

Peru

Country Case Study

The challenge of mineral wealth:
using resource endowments to foster
sustainable development

July 2007



PERU COUNTRY CASE STUDY

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The findings, interpretations, conclusions and recommendations expressed in this report are entirely those of the authors and do not necessarily reflect the views of the Government of Peru, the United Nations Conference on Trade and Development, the World Bank, its Executive Directors, or the countries they represent.

PREFACE

In the past five years, the economic, social and environmental dimensions of mining and minerals have been the subject of wide-ranging consultation, critical comment, research and analysis. The Mining Minerals and Sustainable Development Project (MMSD) and Extractive Industries Review (EIR) respond to the unprecedented focus of public attention on the sustainable development challenges for extractives in general and mining in particular.

In May 2004, ICMM¹ initiated its **Resource Endowment**² initiative³ to better understand how large scale mining activity in low and middle income countries can enhance the socio-economic development of host countries. The initiative aims to isolate the drivers of development effectiveness in the mining and metals sector and to document the policy frameworks, operational practices, and partnership arrangements that deliver sustainable outcomes on the ground. This action-research project is being done together with UNCTAD and the World Bank Group. ICMM also consulted stakeholders such as mining companies, governments, donor agencies, labor and non-governmental organizations (NGOs).

Much of the “resource curse” literature has focused on problems rather than solutions. Consequently it is not of much practical help in designing improved policy or filling gaps in knowledge. For example, how have apparently “successful” countries avoided problems now so widely perceived? Can such outcomes be repeated in other developing economies endowed with an abundance of mineral resources? How should the main stakeholders work together to enhance positive socio-economic outcomes from mining investments?

To help bridge these gaps, some of the specific questions the Resource Endowment initiative attempts to address are:

- How the mining sector overall contributes to national development?
- What strategies have been effective in managing revenues generated by natural resources for sustainable development and poverty reduction?
- How an individual mining project contributes to development at national, regional and local levels?
- What are the practical and policy implications for mining companies, host country governments, development institutions, and NGOs?
- What might the distinct responsibilities of these development partners be to support implementation of findings and recommendations?

The three distinct phases of the initiative and related products are outlined below.

¹ The International Council on Mining and Metals.

² The Challenge of Mineral Wealth: using resource endowments to foster sustainable development.

³ The initiative is managed by Kathryn McPhail, Principal, ICMM.

Phase 1: Analytical Framework and Tools

The initial phase of the project concentrated on the development of an analytical framework focusing on governance processes, including the underlying factors and rules of the game that affect social and economic interactions and outcomes. These aspects were incorporated into a practical Toolkit to assess local, regional and national socio-economic impacts of mining. The Toolkit also deals with how mining operations impact on governance structures, institutions and policy changes at different levels of government. Phase 1 involved an extensive literature review, and a 'coarse-sift' comparative analysis of the relative economic and social well-being of 33 countries with a high dependence on minerals. Initial findings were critiqued in a multi-stakeholder workshop which helped to shape a revised approach.

Phase 1 Published reports:

- Analytical Framework: Executive Summary
- Resource Endowment Toolkit

Phase 1 Additional Online Resources:

- Analytical Framework: Main Report
- Literature Review
- November 2004 Workshop proceedings

Phase 2: Testing, Synthesis and Emerging Lessons

This involved applying the Toolkit to two main and two comparator countries, Peru (with Chile as a comparator) and Ghana (with Tanzania as a comparator). In all four countries, mining had shown some evidence of having successfully contributed to economic and social improvements. The purpose was to test the Toolkit, to assess whether it could be applied to a broader set of mining countries, and to propose refinements. The findings were reviewed by a second multi-stakeholder workshop which provided valuable feedback.

Phase 2 Published reports:

- Four country case study executive summaries
- Synthesis report of findings of the four case studies

Phase 2 Additional Online Resources:

- Ghana, Tanzania, Peru and Chile country case studies
- October 2005 Workshop proceedings

In addition, a number of other publications summarize the process or findings of both Phases 1 and 2 and signal ICMM's approach to Phase 3.

- A Spotlight series that summarizes key aspects of Phases 1 and 2 (The Prize; The Challenge; Ways Forward; and Process and Feedback)
- Resource Endowment Guide to Phases 1, 2 and 3

Phase 3: Action Learning through Partnerships

The activities of Phase 3 will include a number of 'pilot projects' in partnership with others to encourage uptake of the Phase 2 recommendations and, as a consequence, enhance the contribution of mining to social and economic development. Phase 3 will also focus on dissemination and outreach.

For the latest information on Phase 3, including details of pilot activities and partners visit www.icmm.com

EXECUTIVE SUMMARY

Peru has a long mining history. Before and during colonial times gold and silver mining was a particularly important economic activity. Today the country remains a very significant global provider of minerals. It is the world's second largest supplier of silver, third of zinc, fifth of copper and sixth of gold. Many new investments have taken place since the early 1990s and there are a considerable number of operations at various stages of development.

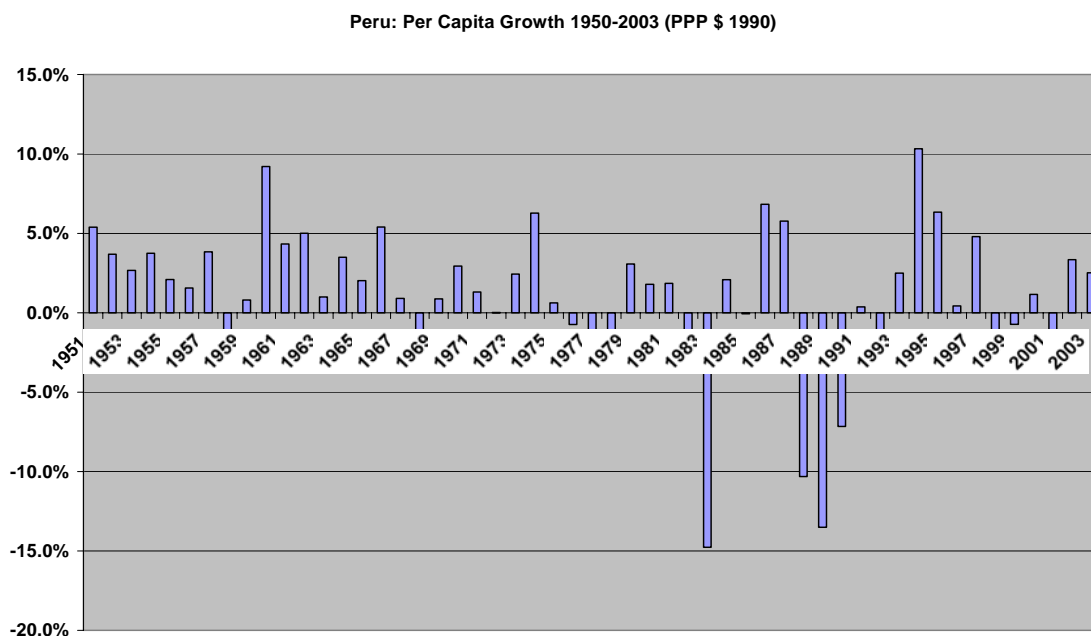
In recent history three distinct periods of economic policies have governed the sector. Up to the late 1960s mines were largely privately owned. Starting in 1968 a large proportion of mining activities was taken over by the state under the left wing military regime. This ownership structure prevailed during the democratic governments of the 1980s. With the start of the Fujimori Presidency in the early 1990s the underlying philosophy for governing the economy took a complete U-turn. Private sector involvement, especially foreign direct investment, was actively encouraged and nearly all of the state's mining assets were privatized. Between 1992 and 2004 domestic and international mining companies undertook total investments of about US\$9.8 billion. There is no shortage of promising prospecting opportunities, so the availability of suitable ore bodies is unlikely to constrain this recent mining boom.

How has the resurgence in the mining sector impinged on the economic performance of the country and on the living standards of its people? To answer these and related questions the case study examines the performance of the sector with respect to macroeconomic management and economic and social contributions at the national, regional and local level. The impact at the local level is explored by means of a close-up study of Peru's largest operational copper and zinc mine. This is the mine of La Compañía Minera Antamina in the Andean region of Ancash, which took up operations in November 2001. The mine is owned by a consortium of BHP Billiton, Mitsubishi, Teck Cominco and Falconbridge and has an estimated life span of more than 20 years. The study triangulates the local level perspective with the macroeconomic and national effects to identify where the major challenges lie in delivering larger benefits to the Peruvian population. It highlights various institutional and governance problems, including for example in public financial management. It argues that if these challenges could be overcome, larger socio-economic benefits could be delivered, social tensions mitigated, and operational risks reduced.

Macroeconomic Policies and Effects

The mining sector has earned large amounts of foreign exchange and attracted significant amounts of foreign direct investment since the early 1990s. Its contributions to the macro economy have been positive and have coincided with a period of greater economic stability. Liberal economic policies have led

to a relatively stable exchange rate, decreased inflation and official reserves at comfortable levels. The very volatile macro-economy, particularly during the 1980s, and poor economic policy choices in earlier decades were linked to popular pressures which were brought about by socio-political changes to the semi-feudal market economy that dominated in the first half of the 20th century⁴.



In terms of merchandized exports the mining and metals sector has clearly been dominant. In 2004 mining contributed about 6.9 % of GDP (the figure for 2003 was 6.8%) While direct and indirect employment from mining relative to the economically active population is small (in total about 3.5%), this is due to the capital intensive nature of the industry. Broader indirect effects, however, are believed to be large. Of the \$1.5 billion of inputs delivered to the industry, an estimated two-thirds are supplied from within Peru (this includes imported goods delivered by Peruvian suppliers). In 2003 the mining sector paid for about 4% of government’s actual spending and contributed slightly more than 5% to government’s total tax intake (making the sector one of the largest overall taxpayers in the country).

Mining has clearly been one of the crucial economic sectors contributing to Peru’s turn-around macroeconomic performance. Unfortunately, this positive macroeconomic picture is not mirrored by improvements in high levels of unemployment and a reduction of the informal economy. Poverty levels and inequality have remained stagnant and there is generally low trust in public institutions and policy processes. In this respect, Peru differs from the other case studies where, in the cases of Chile and Ghana, clear or at least some improvements in people’s living conditions and economic satisfaction can be demonstrated.

⁴ These changes include growing urbanization, immigration and political enfranchisement of larger segments of the population.

What has constrained the mining sector from making greater contributions? The major proposition of the case study is that macroeconomic and structural reforms at the national level have not been matched by equal improvements in institutional capacity and in political-administrative processes delivering broad-based public services at the regional and local level where many social needs remain unaddressed. Reforms at the national level have established secure property rights for the rural and urban poor and electoral rules that support effective public policy consensus and coalitions building.

Social Performance and Reduction of Poverty

Official statistics show that over the period from the 1960s to 2002 three key social indicators - infant mortality, life expectancy and literacy rates - have generally improved. But on the other hand, the 2004 UNDP Report on Human Development for Peru finds that the country has been unable to reduce social inequality and appalling disparities in income and regional development. More than half of Peru's population continues to live in poverty and nearly a quarter lives in extreme poverty. Extreme poverty affects more than half of the rural population, compared to slightly less than 10% of urban dwellers⁵.

In this context mining companies have often become the target for demands from local communities to deliver goods and services, which should ideally be demanded from and provided by government. In many instances mining companies have responded to such pressures and have provided additional resources. But this has not alleviated social tensions and occasional violent confrontations. Lack of real improvements in social performance has prompted recent political election promises to decentralize and to reform the political system, while the economic policy stance of the 1990s has largely been sustained. The study is critical whether in their current form these reforms can deliver better results.

The study has found it difficult to assess the sector's contributions to poverty reduction at the regional level. Available data shows no clear patterns or proof that mining improved (or undermined) regional living conditions relative to national averages. Since 2002 half of corporate income tax collected from mining companies is redistributed to regions, municipalities and districts where mines are located⁶. This mechanism - the *Canon Minero* - allows these sub-national entities more independent expenditure decisions, whilst other intergovernmental transfers funded by general tax collection remain earmarked for (poorly) targeted expenditure programmes determined by central government. *Canon Minero* transfers constituted only slightly more than 1% of total actual government spending, but annual percentage increases

⁵ As a consequence extreme poverty disproportionately affects the indigenous population.

⁶ Between 1997 and 2001, the *Canon Minero* redistributed 20% of corporate income tax collected from mining companies. The increase to 50% came about in the context of Peru's decentralization process embarked upon in 2001 and subsequent intensive lobbying by Members of Congress of mining affected communities and by mining companies.

in transfers have been spectacular, particularly for some sub-national entities. The rules for redistribution of the transfers have been changed three times in the past four years, reflecting the highly controversial nature of the criteria.

Mining companies may have seen it as a positive development that local communities receive more funds that can be clearly tagged and traced as arising from the investments of mining companies. But this mechanism also carries substantial risks. One of these is that large increases in revenue transfers to sub-national governments could trigger a local 'resource curse', particularly in light of weak local public financial management capacity and unclear delineation of administrative responsibilities. The study highlights that there is no automatic link between higher amounts of public money spent at the sub-national level and better outcomes for local communities as well as less social tensions.

The Contributions of Mining Companies

The close-up study of the Antamina mine clearly shows that this mine contributes significantly to regional GDP. Despite the industry's capital intensity, there are direct and indirect employment effects. Indirect employment is about 10 times higher than direct employment and is mostly generated by the major contractors. Only 16% of directly employed personnel come from the districts near to the mine, while the remainder comes largely from elsewhere in Peru. Thus, high expectations by the surrounding population regarding local job creation have not been fully met. The main reasons for this is the difference between the skills available nearby and those required for working at the mine. The mine and some of its contractors seek to provide more localised training initiatives to help match the local skills base with industry needs.

Antamina's company policy includes a range of development goals, including for example the provision of 100% access to basic services for communities in the area of impact and co-financing and implementation of sustainable development projects, either directly or in collaboration with other organisations. The mine demonstrates that companies are making considerable efforts in providing meaningful levels of social investment, and are trying to increase local content and employment. This requires a proactive stance from the start and collaboration with local entities. But there are clear limits to what mining companies can achieve on their own. Where standards of living are generally low, expectations are high, and government usually lacks presence regarding the provision of basic public goods and services. This puts the pressure on mining companies to provide alternative social spending. Irrespective of amounts spent, local communities do not perceive social investments as sufficient and have high expectations that companies substitute for the absence of regional and local government action.

Companies' main constraints for enhancing further contribution to socio-economic development and better living conditions are weak administrative and public financial management capacity at the regional and local level. These limit trickle-down effects that are expected through the creation of

productive activities linked to the main operation, and it leaves a vacuum where public entities are necessary counterparts. The study finds that institutional and governance arrangements supporting economic development and economic diversification through a local supply chain remain incomplete. This also undermines the sustainability of mining communities after mine closure. *Resource Endowment Spotlight 02 - The Challenge* points out that this is the area where government authorities and mining companies still have a long way to go in collaboratively developing a local supply chain.

Successful Policy Changes

What explains Peru's improved macroeconomic performance since the early 1990s? As in the other three case studies, the *reform of mining legislation* has been one of the favourable conditions for the resurgence in private sector investment in the mining and metals industry. General legislation introduced in 1991 brought about a regime of legal stability for foreign investment. To set specific terms and regulations for the sector, mining legislation was introduced in 1992. All functions were centralized in one ministry, previously required social obligations were removed, and net earnings became the basis of central government taxation with many of the contracts containing stability clauses for periods of 10-15 years. This legislation created an extremely attractive investment regime for large multinational mining companies⁷.

In relation to *macroeconomic policies*, Peru has made formidable progress. The study tests Peru's macroeconomic data against the various propositions when and how 'resource curse' could have occurred and finds no connections at a macro level. Over the past 15 years, the macro-economy has been well understood and competently managed. In such a context mining can play a kick-starting role in boosting a previously ailing economy. For reasons given above, the main risks are that 'resource curse' effects could occur at the local level and that trickle down mechanisms are not forthcoming automatically.

These risks relate to Peru's *institutional and governance arrangements*, where the case study identifies various problems. Reforms over the past 15 years have focused on central government and on commercializing certain market related government functions to separate these from central government. This has come at the neglect of improving administrative and public financial management capacity at the local and regional level where poor public service delivery keeps living conditions stagnant.

Challenges to enhancing Economic and Social Benefits

The study emphasises that institutions and governance structures are a key variable for enhancing the positive socio-economic contributions that the mining sector can potentially make. They set the framework for and condition how public sector entities, citizens and private sector companies relate to each

⁷ Considering the circumstances under which mining legislation was introduced, the incumbent regime governed under extensive powers passing urgency legislation by decree. While this facilitated the process of introducing fundamentally new economic policies, it may have tainted the legislation's domestic legitimacy.

other. Peru's performance regarding those governance indicators conventionally measured by the World Bank has been weak. On one hand the political transition at the beginning of the 21st century has led to more participation and trust of society in the political process and has improved political rights, but real improvements in the workings of the public service and administration and the legal system have remained outstanding. The latter are key for delivering better services to people and enabling them to take advantage of economic opportunities. In addition, they provide the link between revenue from mining activities paid to central government and the social and economic benefits that citizens receive in return.

