point to stability and some worsening social indicators that hamper democratic governance. Also evident is a significant, uninterrupted growth for forty months, which however does not translate into sufficient productive employment, so that the people do not “feel” that their families’ economic situation is improving.

We have attempted to explain the reasons for this contradiction owing to which “the economy is doing well but the people are doing poorly”. We posited two main observations: (a) economic policies that have been implemented make the mistake of assuming that the measures they prescribe are going to be applied to a homogenous economy, whereas we assert that

four different types of economy coexist in the country; and (b) there is a legal, formal State that nevertheless represents, understands, and affects only a minority of the population, and a parallel, informal State that, although it does function, goes its separate way, impervious to the shifting economic policy and to politics in general.

On the basis of these two assertions, we have proposed a ten-point agenda we consider fundamental for achieving consensus-based development; we have affirmed that ensuring social justice is the State's main task and that, to accomplish it, the State must act with fiscal responsibility. We have outlined the main features that, in our view, should characterise a thorough tax reform, and have insisted that one of the features of citizenship is compliance with the obligation to pay taxes.

In the 1970s and 1980s, Peru adopted an import substitution model through which it established an incipient industrial base; in the 1990s, under the neoliberal economic opening model, Peru became competitive in modern sectors and exports, while poverty, inequality, and informality increased; and in the following years, growth has not generated sufficient productive employment.

In the early years of the 21st century, we face simultaneous challenges: to achieve sustained growth with employment; to promote investment, diversify exports, decentralise production, increase productivity and competitiveness, and reduce poverty and inequality. The main challenge, though, is to understand that fundamental solutions are not going to come from "outside", much less spontaneously: strategic planning and a minimum of consensus are needed. Accordingly, this article has put forth varied economic policy suggestions and proposals, which, we hope, will contribute to the debate. ■■■