What is required are institutions and governance structures that support private sector activities of different sized enterprises while at the same time addressing economic and social exclusion. Since the 1990s those institutions and governance structures in place have facilitated macroeconomic policies achieving positive aggregate results. But they have failed to produce the sort of public policies and services (and thus trickle-down mechanisms) that reduce poverty to an adequate extent.

Why does it matter for the mining industry? If institutions and governance structures are unsuitable to deliver greater social returns from public funds, social tensions and conflicts arise, and they create pressure on mining companies to increase social benefits. Mining companies have become the target for many demands from local communities to deliver goods and services - many of which should normally be provided by government. When mining companies fill the governance vacuum the arrangements are unlikely to be optimal. There is no guarantee that direct company payments satisfy all demands. And if public policies do not respond to popular demands, the taxes and other revenues that mining companies are paying to central governments will not be seen as benefiting local communities.

But to simply presume that better institutions and governance arrangements can somehow be grafted onto societies is to fail to recognise the complex processes that are involved in doing this in practice. This is why the ICMM 'Synthesis of Four Country Case Studies' report emphasises the need for collaborative actions between governments, companies, donors and non-governmental organisation to capture the full potential benefits of mineral wealth. *Resource Endowment Spotlight 03 - The Way Forward* summarises the practical recommendations of the ICMM's project derived from the four case studies. The Peru case study shows in particular the risks and opportunity costs of poorly addressing the challenges of mineral wealth and constraining the potential prize from being earned.

1 INTRODUCTION

1.1 OBJECTIVES

This report was prepared by Oxford Policy Management (OPM) and Environmental Resources Management (ERM) on behalf of the International Council on Mining and Metals (ICMM). It is one of four prepared under ICMM's *The Challenge of Mineral Wealth: Using resource endowments to foster sustainable development* initiative, also referred to as the Resource Endowment initiative. The aim of the Resource Endowment initiative is to establish how, and under what conditions, mining activities contribute to the socio-economic development of host communities and countries. In order to inform this debate, four case studies have been undertaken in Ghana, Tanzania, Peru and Chile – these are countries that are both heavily dependent on mining and which have performed relatively well in recent years. This report has been prepared to provide an objective assessment of the positive and negative socio-economic impacts of mining projects in Peru.

Phase 1 of the initiative took place from July 2004 to January 2005. It developed an analytical framework for this study, which has been summarized in a Resource Endowment Toolkit. The Toolkit has been extensively peer reviewed by social development specialists and economists in academia, non-governmental organizations and government. Phase 1 has benefited from inputs from a wide range of stakeholders at a workshop held in London in November 2004. Many of the stakeholders have been critical of some aspects of mining company performance in the past. Their views have actively been sought to ensure the Resource Endowment initiative addresses the concerns of a wide range of interested stakeholders.

Phase 2 of the initiative tested and validated the analytical framework developed during Phase 1. It conducted case studies of four countries, of which this report on Peru is one. As mentioned, the other three case studies are Ghana, Chile and Tanzania. Ghana and Peru were chosen as the two major studies, and two consultant teams have conducted country visits for them. Tanzania and Chile serve as comparator country cases. The Tanzania and Chile studies have largely been desk-based.

Fieldwork for the Peru case study took place from April to June 2005, and the data presented largely refer to the situation at the time of the fieldwork. The data on purchasing, labor costs and tax contributions are for calendar year 2005.

Peru has a considerable number of mines at various stages of development – pre-feasibility or feasibility studies, construction, operation, closure or post-closure. Many new investments have taken place over the past 15 years. Peru also has a number of closed mines, and mining legacies that predate the recent increase in mining investment.

To examine impacts at the local level this case study has focused on the Antamina copper and zinc mine as an example. Antamina is the largest operational copper mine in Peru, and is owned by a consortium consisting of BHP Billiton, Mitsubishi, Teck Cominco and Falconbridge. It was officially declared open in November 2001, with an estimated life span of 22 years.

The country case studies hope to answer the following questions:

- How has mining contributed to social and economic development nationally?
- How does Antamina's mining investment contribute to development at the national, regional and local level?
- What national, regional and local governance structures and policies have been effective in explaining the outcomes of both the mining sector as a whole and Antamina's mining investments? Have revenue generated by mineral and mining extraction enhanced sustainable development and poverty reduction?

1.2

CONSULTEES

A very wide range of stakeholders was consulted during the preparation of the case study, as shown in Box 1. It must be stressed that agreeing to be consulted should not be taken as endorsement of the objectives of the study, or of the findings of this report.

Box 1

List of Consultees

- Antamina management in Lima, Huarney and at the mine;
- The Government of Peru, including various ministries and semi-autonomous agencies;
- Local NGOs and think tanks;
- National universities and research centers;
- Regional government representatives
- Mayors and civil servants of municipalities;
- Country representatives of the international financial institutions, the UNDP, and international NGOs;
- Community representatives;
- Representatives from women's associations;
- Businesses and representatives of business associations at both the national and local level, including the National Society for Mining, Petroleum and Energy, other mining companies and suppliers to mining companies;
- Suppliers;
- Representatives of the media; and
- Informed persons of the political, economic and social establishment.

1.3

REPORT LAYOUT

This case study report is presented in five further chapters.

- *Chapter 0* gives economic, political and social background information on Peru.
- *Chapter 3* asks what the quantitative contributions of mining are to economic growth and poverty reduction at the national, regional and local level.
- *Chapter 4* enquires about the linkage between mining investment and economic growth and poverty reduction. It investigates the *proximate explanations* of the economic and social performance described in *Chapter 3*.
- *Chapter 5* explores the deeper reasons behind the observed outcomes at the national, regional and local level, which the *proximate influences* cannot fully explain. It probes selectively into the various dimensions of the analytical taxonomy included in the *Resource Endowment Toolkit*.
- *Chapter 6* synthesizes the experience.

2.1 PERU'S PEOPLE

Peru is the fifth largest country in Latin America in terms of population, after Brazil, Mexico, Colombia and Argentina. It has a population of approximately 27 million people. The population is diverse and divided socio-economically between the usually better off European descendants (13%), 'mestizos' (37%) and a large group of indigenous Amerindians (45%). There are also Afro-Peruvians and other minorities.

The socio-economic divide follows a geographical pattern, between the richer and mainly Spanish-speaking coastal areas, and the traditional, largely Quechua speaking Andean cultures of the mountains and highlands. As a result of high rural to urban migration over the past decades, the urban population has increased from 35.4% of the total population in 1940 to around 75% in 2004.

Figure 1 Map of Peru



2.2 PERU'S ECONOMY

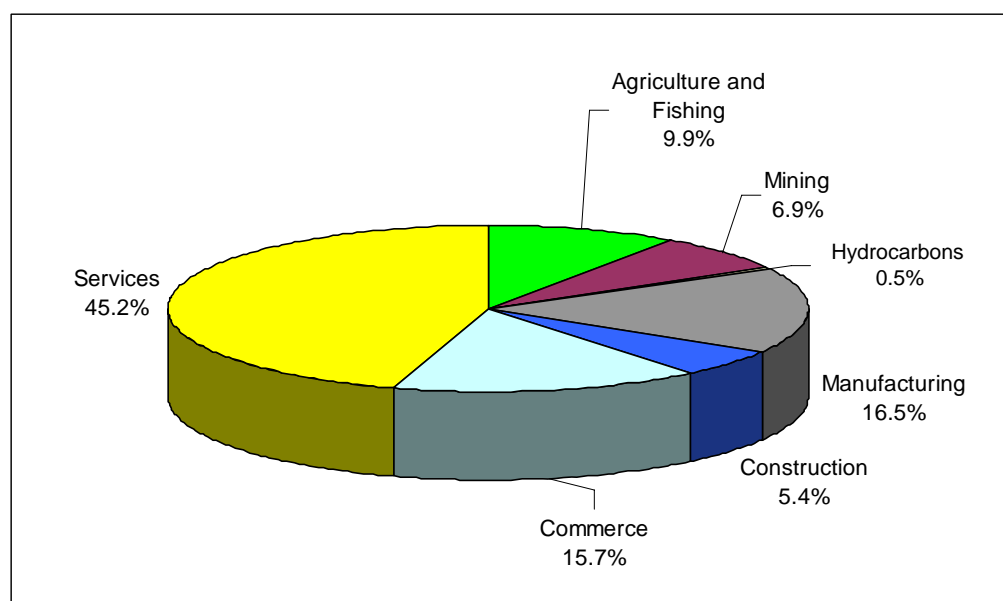
Peru's economy is partly dictated by its varied geography, consisting of a warm arid coastal region, an arid but more temperate Andean region, and a tropical region

bordering Colombia and Brazil. The Andean region provides abundant mineral resources in the mountainous areas and opportunities for pastoral agriculture. The coastal region provides access to fishing grounds and has been made suitable for commercial tropical agribusiness, whereas the tropical region further inland has remained little explored for commercial agriculture.

In recent years, Peru has outperformed its regional neighbors with GDP growth rates of 4.9% and 4.0% for 2002 and 2003, respectively. In 2004, the GDP growth rate was 4.8%. High levels of inward investment in the mining and energy sectors have supported this growth. In 2002 and 2003, mining contributed 6.6% and 6.8% respectively to GDP. In 2004, the contribution was 6.9%. In future, strong contributions to GDP growth are also expected from the Camisea gas project and other mining expansions⁸. Recent months have also shown high growth in the agribusiness and textile industry. Figure 2 shows the composition of GDP for 2004.

The exchange rate has been relatively stable over the past fifteen years, inflation has decreased and official reserves have reached comfortable levels. But persistently high levels of unemployment and informal economic activities, poverty and inequality, and low trust in public institutions and policy processes have not been improved by the relatively strong macroeconomic performance⁹.

Figure 2 GDP Composition, 2004



Source: INEI and BCRP, 2006 (updated)

A high level of export dependence on revenues from minerals and metals leaves the economy somewhat susceptible to fluctuations in world commodity prices. However, this risk is buffered by a high diversity of export patterns and destinations.

2.3 *BRIEF HISTORY OF PERU*

When the first Spanish arrived in 1531, Peru was the heartland of the Inca civilization that extended from present-day Ecuador to central Chile. The Inca Empire preceded the Spanish conquest for at least 300 years. Lima was founded in 1535, and was the

⁸ It is anticipated that the Camisea project alone will earn Peru an extra percentage point in annual GDP growth, as well as approximately US\$10bn in tax revenues and royalties over the next 40 years.

⁹ Peru received favorable reviews in terms of its macroeconomic environment, from a recent IMF mission (IMF, 2005).

capital of the Viceroyalty of Peru as well as the focal point for Spanish expansion and domination of western South America and the Caribbean.

From the mid-18th century the extent and power of the colonial administration in Lima started to decline. Peru declared independence in 1821. A long period of instability followed under a succession of generals. Peru fought a number of wars with neighboring Chile over territories rich in natural resources in the south. In the late 19th century, a railway was constructed connecting the mining centers in the highlands with the coast. This brought large foreign capital investments and extensive development.

At the beginning of the 20th century, economic development, immigration and growing urbanization evoked a political power struggle between the conservative elite and more liberal elements pressing for changes to the social and economic structure of the country. Some reforms in the first half of the 1960s improved the economic conditions of peasants and workers and thus the political position of an increasingly enfranchised population. This brought initial changes to the liberal, but semi-feudal market economy, which prevailed until the late 1960s.

A military regime came to power in 1968. It fundamentally changed Peru's political and economic structures, eliminating the old oligarchy and consolidating the army. The military regime also developed an administrative system, with which it could influence the economy and society. The military regime prepared for the return to a civilian government by drafting a new constitution in 1979. Two democratically elected presidencies attempted, but failed, to introduce economic and social reforms in the 1980s. During those years Peru experienced a permanent state of economic crises, social discontent and political upheaval, punctuated by frequent terrorist activities.

In the 1990s, the Fujimori presidency launched a structural adjustment program and reversed Peru's economic structure to a liberal market economy by following the conventional reform agenda of the time. This change in economic policies resulted in remarkable aggregate macroeconomic and fiscal achievements and a large increase in foreign direct investment. But political and social discontent grew, as real improvements in social performance were not forthcoming, especially after the abuse of executive powers and corruption were exposed.

In 2001, a consensus-based transition government prepared the way for the election of the present Toledo government. This presidency has upheld the economic achievements of the 1990s. It has also embarked upon carrying out the election promise to decentralize and to reform the political system. This report argues that many political and social challenges remain and have influenced the social environment within which large mining companies operate and the benefits that large mining investments can generate. When this report was being finalized, Peru was preparing for the 2006 Presidential election on 9 April 2006 and the outcome was uncertain. However, issues of social exclusion and public benefits from the exploitation of mineral resources have featured prominently in the election campaign.

2.4

PERU'S GOVERNANCE STRUCTURE

Peru is currently governed as a presidential democracy with a single legislative chamber: the Congress of the Republic. The core elements of Peru's political institutions and governance arrangements go back to the 1979 Constitution, designed for the transition from military to civilian rule. They are now based on the 1993 Constitution, which was drafted under the Fujimori presidency following the

suspension of the Congress in 1992.

Peru's political past has been riddled with political instability and crises. Since independence, the country has had 13 constitutions, at least 26 successful coups and 108 different governments. Less than 10% of these governments ever completed their terms¹⁰.

Over the past decades the country's governance system has generally been described as supporting a strong executive with strong pro-active powers. Thus, the personal ambitions of individual presidents have dominated policy-making. Congress and other branches and tiers of government have played a very limited role in representing the electorate, influencing the national policy agenda and ensuring that the public sector delivers results. This has had repercussions on the legitimacy of, and trust in, public institutions, which has affected the ability of government to effectively mediate between different social and economic interest groups.

Recent years have seen a number of reforms, including the decentralization process that started in 2001. The results of these reforms in terms of long-term improvements in institutional capacity, political and administrative processes, and broad-based public service delivery remain to be seen.

¹⁰ Moron and Sanborn (2005, page 3)

3 **WHAT ARE THE QUANTITATIVE CONTRIBUTIONS OF MINING TO ECONOMIC GROWTH AND POVERTY REDUCTION AT THE NATIONAL, REGIONAL AND LOCAL LEVEL?**

3.1 **OVERVIEW**

This chapter addresses Stages 3 and 5 of the Toolkit as developed in Phase 1 of the Resource Endowment initiative. The chapter begins by exploring the macroeconomic and social contributions of the mining sector at the national level, then discusses the sector's contributions to sub-national development, and also assesses the different contributions of the Antamina mine.

3.2 **MACROECONOMIC AND SOCIAL CONTRIBUTIONS AT THE NATIONAL LEVEL**

3.2.1 ***Mining, and its Contributions to Economic Performance***

Before and during colonial times mining was a major economic activity: especially gold and silver mining. By the early 1980s, state-owned companies had come to dominate the sector, focusing on the export of iron, copper and silver. In the early 1990s, the sector was again privatized with US\$9.8 billion of private money invested between 1992 and 2004 by both domestic and international companies¹¹.

The Peruvian mining industry consists of large, medium and small/artisanal mining operations¹². Foreign multinational mining corporations dominate the development of large ore bodies. Peruvian operations, including small and artisanal miners, are particularly important for their employment potential and their influence on Peru's domestic political processes. Estimates suggest there are as many as 50,000 informal small and artisan miners, who account for around 10% of total Peruvian gold supplies¹³. Unfortunately, poor operating practices mean many of the informal miners are at great risk from health, safety and environmental concerns.

Mining in Peru plays a very important role for global supplies of minerals. Peru is currently the world's second largest supplier of silver, third of zinc, fifth of copper and sixth of gold. Its mineral potential is rated equal third with Brazil after Chile and Canada¹⁴. Figure 3 shows the main mining areas that represent that potential.

¹¹ Privatization has led to gains in competitiveness in the sector, and a growth of investment in exploration and production. During 2001-2003, the sector attracted US\$2.2 billion of foreign direct investment, 37% of Peru's total (World Bank, 2005).

¹² A detailed and comprehensive description of the mining sector in Peru can be found in World Bank (2005).

¹³ World Bank (2005)

¹⁴ CAD (2005).

Figure 3 Mining in Peru



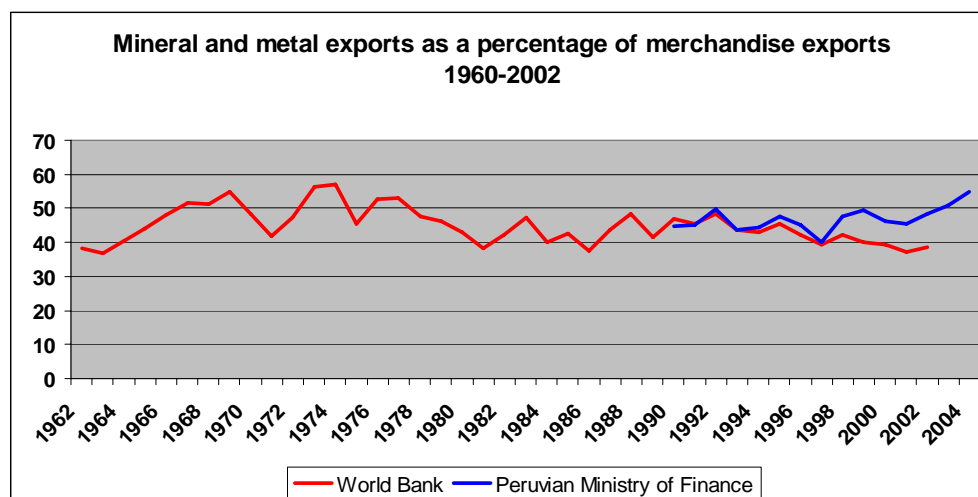
Legend: yellow = gold, blue = other metals

Figure 4 shows that in recent years mining has dominated Peruvian exports. But it only contributes about 7% of GDP (2004). This share increased from about 4.2% over the past ten years. Formally, mining employs more than 70,000 workers directly and 350,000 indirectly¹⁵. This represents about 0.6% and 2.9%, of the economically active population respectively. Indirect effects are believed to be large. Of the \$1.5 billion of inputs to mining, it has been estimated that two-thirds are provided from within Peru¹⁶. This estimate includes imported goods provided by Peruvian suppliers.

¹⁵ World Bank (2005)

¹⁶ SNMPE (2005)

Figure 4 Mineral and Metals Exports, Percentage of Merchandise Exports, 1960-2002



Sources: 'World Bank' refers to the World Bank Development Indicators; the data from the Peruvian Ministry of Finance was supplied in a private communication.

In 2003, the mining sector paid for about 4% of government's actual spending and contributed slightly more than 5% to government's total tax intake. A World Bank report (2005) on mining in Peru suggests that the mining sector is the fourth largest overall taxpayer in the country, after manufacturing, services and commerce. It is one of the top contributors of income tax. In 2004, mining companies contributed about one-third of the income tax paid to the central government¹⁷. The industry's projections indicate this trend is expected to increase in the future. Investments made in previous years are now operational and are scaling up production while new prospects and explorations are also under way. For 2005-2007, it is foreseen that the sector will grow by an average of 6.6%. The Peruvian tax system is considered to be globally competitive for mining.

Most taxes are collected by the semi-autonomous revenue collection agency SUNAT, which the Fujimori government established in the early 1990s in the process of a major tax reform¹⁸. Over the past decade, revenue collections by the Peruvian government have fluctuated around 14-15% of GDP. SUNAT has recently started to publish revenue collection data by economic activity; Figure 5 shows the data for 2005.

In addition to corporate income tax, the mining industry pays a range of other taxes, such as value added tax on services, equipment and mineral sales, payroll tax and excise tax on fuel¹⁹. The industry also pays a concession fee (*derechos de vigencia*) of US\$3 per hectare, which is retained by sub-national governments²⁰ (see Table 1 for domestic tax collection by economic activity from 1998 to 2005). Table 2 relates mining's revenue contributions to the 2003 executed budget. A mining royalty was recently introduced; this change to the mining fiscal system was pushed for as part of decentralization. Once enforced, the mining royalty will be collected and retained by regional governments.

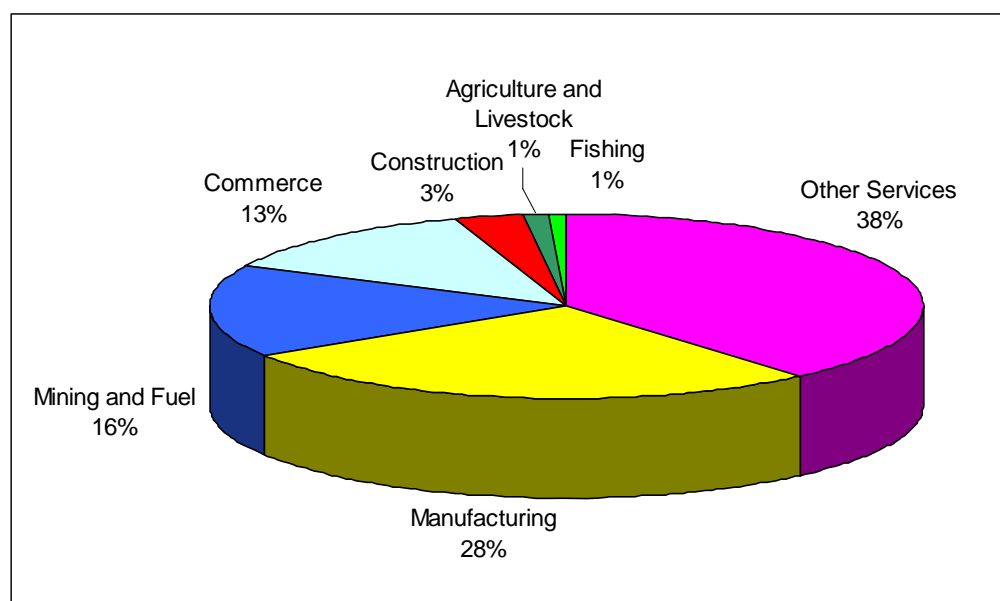
¹⁷ There is some disagreement over this figure. According to SUNAT, the government's tax collector, the figure is 23% but according to the companies (Sociedad Nacional de Minería Petróleo y Energía) the figure is 29%.

¹⁸ The four most important tax categories are the income tax (individuals and corporations), the general sales tax (a value added tax), the selective tax on consumption (an excise tax) and tariffs on imported goods.

¹⁹ The World Bank (2002) Public Expenditure review provides a detailed description of the Peruvian mining fiscal system.

²⁰ For details on this see Vigila Peru (2005, page 19-20).

Figure 5 Domestic Taxes Paid by Economic Activity for 2005 (actuals)



Source: SUNAT, 2006 (updated)

Table 1 Domestic Tax Collection, by Economic Activity

(in Million of Nuevo Soles)	1998	1999	2000	2001	2002	2003	2004	2005
Total Domestic Taxes	17,093	16,203	16,867	18,062	18,734	21,376	24,054	28,041
thereof total corporate income tax	2,913	2,255	2,461	2,939	3,164	4,752	5,386	7,223
Agriculture and Livestock	147	138	149	191	217	276	296	305
Fishing	66	50	86	77	115	139	202	250
Mining and Fuel	2,139	2,053	2,305	1,195	1,010	1,747	2,737	4,507
thereof Mining	641	503	699	613	689	1,092	1,742	3,126
Mining as % of total domestic taxes	3.8%	3.1%	4.1%	3.4%	3.7%	5.1%	7.2%	11.1%
thereof Corporate Income Tax for Mining Companies	246	138	246	182	300	589	989	2,168
thereof earmarked for Canon Minero	169	87	55	81	137	286	451	888
Manufacturing	4,884	4,679	4,755	6,040	6,887	7,174	7,281	7,713
Other Services	6,810	6,469	6,756	7,905	7,671	8,689	9,808	10,806
Construction	785	702	694	586	544	754	666	851
Commerce	2,262	2,111	2,122	2,066	2,290	2,597	3,065	3,609

Sources: SUNAT, 2006, (updated)

Exchange Rate: 1 US\$ - 3.35 Nuevo Sol

Table 2 Mining's Contribution to the Budget, 2003

(in Million Nuevo Soles)	
2003 Executed Budget	26,614
2003 Domestic Tax Collection	21,376
Mining revenue as % of Domestic Taxes	5.2%
Mining revenue as % of 2003 Budget	4.1%
Mining Corp. Income Tax as % of Budget	2.2%
Canon Minero as % of 2003 Budget	1.1%

Sources: MEF, World Bank (2005), Vigila Peru (2005)

Exchange Rate: US\$1=3.35 Nuevo Sol

In recent years, increasing amounts of the revenues have been returned to the regions, municipalities and districts where the mines are located. The reasons for this, and its implications, are addressed in the next sub-section.

In recent history, there have been three distinct periods of economic policies governing the mining sector. The first period includes the 1950s and 1960s when mines were largely privately owned. The second period began with the left wing military regime under President Velasco, which started in 1968. Clearly hostile to private sector investment in the economy, the Velasco regime fundamentally changed economic policies and the state took over a large proportion of mining activities. This situation more or less prevailed during the democratic governments of the 1980s until

the start of the Fujimori Presidency in early 1990s.

During the 1970s and the 1980s, there was only limited investment in mining. In the 1970s, mining output continued to increase, especially for copper, but output stagnated in the 1980s, as the sector was forced to live off the investments of the first period of the 1950s and 1960s. For example, in 1988, the value added from the mining sector was 14% lower than it had been in 1980²¹.

After 1990, the underlying philosophy for governing the economy took a complete U-turn and tried to encourage private sector involvement in the economy generally, and foreign direct investment in particular. This process included radical new legislation for the mining sector. In the early 1990s, 90% of the government's mining assets were privatized and private mining companies began to re-engage on a large scale. For example, during 1993-2003, foreign direct investment in mining totaled \$6.7 billion, while during 1992-2004, investment by domestic and foreign investors totaled \$9.8 billion²².

The following conclusions can be drawn about the contributions that the mining sector makes at the national level:

- After 1990, the mining sector's contribution to the macro economy has been positive, earning large amounts of foreign exchange and attracting significant amounts of foreign direct investment. This period also coincides with a period of greater economic stability.
- The extremely poor performance during the 1970s and 1980s can largely be explained by poor macroeconomic policies driven essentially by socio-political pressure and ideological factors.
- The mining boom is unlikely to be constrained by the availability of suitable ore bodies. At present there is no shortage of promising prospecting opportunities. The area occupied by mining increased by a factor of five in the 1990s. More than half of all titled agricultural communities are currently included in the areas of influence of mining²³. Exploration is likely to reveal significant further opportunities for mining development. The World Bank (2005) projects an increase in mining output during 2005-2007 of 6.6% annually.

3.2.2 *Peru's Social Performance*

Between the 1960s and 2002, official statistics show steady improvement in the three key social indicators: infant mortality, life expectancy and literacy rates. Unfortunately, the UNDP (2004) Report on Human Development in Peru qualifies these results, emphasizing that inequality and poverty have remained Peru's greatest challenges. The report shows that more than half of the population continues to live in poverty. Nearly a quarter of all Peruvians live in extreme poverty, including foregoing proper nutrition²⁴. Poverty also has a particular rural, and thus indigenous, dimension. Extreme poverty affects more than half of the rural population compared to slightly less than 10% of urban dwellers. In addition, social exclusion and marginalization disproportionately affect people with little education and females.

Despite Peru's remarkable economic turnaround in the early 1990s, and irrespective of political regimes which have attempted to provoke social transformation, this

²¹ Federal Research Division (2003)

²² Economist (2005) and World Bank (2005)

²³ Echave and Torres (2005)

²⁴ UNDP (2004)

situation has not fundamentally changed in many decades. International observers conclude that, to date, the country has been unable to reduce: social disparities; high poverty rates; and income and regional development disparities. The present welfare system is ill suited to address this situation²⁵. In short, Peru retains one of the most unequal patterns of income distribution in Latin America and social exclusion is deeply entrenched.

Box 2 illustrates the complex history and nature of Peru's poor social performance.

Box 2

The History and Nature of Peru's Social Problems

Some trace the historical roots of Peru's severe inequality to the Spanish conquest of the fairly advanced Inca Empire, which left behind a hierarchical divide between a small European ruling elite and the indigenous population. The labor of those at the lower strata of the social spectrum generated the wealth that sustained those at the higher level. Others go back even further, and argue that hierarchical society pre-dates the arrival of the Spaniards and that geographical terrain and diversity also supported fragmentation. Successive waves of immigration from Africa, China, Japan and Europe resulted in a nuanced ethnic and social mix and, with large-scale migration from rural to urban areas during the mid-20th century, increased the social pressure on the status quo, which led the military government to take radical and economically detrimental steps to seek national integration.

Subsequent political regimes have struggled to strike a balance between fundamentally redressing social imbalances and promoting economic growth. But institutional changes relating to the 1979 Constitution expanded opportunities for participation and political competition, empowering social groups at the lower social tiers to the extent that political elites had to take account of their demands.

However, institutional changes have not successfully overcome fundamental weaknesses in the political-administrative system, including the lack of secure property rights for the rural and urban poor. The 1979 Constitution reinforced a strong central executive with legislative and emergency powers that came at the expense of the legislature, the independence of the judiciary and the development of governance capacity at the sub-national level. This has had profound effects on the accountability relationship between the electorate, its representatives in Congress and the executive. In addition, it is said that Peru suffers from a weak, fragmented and volatile party system. This has made it difficult to build coalitions and consensus and has provoked tendencies to stress direct democratic relationship between the head of state and supporters. In turn this has undermined the checks and balances that the legislature is meant to exercise through its oversight role of the executive.

In summary, despite aggregate macroeconomic and fiscal achievements since the early 1990s, economic exclusion and many social needs remain unaddressed. This has unfortunately led to mining companies becoming the target for many demands from local communities to deliver goods and services that should ideally be demanded from, and be provided by, the government. Mining companies have also faced social tensions and occasional violent confrontations with local communities. In many instances mining companies have agreed to provide additional resources at the local level in response to these pressures. However, on the aggregate level it is difficult to draw a clear one-dimensional conclusion how the mining sector has contributed to poverty reduction.

²⁵ The present welfare system is limited to certain sectors and reaches only part of the population. Social programs are poorly targeted and have little effect (World Bank, 2002, Ch 3 and 4). High levels of informal employment have also eroded the welfare system (Bertelsmann Transformation Index, 2003).

This sub-section explores what the contributions of the mining sector have been to economic growth and poverty reduction at the sub-national level. This first requires an explanation of what the sub-national levels of the political-administrative system are. Until recently, Peru has been a centrally governed country. Although the key features of a decentralized political-administrative system were laid in 1997, sub-national government entities have only achieved real significance since the 2001 political transition.

Currently, Peru is subdivided into 25 regions, 194 provinces and 1826 districts. The latter two are referred to as municipalities. Regions have only been empowered as independent political entities since 2002. Previously regions were referred to as departments and represented the sub-national administrative directorates of central government ministries. The present structure of regions is not fixed. There is currently a process under way to rationalize their number. Government is expected to decide on proposals for regional reorganization by October 2005²⁶.

Because Peru's sub-national political-administrative structures remain in flux, it was difficult to access data that would allow a distinction to be made between the economic and social contributions that the mining sector has made over time. Thus the remainder of this sub-section looks at intergovernmental transfers of mining revenue and the possibility of links between mining and regional poverty alleviation.

3.3.1

Direct Intergovernmental Transfers of Mining Revenue

In recent years, increasing amounts of the mining revenues have been transferred to the regions, municipalities and districts where the mines are located. This has been the result of the *Canon Minero*.

The *Canon Minero* is a mechanism for the direct distribution of mining revenue collected by central government to sub-national governments. It is not a special tax or special fund, but merely the earmarking of 50% of corporate income tax collected from mining companies. It existed before the recent political transition in 2002, but different sources in Lima indicate that from 1997 to 2001 it earmarked only 20% of the mining companies' corporate income tax payments²⁷.

The decentralization process has altered the redistribution of revenue from the exploitation of natural resources to sub-national governments. The *Canon Minero* increase from 20% to 50% has been the result of intensive lobbying of members of Congress by mining affected communities and by mining companies. Thus these changes are inherently linked to the political change process embarked upon since 2001, combined with rising expectations regarding benefits by mining affected communities.

There is a political rationale for these changes: transfers through the *Canon Minero* allow sub-national governments to take more independent expenditure decisions, whilst other intergovernmental transfers funded by general tax collection, including from mining companies, are earmarked for targeted expenditure programs

²⁶ The number of provinces in a region and the number of districts in a province vary considerably and so do the number of inhabitants and the size of the geographical area that each entity covers.

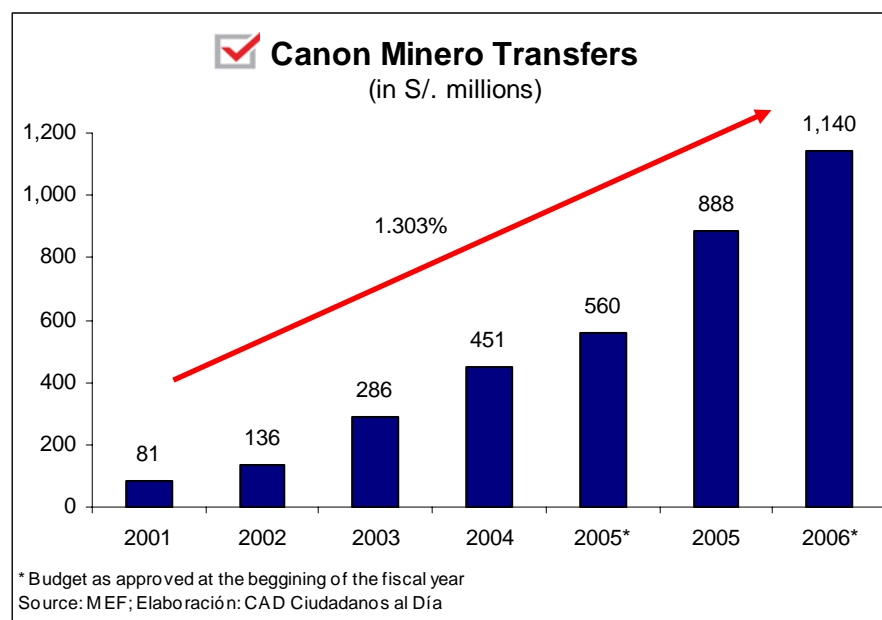
²⁷ The figures in Table 3.1 prior to year 2000 would suggest otherwise. It is not clear why. Also note that there are direct collections by sub-national governments, including the concessions (*derechos de vigencia*) and the newly introduced mining royalty. In Tables 3.1 and 3.2 the former should be included in total revenue from mining.

determined by central government. There are some limitations on what the *Canon Minero* can be spent. The implications of this are discussed in Chapter 5.

Because of the redistributive impact that *Canon Minero* receipts have on the sub-national level, the rules for the redistribution of the *Canon Minero* have been changed three times in the past four years. They are likely to remain subject to further negotiations between Members of Congress and the government. This reflects the highly controversial nature of the distribution criteria. The controversy will probably intensify with the expected high increase in revenue from the mining sector in future years.

Although the 2003 *Canon Minero* transfers constituted slightly more than 1% of total actual government spending, increases in transfers have been spectacular, particularly for some regions, provinces and districts (see Figure 6 below). The drivers of these increases are currently high commodity price levels and significant increases in the volume of exploited metals and minerals resulting from investments since the early 1990s.

Figure 6 Canon Minero Transfers 2001-2006 (Million Nuevo Soles)

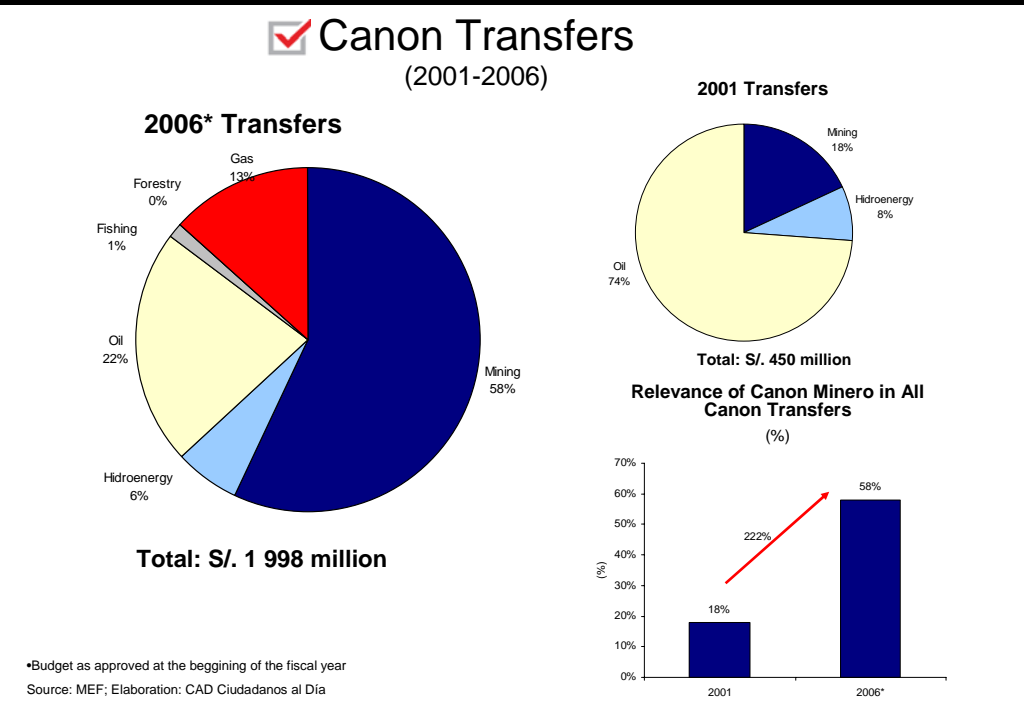


Source: Ciudadanos-al-Dia (2006) (updated)

Figure 7 shows how the importance of the *Canon Minero* relative to other canons has increased in the past six years.

Figure 7

Relative Importance of Canon Minero versus Other Canons 2001 and 2006



Source: Ciudadanos-al-Dia (2006) (updated)

Whilst mining companies may see it as a positive development that local communities receive more funds that can be clearly tagged and traced as arising from the investments of mining companies, there are two important concerns:

- The fiscal system of direct intergovernmental transfers of revenue from mining remains under revision and is subject to contentious political negotiations between central government, the Congress and sub-national government entities. Underlying the decentralization process, which drives this, is a dynamic process of socio-political change whose outcome is by no means certain, and could have positive or negative implications for political stability.
- Substantial increases in revenue transfers to sub-national governments could potentially allow a “local resource curse” to occur. This is particularly the case when local public financial management capacity is weak and the delineation of administrative responsibilities and the strategic revisions of sector policies in a decentralized government system are unclear. There are no guarantees that higher amounts of public money automatically result in sustainable improvements in living conditions for local communities.

Both of these concerns will be further explored in Chapter 5.

3.3.2 Mining, and Poverty Reduction at the Regional Level

The contributions to poverty alleviation at the regional level are uncertain. Revenue paid to the central government and then redistributed to the regions, either through the *Canon Minero* or other transfers, should contribute to poverty alleviation by helping fund public service provision and broader investment plans. However, the link between greater transfers and better outcomes at the sub-national level is by no means automatic. Potentially positive effects can be diluted if government fails to spend the money efficiently and effectively, either through misguided policies or

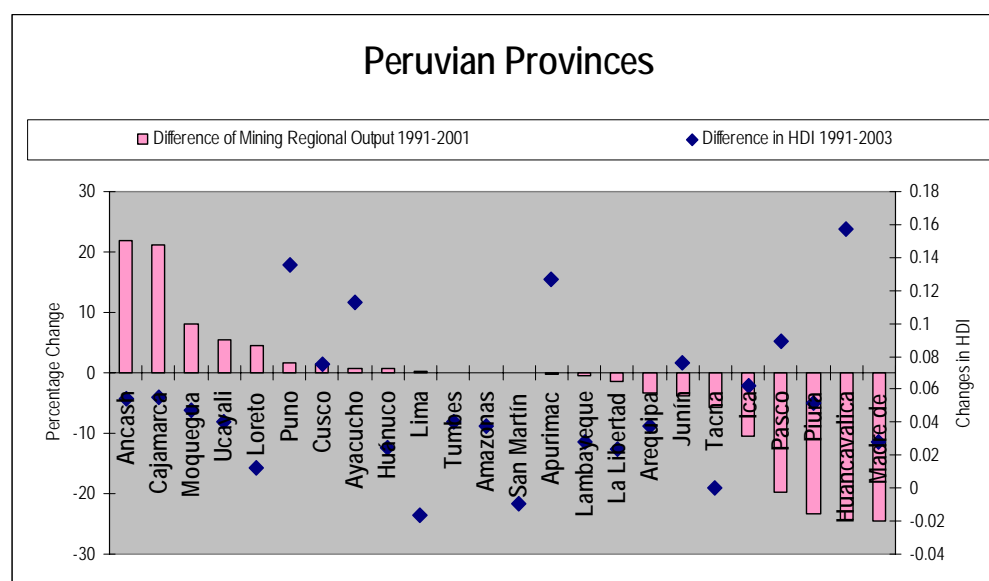
simply through a lack of public expenditure management and administrative capacity²⁸. Furthermore, previous sub-sections of this report have illustrated that compared to total government spending the importance of mining revenue is moderate. The relative importance of revenue retained at the sub-national level and of non-earmarked transfers through the *Canon Minero* can, however, be high. Furthermore, the efficiency of spending can differ between revenue received through the *Canon Minero* and that received through other intergovernmental transfers.

Published evidence on mining's contribution to regional and local poverty alleviation is mixed. A preliminary study by the *Instituto de Estudios Peruanos* on the basis of household survey data suggested that households in mining districts might be less prone to poverty than households in comparable non-mining regions²⁹.

Figure 8 shows the changes in the HDI ranking in the regions between 1991 and 2003 in relation to the importance of mining. Table 3 provides the underlying data.

The data shows the absolute percentage change in the contribution of mining to regional output between 1991 and 2001 and the change in the HDI ranking between 1991-2003 for each region. For example, in Ancash and Cajamarca, regions which both had significant increases in mining output during the period, the improvement in HDI was around the average for all the regions. The best improvement in HDI came in Huancavelica, where mining's contribution to output fell by over 20 points.

Figure 8 Mining, and Human Development Index



Source: COOPERACCION (2005) and UNDP (2005)

²⁸ As mentioned before, the inefficiency and ineffectiveness of social spending in health and education is pointed out by the World Bank Public Expenditure Review (2002).

²⁹ Barrantes (2005)

Table 3 Mining and Human Development Index (HDI), by region

Provinces	1991			2001			2003
	% of mining of regional output	% of region in national mining output	HDI	% of mining of regional output	% of region in national mining output	HDI	HDI
Amazonas	0.3	0.0	0.464	0.3	0.0	0.515	0.502
Ancash	2.5	1.4	0.503	24.5	14.2	0.577	0.558
Apurimac	0.9	0.1	0.361	0.6	0.1	0.457	0.488
Arequipa	7.4	6.3	0.615	4.0	3.5	0.635	0.653
Ayacucho	1.1	0.2	0.397	1.8	0.3	0.488	0.510
Cajamarca	6.2	2.0	0.436	27.4	12.6	0.495	0.491
Cusco	7.0	2.8	0.436	8.5	3.8	0.537	0.511
Huancavelica	29.4	5.9	0.307	5.1	0.9	0.460	0.464
Huánuco	4.2	0.7	0.451	4.9	1.1	0.494	0.476
Ica	17.0	7.9	0.600	6.6	2.7	0.667	0.662
Junín	15.7	8.9	0.519	12.0	6.9	0.578	0.596
La Libertad	5.3	3.1	0.561	3.9	3.0	0.613	0.585
Lambayeque	1.1	0.5	0.588	0.7	0.4	0.625	0.617
Lima	0.7	4.6	0.736	1.0	8.9	0.744	0.720
Loreto	17.2	5.8	0.512	21.7	9.7	0.563	0.525
Madre de Dios	58.3	4.4	0.573	33.7	2.3	0.621	0.601
Moquegua	17.4	4.6	0.603	25.4	5.5	0.666	0.650
Pasco	74.7	11.6	0.502	54.9	10.7	0.575	0.591
Piura	29.4	22.3	0.504	6.0	4.1	0.551	0.556
Puno	9.9	3.7	0.414	11.6	4.6	0.512	0.550
San Martín	0.0	0.0	0.534	0.0	0.0	0.553	0.525
Tacna	19.0	3.1	0.665	13.2	3.8	0.681	0.665
Tumbes	0.1	0.0	0.569	0.1	0.0	0.620	0.610
Ucayali	0.1	0.0	0.523	5.5	0.9	0.565	0.563

Sources: Cooperacion (2005) and UNDP 2004

In summary, there is no clear pattern and there are many other possible factors that condition the relative poverty of a region, such as the geographical location and the efficacy of public spending of social programs. No strong conclusions can be drawn about whether mining improved or undermined regional HDI relative to national averages.

3.4 THE SOCIO-ECONOMIC IMPACTS OF THE ANTAMINA MINE

This sub-section of the report draws on Stage 5 of the Toolkit and the impact of the Antamina mine, situated in the region of Ancash.

3.4.1 The Region of Ancash

The Antamina mine is located in the region of Ancash, which has an estimated population of nearly 1.1 million people, around 4% of the population of Peru. The mine and contractor and other ancillary facilities are located in the district of San Marcos, in the province of Huari.

The main industries of Ancash are agriculture, fishing and mining. The agricultural sector has been in decline in recent years, even though around two-thirds of the region's inhabitants work in the sector. Along the coast the main cash crops include sugar cane, cotton and corn, and in more temperate zones potato, wheat, oats, alfalfa and fruit trees.

Mining makes a significant contribution to the economy of Ancash. In 1995, it contributed 3.1% to the region's GDP. This increased to 16.8% in 2001. In 2005, the region of Ancash provided 9.44% of Peru's gold production, 14.7% of silver, 38.02% of copper, 6.5% of lead and 23% of zinc³⁰. The dramatic increase in mining's contribution

³⁰ MEM as elaborated by SNMPE, January 2006.

to the regional economy is largely attributable to two large mining projects becoming operational – Pierina and Antamina.

The Antamina Mine

The Antamina copper-zinc mining operation is located in the Andes Mountains, approximately 285 km north of Lima. The mine is 4,300m above sea level.

Construction began in 1998, following the completion of a feasibility study. Bechtel was appointed as the principal engineering contractor for the project. The mine was completed in 2001 at a cost of US\$2.3 billion, four months ahead of schedule. Commercial production began in October 2001. The mine is one of the largest combined producers of copper and zinc in the world. On average 350,000 tons of ore are processed each day with 1.5 million tons of concentrate produced each year. Antamina has an expected life of 22 years, four of which have passed.

Antamina has facilities at a number of locations in the region of Ancash. The main ones are the mining operation in Huari, the port in Huarmey and a housing development for mining employees in Huaraz. The head office is in Lima.

3.4.2 *Company Policy on Sustainable Development*

The mine is operated by La Compañía Minera Antamina S.A. (Antamina) with four major shareholders: Falconbridge (33.75%), BHP Billiton (33.75%), Teck-Cominco Ltd (22.5%) and Mitsubishi Corp (10%). Antamina created five strategic goals for 2009 in the areas of: safety, operational excellence, personal development, value creation and sustainable development. There are seven sub-goals for sustainable development, of which the following three relate more closely to the socio-economic contributions of the mine:

- 100% of communities in the area of impact have **access to basic services** (water, health, education, electricity, and rural telecommunications);
- 15 alliances of co-financing or co-execution with other organizations are established for **implementing of sustainable development** projects in the area of influence; and
- 100% increase in **per capita income** in the area of impact.

Clear targets, actions and responsibilities have been identified for each of these strategic goals.

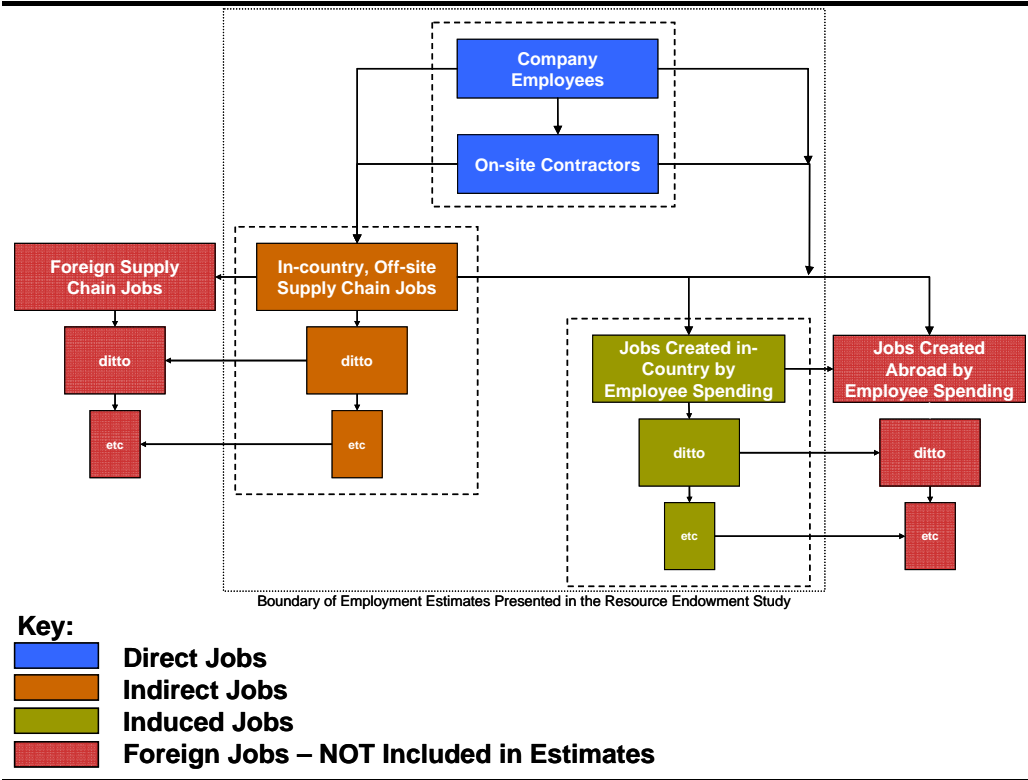
The purpose, principles and policy for sustainable development/social responsibility was signed off by the president and chief executive in November 2004 and includes the following policies:

- to integrate sustainable development considerations and practice into the corporate decision-making process; and
- to contribute to the equitable distribution of economic benefits and the social and institutional development of neighboring communities.

3.4.3 *Direct and Indirect Employment*

One of the most visible economic impacts of the mining operations is the employment they create, directly through jobs within the mining operation, as well as indirectly through suppliers and contractors and the household spending off these employees. Figure 9 illustrates these effects.

Figure 9 Illustration of Employment Impacts



Antamina employs around 1,460 people (direct employment) at the mine, the port, the Lima head office, and in Huaraz. Table 4 provides the direct employment figures for 2005 by site location. As of the end of 2005, Antamina employed 1,463 people, 26 of whom were expatriates.

Table 4 Direct Employment, 2005

	Staff (management)	Workers (operational)	Total	Percentage of total employees
Mine (Antamina)	387	909	1296	89%
Port (Huarmey)	38	66	104	7%
Head Office (Lima)	49	0	49	3%
Huaraz	6	0	6	<1%
San Marcos	8	0	8	1%
Total	488	975	1463	100%

The table shows that the vast majority (89 %) of people work at the mine. The proportion of women in the workforce varies by location: at the mine 12% of staff and 1.3% of workers are female, whereas the proportions for the port are 18% and 3% respectively. In the head office 65% of staff are female, 6% are expatriates; at the mine 6% of staff are expatriates. The number of expatriates has declined from 65 in 1999 to 26 at the end of 2005.

Table 5 shows that about 16% of Antamina employees come from districts near to the mine, a small number from elsewhere in Ancash (7%) but the vast majority of employees (about 77%) come from elsewhere in Peru, most of them from Lima.

Table 5 Source of Direct Employment, 2005

	From near Mine	From elsewhere in Ancash	From elsewhere in Peru
Mine	212	97	987
Huaraz	0	2	4
Port	14	5	85
Lima HQ	0	0	49
San Marcos	1	2	5
TOTAL ⁽³¹⁾	227	106	1,130
	16%	7%	77%

Source: Human Resources Department, Antamina

In 2005, the level of **employment** created through contractors was 2,107. This has remained relatively constant since the mine became operational. However, during the construction phase (1999 to 2001) Antamina engaged 50 contracting companies, which employed 9,795 workers ³²).

In order to provide an indication of the major sources of indirect employment, Table 6 lists the **major contractors** to Antamina for on site employment. These contractors are responsible for around 88% of the indirect employment generated by Antamina. In addition to on-site employment, a small number of employees who depend on Antamina will be working in the headquarters of the suppliers, performing support or administrative functions. Table 6 also lists the level of dependency for each supplier on Antamina. The proportion varies enormously but averages 20.78%.

Table 6 Top 20 Contractors in Terms of Number Employed at Antamina, 2005

Contractor	Goods/services provided	On-site ³³ (Antamina)	Total number of employees	Percentage of Total
SODEXHO	Lodging and Food (Mine)	292	1096	26.64%
ORUS	Security	210	3,500	6.00%
JAVFRANK	Welding service	137	175	78.29%
TRANSLEI	Road Maintenance	224	948	23.63%
M & JAKELL'S CHAVIN	Personnel (Rescue Services)	103	120	85.83%
CAMESA	Electrical Service	103	210	49.05%
BUCYRUS	Maintenance of Shovels and Drills	90	195	46.15%
FERREYROS	CAT spare parts and repairs of CAT equipment	114	1,400	8.14%
MULTICOSAIL OR	Internal Transport	101	103	98.06%
GMI	Engineering	59	202	29.21%
ANGO RAJU	Equipment Rental	38	41	92.68%
IBARCENA	External Transport	30	93	32.26%
EUREST	Lodging and Food (Port)	39	348	11.21%
CENTURY	Disposal of Materials	27	66	40.91%
CICA	Port irrigation project	32	60	53.33%
MECOMA	General Services	70	70	100.00%
Boart Longyear	Drilling Services	65	150	43.33%
Huaripampa	Equipment Rental	54	54	100.00%

³¹ Note that the total varies slightly with the total for 2004 above. An explanation for this discrepancy is that employment data is measured at different times of the year.

³² Figures taken from Apoyo Consultoria (Nov 2001)

³³ Note that these are estimates of full-time equivalents provided by the contracting department.

Contractor	Goods/services provided	On-site ³³ (Antamina)	Total number of employees	Percentage of Total
LASER	Maintenance	34	45	75.56%
Hijos de Ayash	General Services	28	28	100.00%
TOTAL		1,850	8,904	20.78%

On average about 25% of contractor employees are from the communities around the mine. The jobs that local workers get through contractors include security, drivers, cleaners, assistants, welders and mechanics.

A major issue that emerged through interviews with a range of stakeholders within and outside of the mine was the expectation of local job creation. Expectations, which were fuelled by early promises by the company, have not been fully met and employment of people from surrounding communities is still very low. One of the reasons for this is said to be the difference between the skills available in nearby communities and the skills required for conducting work at the mine.

Antamina is responding to this challenge by creating an employee database of local workers. The mine is also trying to work closely with its contractors to provide more local employment opportunities. For example, local employment is included as a criterion for assessing contractors as part of tender process. Furthermore, Antamina intends to carry out more localized training initiatives in order to help match the skills base of nearby communities to the needs of Antamina.

Suppliers and contractors also provide training for their employees. Sodexo, for example established a training center in San Marcos for trainee chefs, some 25 kilometers from the mine. Antamina provided the building and Sodexo the running costs. When the trainees complete the training they work for Antamina or other organizations.

In addition to direct and indirect employment, jobs are also created through the money employees and contractors' employees spend on goods and services. The distribution of employees and contractors to Antamina means that these multiplier effects are best assessed at the national rather than local level. A study for the World Bank found that the additional further impacts could be between 1.65 and 2.5 times the direct and indirect employment. On this basis a further 5,890 to 8,925 jobs depend on Antamina in Peru.

3.4.4

Procurement

There are approximately 1,500 contractors that provide goods and services to Antamina. Approximately 85% of these are based in Peru, and are mostly located in Lima.

Table 7 provides a breakdown of total procurement spent with contractors and suppliers, for goods and services. The total procurement in 2005 was \$264.6 million, of which 67% was spent with contractors and 33% with suppliers of goods.

Table 7

Total Spent on Goods and Services, US\$'000s, 2005

	Total Spend	National	Imported
Contractors	87,948	86,283	1,665
Suppliers	176,644	148,115	28,529
TOTAL	264,592	234,308	30,194

Procurement is usually conducted through competitive (but closed) tendering. Companies that are eligible to tender have been screened against safety and quality criteria. Generally, major suppliers and contractors have a close working relationship with Antamina.

Table 8 highlights the top ten vendors (suppliers and contractors) for the amount spent by Antamina in 2005. These vendors constitute approximately 49% of total procurement for goods and services from contractors and suppliers.

Table 8 **Top Ten Suppliers 2005**

Vendor³⁴	Value 2005 US\$	Service Provided
Mobil Oil Del Peru S.R.L.	-	Supply of lubes and fuel
Ferreyros S.A.A.	-	Maintenance – Heavy equipment (CAT)
Moly Cop Adesur S.A.	-	Supply of grinding media
Bucyrus International, (Perú) S.A.	-	Shovels
Dyno Nobel – Samex S.A.	-	Supply of explosives & accessories
Cosapi S.A.	-	Construction
Sodexho Perú S.A.C.	-	Catering, lodging, cleaning and laundry services
Transityre B.V. Michelin Exp Facilities	-	Supply of tires
Cementos Pacasmayo S.A.	-	Supply of Lime
Reactivos Nacionales S.A.	-	Supply of Potassium Amyl Xanthate and Sodium Isopropyl Xanthate
Total US\$	130,858,000	
Source: Procurement Data, Antamina		

The main issue in relation to procurement is the weakness of the local supply base. Surrounding communities are predominantly agricultural with very few private enterprises. The municipal enterprises, which have been established by communities near to the mine, just undertake work for Antamina. Contractors generate a higher proportion of local employment than the mine does through its direct purchase of goods. Antamina has several initiatives in place to increase local procurement.

3.4.5 *Social Investment*

Social investments are made directly by Antamina and indirectly by a foundation it has established called the Ancash Association. The total annual investment is in the order of \$5.6m of which approximately \$1.6m is channeled through the Ancash Association. The Ancash Association was formed in 2002 and is a non-profit civil association. Initial resources to develop the association were provided by Antamina, which also forms part of the company's social responsibility commitment in the region. Its mission is to support initiatives for the conservation of natural and cultural resources in the region. The approach taken is to involve the local population in the design and establishment of projects relating to education and health, and economic and human development.

³⁴Note that vendors highlighted in bold were interviewed during the field visit.

Discussions with stakeholders and projects supported revealed a strong belief that Antamina should provide support to communities both directly and indirectly affected by the company's operations. Several explanations were given to justify the strength of this belief in the company's moral obligations to support communities of which the main ones were:

- The company was extracting a resource, and profiting from its sale and therefore should be putting something back;
- There is a right to *compensation* for reduced amenity and any health impacts or environmental damage whether perceived or real;
- The company should ensure that communities are *sustainable* in the longer term;
- The company promised much at the outset, did not fully deliver on these promises and therefore must pay more now; and
- There are no other sources of funding; Antamina has money and should therefore pay for the necessities of local communities.

Antamina is engaged in a wide range of activities, which support the communities in which it operates through both direct and indirect provision. Historic levels of expenditure are summarized in Table 9 and described in more detail below in the overall strategy for social investment and infrastructure provision. The figures cover expenditures for administrative costs and actual project work.

Table 9 Social Investment, US\$

	2003	2004	2005
Mine	290,568	831,233	2,403,396
San Marcos	703,964	312,619	849,870
Huarmey Port	485,762	122,065	1,051,691
Asociación Ancash	1,518,574	1,500,000	1,519,867
Special projects	-	-	1,723,585
TOTAL	2,998,868	2,765,917	7,548,409

The obligations and types of intervention are illustrated in Table 10. The number of stars indicates the strength of the perceived obligation, by both company and community, in relation to the types of community investment. In the case of social infrastructure, for example, the absence of alternative funding and the need to provide compensation are the most powerful arguments whereas economic sustainability is a less significant justification. The main argument used for physical infrastructure and economic development initiatives is that of *compensation* for resources extracted, whereas community development is seen as a way of supporting longer-term sustainability.

Table 10 Obligations and Types of Community Intervention

	Physical Infrastructure	Social Infrastructure	Economic Development	Community Development
Return for resource extraction	***	**	***	*
Compensation	*	***	*	*
Economic Sustainability	**	*	**	***
Meeting promises	**	**	*	**
No other funding sources	**	***	*	**

Key: Obligation is used as a major (**), moderate (*) or minor (*) justification

3.4.6 *Contribution to the National Economy*

- Antamina's contribution to the national economy consists of the total spent on procurement, employment and taxes/payments to public authorities that stays in Peru. Table 11 shows that Antamina contributes \$662 million to the national economy based on data provided for 2005.

Table 11 Contribution to the National Economy in 2005 (US\$ millions)

Item	Retained in PERU	% of Total Contributions
Procurement	\$234	36%
Salaries and labor costs ⁽¹⁾	\$109	16%
Taxes ⁽²⁾ etc.	\$319	48%
Total	\$662	100%

(1) Includes profit sharing mandated by Peruvian law
(2) 2005 taxes paid in 2006

The contribution in 2005 was almost triple that of the previous year, mainly because of additional purchases, rising commodity prices, and because the operation became profitable, which required the payment of income tax and profit sharing. The following findings are noted for employment:

- Directly employed: 1,463
- Contractors: 2,107
- Other supply chain and induced jobs: 5,890 to 8,925
- **Total** **9,460 to 12,495**

As noted above, in the absence of econometric modeling, the 'other supply chain and induced' category is based on World Bank research on employment multipliers. The supply chain and induced jobs are likely to be relatively high due to a number of factors.

- The mine workers are very well paid compared with average Peruvians, particularly at senior levels. They are therefore more likely to employ domestic servants, and to have higher purchases in other personal service categories, which tend to be labor intensive.
- The high levels of tax paid by the mine will support large numbers of jobs, both in terms of direct public sector employees and employees working on programs funded by *Canon Minero*.
- The employment generated in the supply chain is likely to be in relatively labor intensive occupations (the more capital intensive suppliers are likely to come from overseas).

3.4.7 *Concluding Remarks*

In conclusion, Antamina is a large, fairly new, remote mine with other linked operations, most significantly at the Huarmey port. It would, therefore, be wrong to generalize to other mines and contexts. Nevertheless, there are some lessons to learn.

- Antamina is committed to, and invests considerable time and funds in, ensuring that its negative impacts are limited and its positive impacts are of maximum benefit to local communities.

- Antamina makes a distinction between areas of impact and areas of influence, which help to shape the approaches to employment, procurement and community investments.
- There is an attitude of continuous improvement, which underpins strategic policy commitments and program and project development.
- More time and effort could have been invested in consultations and managing expectations before and during the time in which the mine was being constructed;
- Early promises of employment in particular could have been more thought through in terms of the support and training needed to improve the employability of people in the communities around the mine.

3.5

SUMMARY

Chapter 3 has examined the substantial economic and social contributions of mining in Peru at the national, regional and, in the case of Antamina, the local level. It has demonstrated that, at the macroeconomic level, the mining sector has made contributions, particularly since changes in economic policy starting in the early 1990s. Unfortunately, social performance for poverty and inequality has not improved significantly. In recent years, sub-national government has received much higher direct transfers linked to the quantity of mining revenue that the central government receives.

The transferred amounts are expected to increase significantly in future years as new mining investments come on stream. Whether these transfers will have a positive impact on regional economic development and social performance remains uncertain. In the past it would appear that this impact has been limited. Much will depend on local government capacity in support of local entrepreneurship and thus alternative employment creation.

At the very local level, the Antamina example has demonstrated that the company is making considerable efforts in providing meaningful and increasing levels of social investment, and that it is trying to increase local content and employment. The specific baseline data to prove this case is, however, difficult to obtain. Whilst increasing local content and employment requires companies to adopt a proactive approach at the outset of mining investment and collaboration with local entities, there are, however, limits to what mining companies can achieve on their own. Where standards of living are generally low and government lacks presence in the provision of basic public goods and services, expectations are high and considerable pressure is put on mining companies to provide social spending that should ideally be funded through public channels. Local communities do not perceive companies' social investments as sufficient and expect that they substitute for the absence of regional and local government action.

4.1

OVERVIEW

Chapter 3 has shown that in macroeconomic terms, the consequences of Peru's reforms in the 1990s have been broadly positive. At the national level the mining sector has contributed to the positive macroeconomic and fiscal developments, in particular with regard to the country's foreign exchange earnings. These contributions are expected to increase as new mining operations start producing. Unfortunately, the effect on social and poverty outcomes has been far more ambiguous and uncertain. The trickle-down mechanisms are neither automatic nor certain, as there are various steps between revenue and other payments to government, and improved living conditions and economic opportunities for society as a whole.

This chapter applies Stage 4 of the Toolkit and explores the *proximate linkages* between mining investments and economic growth and poverty reduction. In addition to asking the question what Peru would have been like without mining since the 1990s, the chapter focuses in particular on economic policies and the importance of governance structures and institutions.

- **Section 4.2** provides a brief assessment what Peru's economy would have been like if the mining sector had not recovered since the early 1990s;
- **Section 4.3** explores the linkages between economic policies and the impact of mining investments on economic performance;
- **Section 4.4** summarizes Peru's performance on governance indicators and enquires about the missing linkage between aggregate economic performance and improved social performance.
- **Section 4.5** concludes and summarizes the challenges for Chapter 5.

4.2

WHAT WOULD PERU'S ECONOMY HAVE BEEN WITHOUT MINING?

Chapter 3 has demonstrated the mining sector has made a positive contribution to the Peruvian macro economy since the early 1990s. Given this, what the Peruvian economy might have looked like if mining had not been present from the early 1990s onwards can be considered. Such a counterfactual analysis suffers from a number of analytical problems. The most obvious is the assumption "other things being equal" cannot hold. Thus without mining the Peruvian economy would have followed a very different path that would have generated different responses, most obviously in the policy field. What these responses might have been can only be guessed at. To establish these responses with any rigor would require a computable general equilibrium model for Peru, which was beyond the scope of this study.

Despite these limitations, it is possible to make some assumptions regarding the Peruvian economy without a mining sector. Between 1994 and 2003, Peruvian GDP grew on average at 3.4% per year and per capita GDP grew at 1.7% per year. Without mining's total contribution to GDP, these would have been 3.1 and 1.4% respectively. Thus without mining, by 2003 per capita income in Peru would have been \$4,113 compared to \$4,395 with mining, a difference of 6.4%. As pointed out in the previous chapters, the contribution of mining has further grown since 2003, given growing investment and rising commodity prices.

Arguably the above assumptions understate mining's contribution since only the direct contribution to GDP in mining output is known. Thus mining's use of other factors of production is not known precisely. However, in 2002, the National Society for Petroleum, Gas and Mining established that of the \$1.5 billion input to mining, \$1 billion was regarded as local input, although local input includes imported goods, which the industry buys from Peruvian suppliers. It is uncertain whether these inputs would have been able to contribute to another sector of the economy.

It is also arguable that mining has complemented both agriculture, by virtue of its water management practices, and tourism, by its contribution to transport infrastructure. Thus without mining the contribution of both these sectors to GDP might also have diminished. Finally, it could be argued that a successful mining sector helped to establish the basic business environment for a successful economy, creating confidence and thereby further encouraging both foreign and domestic investment in other sectors, which has led GDP to increase. In evidence there are some very recent hints that Peru has seen some diversification in agro-business and the textile industry, but on the other hand the informal economy has remained very large, and the business environment for micro and small enterprises has not improved much³⁵.

The absence of mining makes a more substantive difference to the balance of payments than to GDP. Loss of mining exports would obviously worsen the balance of trade. Thus between 1992 and 2003, the balance of trade had a cumulative deficit of \$11.68 billion. Without mining exports, this cumulative deficit would have been \$45.4 billion. To put this in perspective, in 1996, at the height of Peru's debt crisis, the foreign debt amounted to \$34 billion. Although this overstates the impact on the trade deficit since without mining capital goods imports would have been lower, it is nonetheless a significant contribution. Furthermore, the loss of foreign direct investment in mining - some \$6.7 billion between 1993 and 2003 - would have further aggravated the balance of payments deficit. This would have created a number of problems, which would have adversely affected other sectors of the economy. For example, currency convertibility would have been more difficult which would likely have inhibited investment in other sectors, both foreign-owned and domestic. The consequence of a worsening balance of payments on the exchange rate would also have been significant.

The conventional solution to a balance of payments deficit is for a currency to devalue to increase the cost of imports and reduce the price of exports thereby producing a quantity response to reduce the net outflow of foreign exchange. One consequence of exchange rate devaluation is that it increases domestic prices thereby possibly fuelling inflation. As inflation was at the very top of the government's macro policy agenda, this could have been serious in Peru.

Without a mining sector, government revenue would also have been less, although whether this would have forced the government to find alternative sources of revenue is unclear. The orders of magnitude are extremely difficult to assess because the revenue data for Peru is incomplete and contradictory. In Chapter 3 it was mentioned that mining revenue funded about 4.1% of total actual budget spending in 2003. Based upon International Monetary Fund (IMF) data the cumulative overall budget deficit between 1998 and 2001 amounted to NS34.8 billion (or approximately \$10.7 billion at the time of writing). Based upon the World Bank report on Mining in Peru, without revenue from mining this would have been 7% higher at NS37.3 billion over the four-year-period. Thus either government spending would have been reduced or

³⁵ ILO (2003)

governments would have had to increase what was already a significant debt burden. It is worth emphasizing that a large part of the improved reputation of Peru's economic management has been its efforts to reduce its outstanding debt and to try and balance its budget.

Finally, as for the impact of mining on national employment, this is difficult to assess. Certainly some of the 70,000 nationals directly employed in the mining sector in Peru and the 350,000 indirect employees would have found alternative work, although unemployment in Peru remains high. Many of those employed by mining in the High Andes would have almost certainly remained unemployed or at best underemployed, given the lack of economically viable alternatives. It is also important to remember, however, that of an economically active population of about 12.2 million, those directly or indirectly employed by the mining sector make up less than 3.5%.

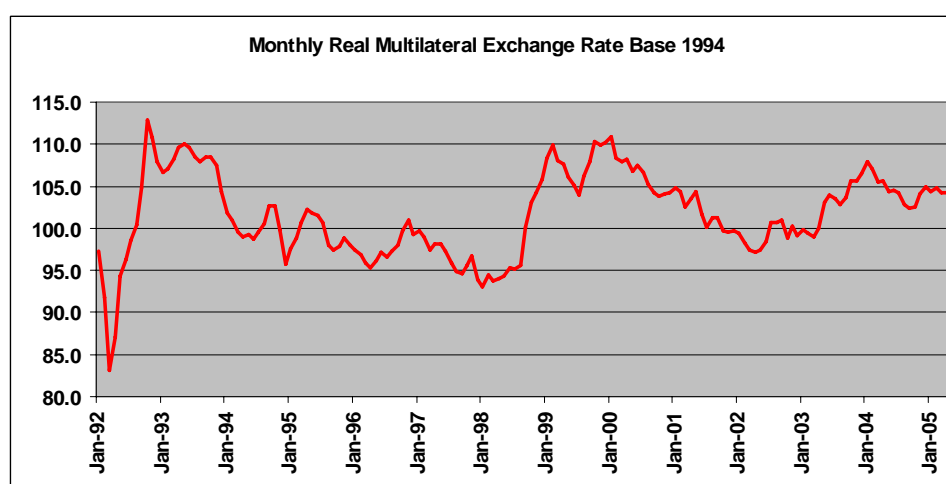
4.3

THE IMPACT OF ECONOMIC POLICIES ON OUTCOMES

Chapter 3 suggested that the economic policies of different governments have affected the performance of economic indicators. Section 4.3 explores this link and finds that on balance the evidence suggests that Peru has not suffered from the presence of a macroeconomic 'resource curse'. Most definitely, this has been the case since the 1990s. Based upon a number of interviews, those now in charge of Peru's monetary and fiscal policies clearly understand the macro-economic transmission mechanisms of the 'resource curse' and how to avoid them.

A serious over-appreciation of the real effective exchange rate that undermines the competitive basis for traded goods production is often associated with the 'resource curse'. Figure 10 shows that, after a series of adjustments associated with the change in macroeconomic policy initiated by Fujimori, from 1993 the real exchange rate effectively depreciated through the late 1990s. Although this was reversed over a short period after the 1998 financial problems, it then reverted to a depreciating trend until the start of 2002. There has since been some appreciation. However, this was not large and was more the result of the weakness of the dollar rather than the strength of the Nuevo Sol. Also, as will be seen below, because of gains in productivity and reductions in costs, the appreciation was too small in magnitude to have inhibited growth in non-mineral exports. Indeed, Peru's export performance has continued to be impressive. This is not a picture of a country suffering from 'Dutch disease'.

Figure 10 The Real Exchange Rate

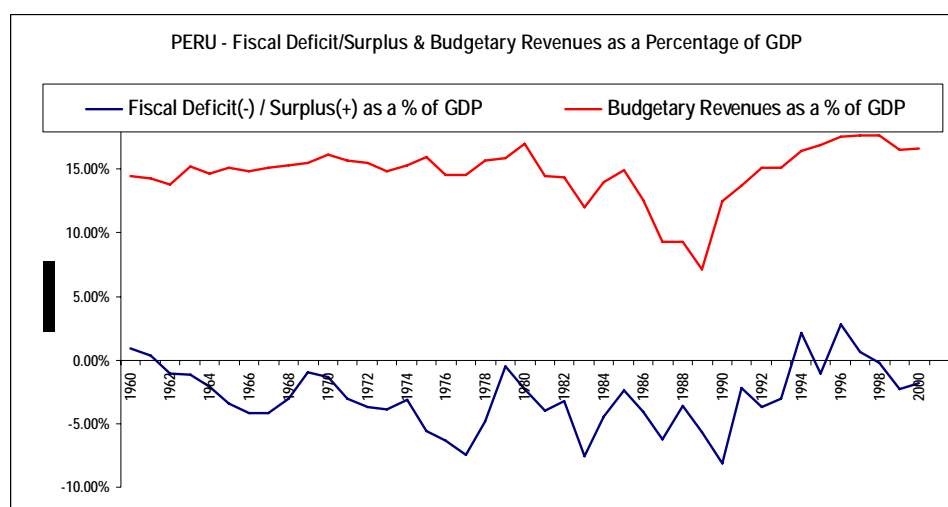


Source: Peruvian Ministry of Finance

Figure 11 illustrates the history of budgetary patterns in Peru. As can be seen, the budgetary situation in the 1980s deteriorated very substantially, which was a reflection of a serious decline in government revenues and great variability in the budget balance reflecting a serious lack of fiscal discipline.

The World Bank notes that pro-cyclical and volatile fiscal patterns result from long periods of fiscal expansion followed by increasingly shorter periods of fiscal adjustment, particularly before the early 1990s. While Peru's GDP growth volatility, as measured by the standard deviation, is about a third higher than the average of Latin American countries, fiscal variables have a much higher volatility than GDP growth because of continuous and erratic changes in policies, both on the tax revenue and expenditure side³⁶.

Figure 11 Budgetary picture



Source: International Financial Statistics

Since 1990, achieving and maintaining fiscal prudence has been a key objective of the Peruvian government. Figure 11 shows that this objective has for the most part been achieved. Thus as the country's GDP has grown, so too has budget revenue relative to GDP until 1999. There has then been a small decline, but nothing like the nadir of 6% in 1989. Nonetheless, the Peruvian tax system is less than efficient and has failed to take full advantage of the strong growth in GDP in recent years.

According to the IMF (2004), Peru is relatively under-taxed compared to other Latin American countries. Under-taxation has taken place since the 1990s when the servicing of foreign debt took priority in public spending. At the height of the debt crisis in 1996, the country owed over \$34 billion and external debt repayment accounted for over 25% of budgetary expenditure³⁷. The size of this debt was severely aggravated because of debt repudiations in the pre-Fujimori years, which meant that the debt continued to accrue. It has been estimated that another three years of strong economic growth will reduce Peru's foreign debt to a manageable level of 30-40% percent of GDP³⁸.

More recently, there have been concerns over the government's ability to maintain spending discipline.

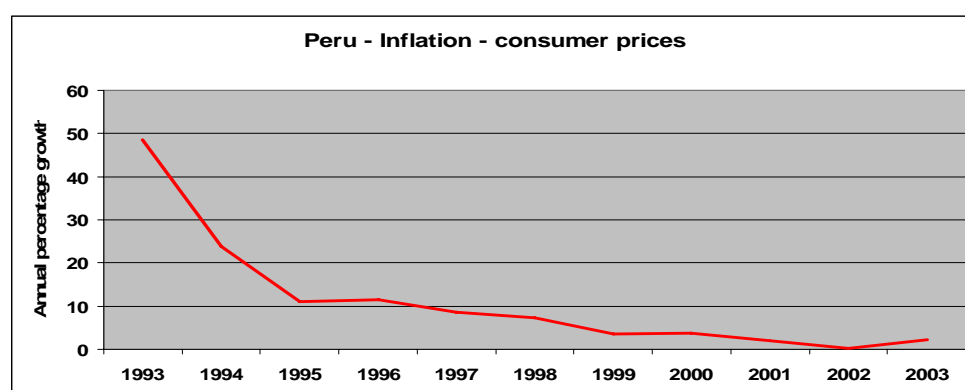
³⁶ World Bank (2002, page 4)

³⁷ Christian Aid (2005)

³⁸ Apoyo (2005)

- First, from the macroeconomic point of view, there is concern that the interplay between economics, politics and expectations could undermine economic stability. As mentioned in Chapter 3, the social pressures, especially in rural areas, are acute. There are concerns that the decentralization process, and how it responds to social needs, might weaken fiscal discipline³⁹.
- Second, the revenue transfers to mining regions through the *Canon Minero* and, more recently, collections of mining royalty, could induce serious attacks of ‘resource curse’ at the local level. This could result in all of the usual problems with the resource curse locally, but without the exchange rate dimensions. The details on the *Canon Minero* show that nominal figures involved are reason for concern⁴⁰. The next few years will see even further increases in revenues at the regional and local level as a number of mines begin to increase their production. This could generate local inflation and a degree of local crowding out.
- Third, there is also a danger that because the *Canon Minero* must be spent upon capital projects – described eloquently by one interviewee as “anything that involves cement” – spending plans will not sufficiently take account of the current cost implications for future years. Such sudden wealth is an invitation to poor spending decisions and corruption.
- Fourth, weak administrative and public expenditure management capacity at a sub-national level may inhibit the ability of regions to spend the revenue accruing in mining regions as a result of the *Canon Minero*. For example, the requirement to get local investment plans approved through the public sector investment program (SNIP) should help avoid the problem⁴¹. Building the institutional structures that can effectively direct funding towards policies, investments and programs, and provide people with real economic and social opportunities, remains a work-in-progress.

Figure 12 Inflation



Source: World Bank

Figure 12 illustrates the pattern of inflation since 1993. To put this in perspective, at the height of the Garcia economic crisis in 1989, inflation was running at 3,399 per cent annually. The record since 1993 has been exemplary and provides another piece of evidence to support the absence of a ‘resource curse’ effect in Peru. It is likely that this tight control of monetary policy will continue. The Ministry of Finance has identified

³⁹ It would appear that some checks and balances on sub-national spending have been put in place. For example, regional governments are not allowed to seek external borrowing.

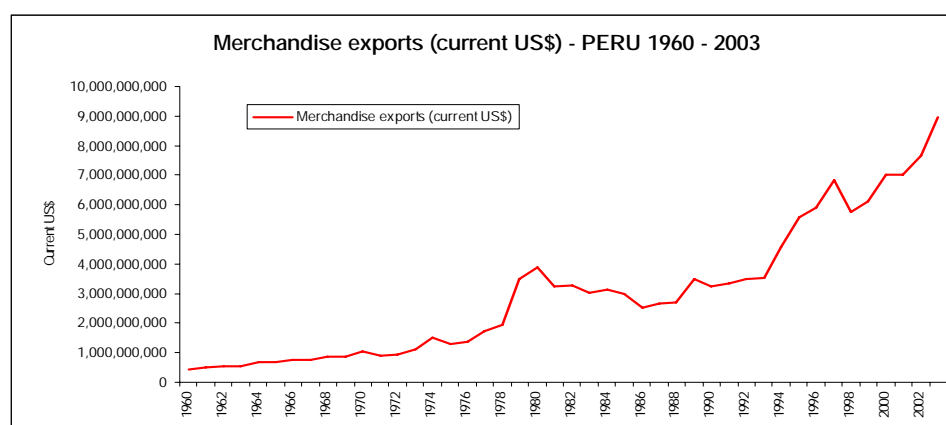
⁴⁰ For example, as can also be seen in more detail in the Annex, the Ancash region where the Antamina mine lies received NS 1.85 million from the Canon Minero in 2001. In 2004, this has increased to NS 63 million (CAD, 2005).

⁴¹ The Spanish abbreviation SNIP stands for Sistema Nacional de Inversiones Publicas.

that one of the important changes in Peru in recent years is economic policy making is increasingly insulated from the political process. Thus, while Presidents may come and go, it is now more likely that the economic mandarins controlling policy coherence remain. This process is reinforced because the memories of hyperinflation are still very raw and painful among opinion-forming Peruvians. There appears to be a solid consensus regarding the importance of fiscal prudence, tight monetary policy and the need to repay debt. Of course, such determination can always be derailed by socio-political demands to reduce poverty and inequality through some quick populist solution. This represents a severe political challenge.

For the trends and variability of export revenues, the following figures illustrate certain key points.

Figure 13 Exports



Source: World Bank

Figure 13 shows the pattern of merchandise exports. The disastrous impact of the economic policies of the 1980s can be seen in the stagnation of exports in that decade. The figures are in the money of the day and therefore understate the decline in the real value of exports. However, since 1990, the picture has improved dramatically and steadily. The only exception was a small glitch in 1999 following the financial crisis, which was not of Peru's making but was driven mainly by contagion from the Asian financial crisis in the winter of 1997/98 and the collapse of the Russian economy in the summer of 1998.

Despite recovering from very low levels in the early 1990s, Peru's trade levels are quite low compared to other countries with similar trade policies. From around 44% of GDP in the period 1980-84, trade (exports and imports of goods and services) fell to 28% in 1990 to 1994 and between 1998 and 2002 rose only to 33% compared with 53% for all developing countries⁴². There is obviously a temptation to put this down to the impact of having a high proportion of natural resource exports through a "... *limited diffusion of technology and productivity enhancements to other sectors, the long term decline in commodity prices relative to those of manufacturing, and, in some cases 'Dutch disease'*" (IMF, 2004, page 36).

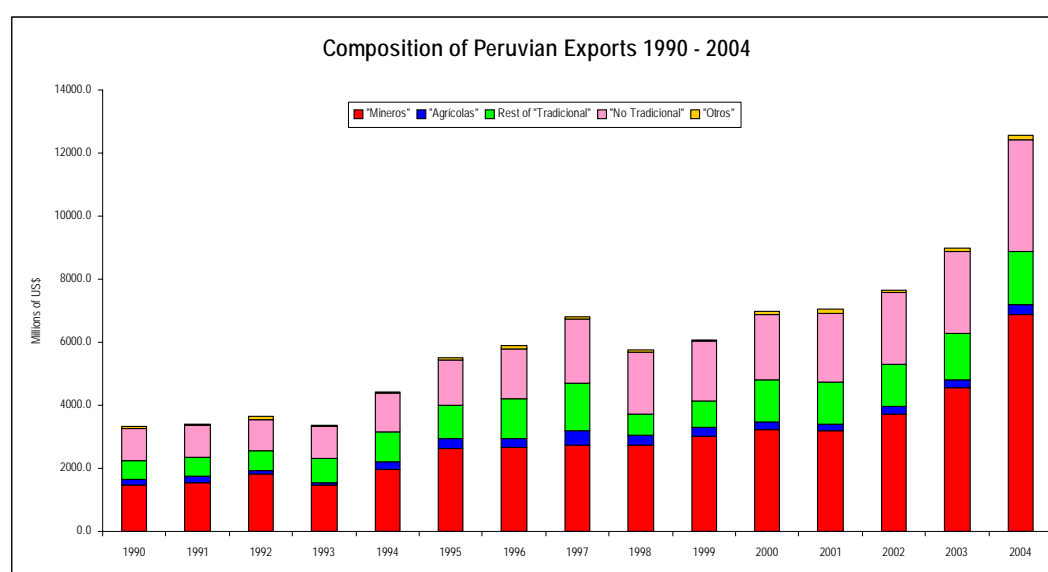
However, as already indicated above, there is no obvious evidence of overvaluation of the Peruvian currency in the 1990s. Peru's real exchange rate against the dollar shows that its existing levels (compared to a decade ago) compare with those of Mexico, are slightly more appreciated than Colombia and Chile and more depreciated than China.

⁴² IMF (2004)

Also with major unemployed resources there is no obvious macroeconomic policy barrier to higher non-mineral exports⁴³.

A new dimension, which may reverse the low level of trade, is the preferential access to the United States' market via the Andean Trade Promotion and Drug Eradication Act (ATPDEA). For the manufacturing of textiles, however, where strong growth has occurred already, this trend could be reversed from 2005 with the elimination of quotas under the Multi Fiber Arrangement, which will favor lower cost countries, such as China and the Asian sub-continent⁴⁴) On the other hand, Peru's high quality textiles are based on rare fabrics, such as pima cotton and the wool of Andean animals, such as llama, baby alpaca and vicuna, all of which occupy highly priced niche markets.

Figure 14 Sources of Exports



Source: Ministry of Finance

Part of the reason for the steady rise in exports is Peru's export patterns are becoming increasingly diversified, which again belies any notion of the presence of 'resource curse'. This is normally characterized by great dependence upon a single source of export revenue. Even for minerals, there is considerable diversity of metals and ore exports. This helps mute revenue volatility arising from fluctuating metals prices. Peru's export partners are also diverse with no geographic region dominating. In 2003, the US, UK, China, Switzerland, Chile and Japan accounted for 64% of export destinations⁴⁵. Thus if one region suffers recession, this does not necessarily portend serious problems for Peruvian exports. Finally, as can be seen from Figure 14, there has been strong growth in exports other than minerals, particularly very strong growth in non-traditional exports. This does present hope for Peru, since this is dominated by high quality textiles and high value added agricultural crops, both of which are labor intensive.

In terms of the linkages between economic policies and the impact of mining investments on economic performance, there appears to be no connection between mining and a 'resource curse' at a macro level. Macroeconomic aspects are now well understood and very manageable. Peru from the early 1990s till now provides a good example of this competent management and where mining has played a very positive

⁴³ Political uncertainties may have inhibited further private sector investment.

⁴⁴ IMF (2004) reports that the cost of producing a garment in Peru is around 50% higher than in China.

⁴⁵ CIA (2005)

role in the country's overall economic progress. The Peruvian economy has been growing across the board and there are no signs of crowding out. On the contrary, there are signs of growing synergies between mining and other sectors of the economy such as agriculture and tourism. Increasing the role of the private sector has generally been very positive for the economy for investment levels, public revenues and growth. The exception is perhaps the 1970s and 1980s, when mining protected the system from the consequences of poor macro policies for longer than would otherwise have been the case. At the time, mining was virtually all state owned and so investment in the sector was less obviously dependent on pricing considerations⁴⁶.

There are, however, undoubtedly also a number of areas where caution is warranted.

- There is a danger that in future 'resource curse' effects could occur at the local level as a result of increasing direct transfers to sub-national government entities, if these are not matched by a corresponding increase in administrative and public expenditure management capacity.
- More importantly, the trickle-down mechanism to alleviate poverty is struggling and is by no means automatic. Poverty and social development have not responded much to general economic improvements. Microeconomic and social policies to address these issues have been insufficient. A large informal sector also indicates that the institutional business environment has not, or only to a limited extent, benefited small and micro enterprises.
- In comparison to the rest of Latin America, Peru's economy is performing rather well as a result of its aggregate economic policies, including those applicable to mining, for example taxation. But Peru could also appear to be under-taxed, which when populist politics dominates may raise the temptation that the mining sector presents an easy target to raise greater revenue.

4.4

THE MISSING LINK: INSTITUTIONS AND GOVERNANCE STRUCTURES

The history of mining in Peru since the middle of the 20th century has been linked to shifts in underlying economic policy. The nationalization of the mining sector from 1968 was driven by an ideological stance that in retrospect seems ill conceived, and which did not alleviate the social needs that it meant to address. Privatization at the beginning of the 1990s was also partly driven by the international policy consensus at the time. On aggregate the latter has achieved better results. However, positive aggregate achievements have not been matched by an equally positive effect on poverty reduction.

Phase 1 of the Resource Endowment initiative strongly emphasized that institutions and governance structures are a key variable for enhancing the positive contributions that the mining sector could make for broader socio-economic development and poverty reduction. Institutions and governance structures set the framework for and condition how public sector entities, citizens and private sector companies relate to each other. This means that for the mining industry if institutions and governance structures are unable to produce positive interactions and synergies between these groups, then the contribution of mining activities to broader socio-economic development and poverty reduction will be constrained.

⁴⁶ Arguably, Peru has experienced a negative impact from natural resources with the Guano boom of the late 19th Century and the economic boom of the 1960s associated with fishmeal. In both cases government did not reap any real benefits in terms of constructing infrastructure or promoting sustainable development.

This emphasis on institutions and governance structures is supported by internationally acknowledged research, which during the course of the 1990s has confirmed that the quality of *governance* as an independent variable explains many of the cross-country differences in socio-economic outcomes. A number of quantitative studies in the ‘resource curse’ literature have suggested that improved governance structures and institutions correlate with better development outcomes⁴⁷. It would appear from this study that Peru’s challenge to use macroeconomic achievements and economic growth to reduce poverty and broaden social inclusion is hampered by its institutions and governance structures.

Indeed, Peru’s performance with regard to conventional ‘governance indicators’ has been weak. Annex 1 reports in detail on the quality of governance in Peru as measured by the six World Bank Governance Indicators. These indicators would most likely appear in the governance conditionality that the Extractive Industries Review (EIR) proposed. Peru’s results regarding the six governance arenas proposed by the United Nations University’s World Governance Survey are also reported. This subsection summarizes the results.

There is one general, but important, caveat: it is only relatively recently that the international community has fully recognized the importance of institutions and governance structures in economic development. Thus, the time series for which data is available is short; the World Bank’s governance indicators cover less than a decade and the UNU World Governance Survey only provides four years’ worth of data. Another consequence is that the definitions and emphases of individual sub-variables that aggregate to an overall assessment of the ‘quality of governance’ remain disputed and subject to refinements. See Annex 1 for the definitions and concepts underlying the indicators that are used here.

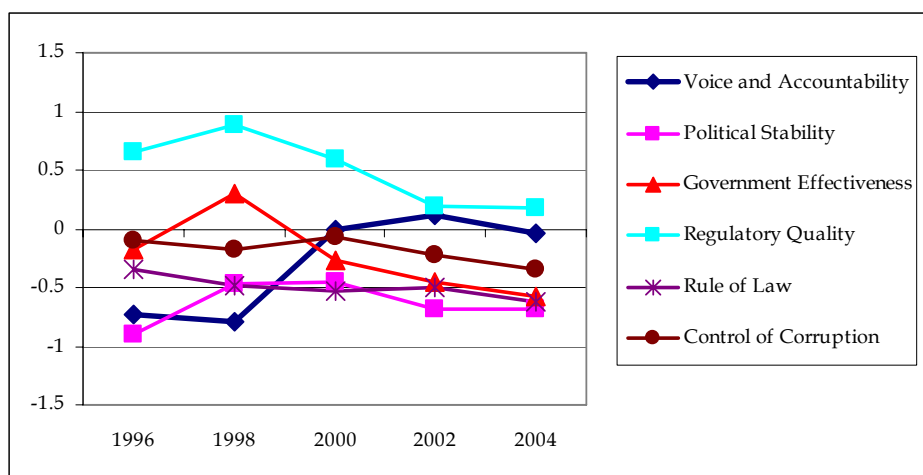
4.4.1 *Peru’s Performance on Governance Indicators: Summary*

Both the World Bank’s governance indicators and the UNU World Governance Survey show that Peru’s political transition at the beginning of the 21st century has led to more participation and trust of society in the political process (the *political society* and *voice and accountability* variables) and has also improved political rights. But real improvements remain outstanding in the workings of the public service and administration (the *bureaucracy*, *government effectiveness* and *regulatory quality* variables) and the legal system (the *judiciary* and *rule of law* variables). These aspects of governance are essential to delivering better services to people and enabling them to take advantage of economic opportunities. They are also key elements in the link between revenue from mining activities paid to central government and the social and economic benefits that citizens receive in return.

Interestingly, the capacity of government to effectively formulate and implement sound policies (measured by the *government effectiveness* and *regulatory quality* variables) improved at the time when the Fujimori government faced increasing criticism for becoming more authoritarian. When the Fujimori government collapsed and the democratic transition of 2001 set in, the significant improvements in the process by which government was selected, monitored and replaced were mirrored by a deterioration of government capacity, as shown in Figure 15.

⁴⁷ Researchers have made use of indicators on the quality of governance reported by a number of survey institutes, think tanks, non-governmental organisations and international organisations, and compiled on the basis of perceptions gathered from a large number of enterprises, citizens and expert survey respondents.

Figure 15 Peru's Governance Indicators from 1996 to 2004



What are the limits of these data? Firstly, the indicators reveal little about the underlying socio-political processes that have driven the changes seen in Peru's governance performance. They do not explain how these processes have resulted from or caused institutional change and what the opportunities for further institutional change might be. The indicators do not describe what the limitations in improving institutions and governance structures are, and what government and its partners can do about them. They thus raise important questions, but fall short of giving answers.

Secondly, the indicators do not distinguish between the vertical tiers of government (national, regional, provincial, district). Thus they shed little light on how weaknesses in public authority reach down the vertical government chain to change the overall quality of the governance system. Identifying and understanding vertical weaknesses within the public administrative system and how these relate to political structures and processes is crucial for overcoming collective action problems, and for redesigning incentives to achieve better results.

This suggests it requires institutions and governance structures, which support private sector activities by large, medium, small and micro enterprises *and* also address economic and social exclusion, to address Peru's social needs and reduce its high poverty levels. It would appear that over the past decades as different political and economic regimes have tried to strike this balance they largely been unsuccessful in reducing poverty. Since the 1990s, Peru's institutions and governance structures have facilitated macroeconomic policies that have achieved positive aggregate results, but they have failed to produce the sort of public policies and services (or trickle-down mechanisms) that reduce poverty to an adequate extent.

4.4.2 Implications for the Mining Industry

Why does it matter for the mining industry? As briefly mentioned in the previous chapter, there are many cases in Peru where mining companies have become the target for demands from local communities to deliver goods and services – many of which should normally be provided by government⁴⁸. In addition, the public funds received from mining activities have become the focus of many disputes between the central government and sub-national government entities and between government

⁴⁸ The World Bank (2005) lists 17 current conflicts between mining companies and local communities. Such negative attitudes explain a fundamental problem, which faces mining in Peru, namely: "...If there is a defining trait that characterizes the social dimension of mining in Peru that all stakeholders agree on, it is the lack of trust among those involved ..." (World Bank, 2005, page 92).

and the Congress. In light of these recent experiences the following propositions would appear to be relevant:

- If a government cannot respond to the demands of its people, or people do not have legitimate and effective institutional channels through which they can influence public policy decisions, the taxes and other revenues that mining companies are paying to central governments will not be seen as benefiting local communities. The criticisms of local communities will relate only partly to the amounts of taxes that are raised.
- If a government is unable to improve institutions and governance structures to deliver greater social returns from public funds (including those generated by the mining sector) social tensions and conflicts can arise. These can create pressures on mining companies where they have to respond to demands for additional direct payments to communities to increase social benefits. Even when mining companies fill the governance vacuum the arrangements are unlikely to be the best. There is no automatic or linear link that guarantees that direct company payments satisfy all demands.
- If additional projects for communities are not tied into a wider framework of collaboration with, and capacity building for, the public sector, sustainability and effectiveness arise too late when mining operations are about to close. Direct benefits to communities may also raise questions of social justice, as they may not be sufficiently inclusive and – rather than satisfy existing demands – may merely provoke new ones.

These propositions are not to say that ‘government’ is necessarily in a position to improve or restructure institutions and governance structures unilaterally or easily. Governments in the real world face limits on their organizational capacity, the wrong incentives within or external to the political-administrative system, disagreement with the Congress (or Parliament) and/or severe resource constraints. Nor does it mean that if a government were able to alter institutions and governance structures it would meet the full normative criteria of ‘good’ governance that the international community might apply when judging governments and their relationship to citizens.

This is the flaw in the logic of many recommendations, for example from the EIR. To presume that better governance can somehow be grafted on to a society fails to recognize the complex processes that are likely to be involved in putting this into practice. It is also the flaw of the economic analysis of political interests, which tends to ignore the institutional and procedural channels through which the ‘public interest’ at different tiers of government is determined and legitimized. It is important to note that a country’s ability to govern needs to grow parallel to the rise of mining investment to prevent social conflict and to ripen long-term benefits from that investment.

4.5

SUMMARY

This chapter has so far argued that the economic and social performance described in Chapter 3 is linked to:

- *sound macroeconomic management* since the early 1990s, which has allowed mining investments to contribute to the good performance of aggregate economic indicators; and
 - *problems with institutions and governance structure* that have impeded the extent to
-

which these aggregate achievements have not resulted in lower levels of poverty and in social improvements through effective trickle-down mechanisms.

It would appear that Peru's institutions and governance structures are challenged to mitigate the social tensions and the sometimes violent encounters that have arisen between the local populations and mining companies. This links to:

- economic and social policies not sufficiently inducing the broader based socio-economic benefits that people expected, either through employment opportunities or the provision of goods and services; and
- public institutions not effectively '*governing*' the different interest groups to overcome collective action problems in order to increase entrepreneurial activities and employment opportunities.

To summarize, while prospects for mining in Peru seem bright and further exploration activity is likely to reveal significant deposits for future exploitation, the industry's future challenges seem to be tensions and conflicts with local populations, additional demands for compensation, and the limited capacity of Peru's political institutions and governance structures to deal with development demands and conflicting interests in a constructive and mutually beneficial way. The next chapter probes more deeply into these issues using a revised version of the analytical taxonomy outlined in the Toolkit.

5 **WHAT ARE THE REASONS BEHIND THE “SUCCESS FACTORS”, CHALLENGES AND CONSTRAINTS, AT THE NATIONAL, REGIONAL AND LOCAL LEVELS?**

5.1 **OVERVIEW – THE STORY SO FAR**

The *proximate linkages* between mining investments and economic growth and poverty reduction have probed the question of why Peru’s institutions and governance structures since the early 1990s have facilitated macroeconomic policies that have achieved positive aggregate results, but have failed to produce the sort of public policies and services that reduce poverty to an adequate extent? *Why have trickle-down mechanisms not worked?*

Clearly, sound macroeconomic policies have been a key ‘*success factor*’ for mining investments to contribute to economic growth. However, it would also appear that there are constraints in institutions and governance structures for those investments to contribute more fully to poverty reduction. Stage 6 of the Toolkit developed an analytical taxonomy, which described different aspects of ‘governance’ and their interactions with crucial drivers of development. A revised version of this taxonomy is reproduced below⁴⁹. It goes well beyond the simple set of aggregative governance indicators that were assessed in the previous chapter to assess how institutions and governance structures impinge on trickle-down mechanisms. This chapter makes selective use of the taxonomy to make sense of the macroeconomic successes on the one hand, but limited social improvements on the other.

- *Section 5.2* summarizes the *legislative framework* for mining that has encouraged the surge in investments since the early 1990s.
- *Section 5.3* explores Peru’s political administrative system and how it supports social cohesion and private sector activities.
- *Section 5.4* takes a closer look at Peru’s fiscal regime and public financial management issues that underpin the political-administrative system, mining legislation and social cohesion.
- *Section 5.5* then explores the reasons for social tensions and conflicts that have undermined *social cohesion* and how this links to the mining sector.
- *Section 5.6* explores some of the limits to private sector development, particularly with regard to smaller enterprises.

⁴⁹ Revisions have been made taking into account the experience gained from the application of the draft Toolkit in the case country studies.

Governance Taxonomy: Linking Common Features of Governance with Operational Issues

<i>Cross-cutting taxonomy of efficient governance</i>	<i>Legal and Regulatory Framework</i>	<i>Political-Administrative System</i>	<i>Fiscal Regime & Economic Policies</i>	<i>Social Cohesion and basic Public Service Delivery</i>	<i>Private Sector Development</i>
<ul style="list-style-type: none"> • <i>State strength</i>: legitimate and capable states at all levels (national, regional, and local); a government whose policy decisions are credible and broadly accepted and an administrative apparatus that can implement government policy. • <i>Limits to state strength</i>: institutional checks and balances that support the legitimacy of government and the administrative apparatus and guard against abuse of state power at all levels (national, regional and local). • <i>Compatibility of formal and informal institutions, rights and rules</i>. • <i>Legitimacy of formal economic institutions</i> guarding essential necessities of a stable economy (e.g exchange rate, fiscal sustainability). • <i>Technical capacity</i> of the public sector/ civil service and decision makers at all levels. 	<ul style="list-style-type: none"> • Basic constitutional set-up, general legal framework and legal mechanisms of consensus building and conflict resolution at all levels of government and the state. • Consistency within the regulatory framework for public sector management and with regard to the contact between public and private sector at all levels of government and state-society relations. • Compatibility of mining sector-specific legislation with general constitutional and legal framework. • Legitimacy of property rights and ability to enforce these peacefully at all levels (national, regional, local). • Company legislation and ownership structures: a regulatory framework that supports economic activities of different sized enterprises (large, medium, small and micro). 	<ul style="list-style-type: none"> • Political system: <ul style="list-style-type: none"> – process by which government (at the national, regional and local level) is selected, monitored and replaced; and – institutional channels through which political interest groups have ‘voice’ at the different levels. • Political representation at different tiers of government: credibility and stability of legislative outcomes. • Policy decision-making process: relationships between the legislature, government and the civil service. • Capacity of the ‘state’ to formulate and implement policies down the vertical chain of public authority from central government to the very local level. 	<ul style="list-style-type: none"> • Sound aggregate macroeconomic management: exchange rate regime and monetary policies. • Legitimacy and dynamics of fiscal (revenue) regime: taxation, royalties, tax exemptions. • Public expenditure management capacity: allocative and operational efficiency at different tiers of government (national, regional, local). • Non-conflicting fiscal accountability relationships between the electorate, the legislature and the executive and within the executive at different levels. • Public administrative system and capacity at all levels (national, regional and local). 	<ul style="list-style-type: none"> • Community development, and local organisational capacity: orderly organisational rights and opportunities. • Industrial/labor market relations that are conducive to consensus building. • Institutional mechanisms for consensus building and managing different socio-economical interests. • Political representation with structured institutional channels for interest representation at all levels. • Basic welfare and social system across all geographical areas. • Equal opportunities in access to primary and secondary education across all geographical areas. 	<ul style="list-style-type: none"> • Regulatory framework for economic activities for different sized enterprises (large, medium, small and micro). • Supportive public services at the national and sub-national level. In particular: <ul style="list-style-type: none"> ○ <i>infrastructure</i>: national and regional regulatory policies, coverage, collaborative funding and financing arrangements at different tiers of government; ○ <i>utilities</i>: national and regional regulatory policies, coverage, collaborative funding and financing arrangements at different tiers of government; and ○ <i>Human capital and labor market institutions</i>: supportive educational policies at different tiers of government and different educational levels.

5.2 *LEGAL FRAMEWORK: MINING LEGISLATION*

5.2.1 *Introduction*

The first column of the taxonomy, *Legal and Regulatory Framework*, covers a broad range of topics, including basic constitutional issues, consistency of the regulatory framework, support for private sector development and public-private interconnections, company legislation, and so forth. This section focuses on the recent changes in mining legislation and their origin and consequences.

5.2.2 *Legislative Changes in Recent Years*

Peru's current legislative framework for mining emerged with the new economic policies developed and implemented under the Fujimori government. The intention of these new policies was to promote private sector involvement to develop the mining and other productive potential of the country⁵⁰. This was in part guided by the World Bank and was not done solely for mining but for all sectors of the economy. It required a whole new set of legislation and regulatory arrangements to create a setting that would be attractive to private sector investment.

The 1991 legislation created a regime of legal stability for foreign investment that eliminated many of the earlier restrictions on foreign ownership and control of assets that had characterized the previous periods of state intervention in the 1970s and 1980s. In particular, it created a transparent administrative system offering attractive tax terms, a convertible currency regime and the freedom to repatriate earnings. This process of deregulation and liberalization applied across all sectors of the economy. The details as they applied to mining are in Box 3 below.

Box 3 The Legal Changes After 1991

In 1992, the General Mining Law was introduced to set the specific terms and regulatory environment for mining. In effect it centralized all the regulatory functions in the Ministry of Mines (MEM), creating a one-stop shop system for foreign direct investment in mining. It also removed from the mining companies many of the previously required obligations for social provision for their workers in the areas of health and education. This move did cause a reaction among local communities. Previously, mine employees had enjoyed education and health care provided by the mine and had come to rely on them. Their erosion did lead many local communities to look to the new owners of the mines – either through privatization or new investment – to fill this gap.

Under the 1992 legislation, net earnings became the basis of central government taxation and many of the contracts contained stability clauses for periods of 10 to 15 years. Tax breaks were also given to the mining companies on reinvested earnings and investment in public service infrastructure. Mining was the only sector allowing such offsets, which indicated the importance the government's economic strategy attributed to the mining sector. In short, the legislation created an extremely attractive investment regime for the large multinational mining companies. This was deemed essential at the time, as in the new global atmosphere of encouraging foreign investment in most of Latin America, competition was extremely fierce between countries for funds for mining. The result of this new regime, given Peru's extremely favorable geology, was an inflow of direct foreign investment. All of these changes introduced by the 1992 mining legislation were embodied in the 1993 Peruvian Constitution.

At the time environmental legislation was not well formulated and indeed was viewed as "cumbersome and unrealistic" (World Bank, 2005, page 17). Before 1990, there was no requirement on the part of the companies to comply with environmental

⁵⁰ World Bank (2005)

standards or with the remediation or compensation for ecological degradation. This situation has since changed as new environmental legislation has emerged that prescribes requirements for audits and environmental management and adaptation plans (PAMAs) to monitor and penalize mining activities that failed to meet environmental standards⁵¹. However, while this has begun to take effect, the environmental legacies of many years of neglect have remained. In particular, there has been no mechanism to manage 'orphan' mining environmental legacies, which are partly to blame for the negative image and fears regarding environmental damage that permeate local communities, despite real and serious efforts by the new mine owners to maintain clean operations⁵².

5.2.3 *Changes to mining taxation*

While assessing the contributions that mining makes to economic growth and poverty reduction, Chapter 3 has already introduced the key elements of Peru's mining taxation. Its legal context needs some further elaboration.

- An important part of legislative developments for the mining sector has been the way in which there is some provision of mining revenues to be redistributed to local communities. In 2001, the Peruvian government altered the *Canon Minero* to allow 50% of the corporate income tax paid by mining companies to be redistributed directly to sub-national government entities. As noted, this change came about through intensive lobbying of Congressmen by mining-affected communities and mining companies. This suggests that local concerns were taken into account only quite late in the process of reforming mining legislation; and that these concerns could take 'voice' after the political transition in 2001 when the Congress had regained recognition as a key institution of the political-administrative system.
- The process of local dissemination of mining revenue has also been reinforced by the introduction of a mining royalty in 2004. This has followed debates and discussions in the Congress. The royalty is to be a fixed sum per volume of output, which is to be distributed in the regional government where the output has been produced. It is regressive as it must be paid irrespective of the profitability of the operation, and thus it can act as an inhibition on investment in marginal projects. On the other hand, the tax is broadly consistent with practices in many other countries. But the royalty has also provoked criticism because it could reduce Peru's attractiveness for mining investment. This effect has been most likely compounded because it has not been clear whether those mining companies with existing stability clauses would be exempt from the royalty by virtue of those clauses. The National Society for Mining, Petroleum and Energy tried to constitutionally challenge the introduction of the royalty. Its appeal was turned down as unfounded in April 2005⁵³.
- Tax raising measures notwithstanding, it is only relatively recently that mining has begun to contribute significantly to government finances in Peru. The fiscal regime created in the 1990s was intended to be attractive to mining companies and has stayed that way. In the future it is expected that the mining sector's contributions to tax revenue will increase as new operations come on-stream and start-up-related tax breaks are phased out, although contributions will of course

⁵¹ An extremely detailed outline of how this environmental legislation developed can be found in World Bank (2005).

⁵² There is criticism with regard to institutional conflict of interest, because the Directorate of Environmental Affairs is located within the Ministry of Energy and Mines, the promoter of mining activities.

⁵³ *El Peruano*, 27.04.2005.

also depend upon what happens to international metals prices. These developments indicate that the stakes for battling over these resources have been, and will be, raised further. This requires institutions and governance structures that can deal constructively with contests between different interest groups over how these resources will be used.

Consequently it is important to consider under what circumstances Peru's mining legislation has been introduced. To summarize the political situation of Peru in the first half of the 1990s: when the Fujimori government came to power it governed with a minority in Congress, but against the background of a situation of severe economic crisis was granted extensive powers to pass urgent legislation by decree. This eased the process of introducing fundamentally new economic policies. When conflicts with Congress over excessive executive powers emerged in 1992, the executive government suspended the Constitution and dissolved Congress. The 1993 Constitution drafted under these circumstances incorporated the new mining legislation. Congress has regained importance as the key interlocutor of the democratic political process only since the political transition in 2001.

5.2.4

Consequences

A key problem with much of the legislation described earlier is that it was designed to focus narrowly to attract investment into mining. The legislation has also been tainted by association with a government that eventually fell due to allegations of authoritarianism and corruption. The legislation lacked any formal mechanisms to involve citizens, or indeed their elected political representative, in important decision-making processes. Consultations were at best *ex post* events that often gave local communities very little time to respond⁵⁴. Based upon a number of interviews, it appears that local communities have little or no trust in the environmental impact assessment process, not least because companies picked and paid for the consultants to produce the EIAs. Even though this is standard practice elsewhere, in Peru it is perceived as a conflict of interest. A further consequence, both at a central and a local level, is that there have been limited institutional means for constructive resolution when conflicting interests have clashed over the generation and use of resources from the mining sector.

Reactions to the problems encountered in the past have included, in 2003, the establishment of the Mining Dialogue Group, which allows for structured discussions between a group of Peruvian and international NGOs, the mining companies, central government and the municipalities. Some legislation on participation and transparency has also been passed, which might contribute to greater understanding and dialogue. However, the practical obstacles lie with the limited capacity of local communities to effectively participate in this rather technical process. The legal requirement to involve local communities has not granted an institutional right to hold local decision-makers to account. There is currently talk of creating an ombudsman specifically for mining issues, as the Office of the Ombudsman appears to be one of the few institutions in Peru that attracts public trust and approval (CAD, 2005). The risks are that these developments will not proceed fast enough, that they may not be sufficient to meet the expectations of local communities, but also that they may not necessarily contribute to a fundamental strengthening of institutions and governance structures that mediate and broker stable solutions when interests fundamentally differ. There has been a sad track record in Peru of direct and violent

⁵⁴ Under the previous legislation, local communities had 40 days to respond to environmental impact assessments. Often these documents were large and highly complex. This is now being changed to allow more time for consultation.

action where there is dissatisfaction; failure to achieve a better system of governing society and its political interests could have serious consequences.

In summary, state strength in the early 1990s allowed the Peruvian government to make fundamental legislative changes, which have clearly encouraged foreign direct investment, including in the mining industry. However, this strength came at the expense of limited political checks and balances. This has undermined the legitimacy of government and public institutions and has resulted in a clash of formal and informal institutions. The consequence of this clash is that the post-1990 legislative basis for the mining sector remains in flux, as is currently demonstrated within the decentralization process. The Peruvian economist Hernando de Soto points out that changes to mandatory law and property rights require recognition of existing social contracts to obtain legitimacy⁵⁵.

5.3 *THE POLITICAL-ADMINISTRATIVE SYSTEM*

5.3.1 *Overview*

The political-administrative system is at the core of a country's institutions and governance structures, and thus how society is 'governed'. This section explores Peru's political administrative system and how it supports social cohesion and private sector activities.

5.3.2 *Main entities*

In Peru the basic framework enshrined in the Constitution sets out a *presidential democracy*, whose main entities are:

- government, or the executive, headed by the President;
- Congress, or the legislature, whose members represent the electorate;
- the judiciary, enforcing the country's laws and regulations;
- the administrative bureaucracy or state apparatus, implementing government policies; and
- subsidiaries of the above at the sub-national government level.

This section uses a more in-depth analysis of these entities, which it summarizes, then draws conclusions that are linked to the performance of Peru's governance indicators outlined in Chapter 4.

Peru's present political system can be traced back to the 1979 Constitution, which was designed for the transition from military to civilian rule. It was replaced in 1993 by a Constitution, which the Fujimori government drew up following the suspension of the 1979 Constitution and the dissolution of the Congress in connection with disputes over the powers of the executive⁵⁶. Figure 16 shows the main entities and Table 12 summarizes key features.

⁵⁵ Hernando de Soto (2000, p.180)

⁵⁶ This event is usually referred to as the '*autogolpe*', see also Chapter 4 of the Annex.

Figure 16 Political-administrative System

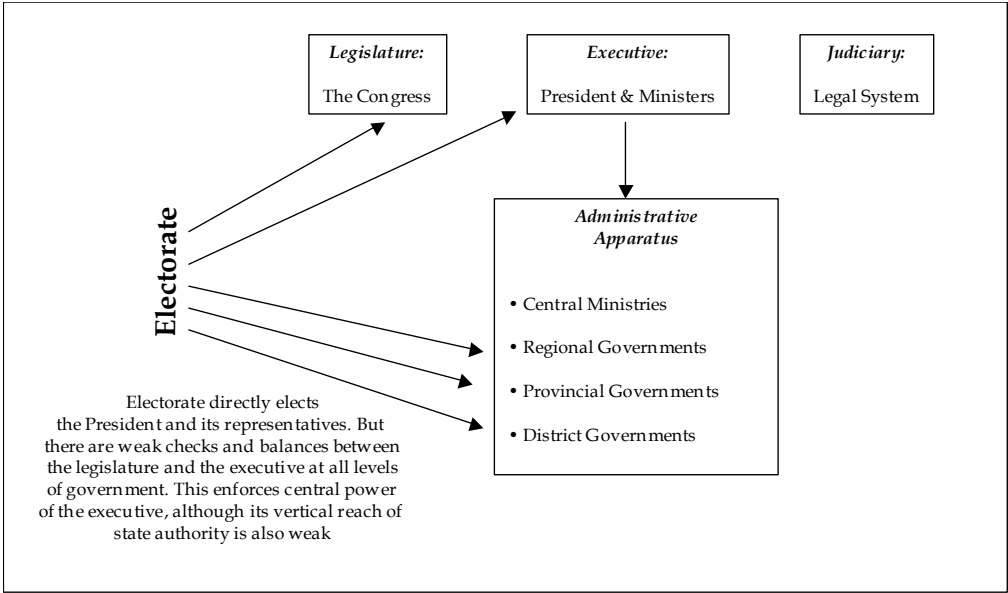


Table 12 Key Features of the Main Entities of the Political-administrative System

<i>Executive</i>	Peru’s Constitution centralizes power with the executive and has allowed a number of institutional possibilities to exercise executive decree authority. Between 1990 and 2000, this was applied to more than two-thirds of new legislation.
<i>Legislature</i>	The legislature has considerable formal power, but this has been undermined by the executive’s use of legislative decrees. Congress has generally lacked efficient oversight mechanism and has not posed a counterweight ‘checking and balancing’ the executive. Public opinion of the legislature, particularly among the elites, remains low. But since the political transition in 2001, Congress has led the debate on a number of important but contentious issues, and between 2001-2004 produced nearly 80% of new legislation. This includes the introduction of the mining royalty, changes to the <i>Canon Minero</i> and legislation to increase transparency.
<i>Judiciary</i>	Peru has a mixed judicial system. Historically it has been under-funded, inefficient and open to political manipulation by the strong executive. Since 2003, judicial reforms have been seen as a priority.
<i>Administrative apparatus</i>	The peak of administrative capacity building falls within the era of the military regime, but by the late 1980s what remained was a bloated and unprofessional public service. In the 1990s, a number of autonomous agencies were created, functioning as ‘islands of efficiency’, but the state apparatus as such has not been reformed. This has had repercussions on the spending efficiency of the public service.
<i>Sub-national entities</i>	Decentralization has been constitutionally enshrined since 1979. But it has only come into effect with the political transition process embarked upon in 2001. The current set up remains in flux and is expected to see a rationalization of regions.

This brief description explains some of the observations with regard to Peru’s performance on governance indicators:

- improvements since 2001 in *voice and accountability* and *political society*;
- persistent low scores of the *judiciary* and *rule of law*; and
- deterioration, and then lack of improvement, in *government effectiveness* and *regulatory quality*.

At the aggregate level, the political-administrative system has generally supported a

strong executive with the ability to reform and change economic and other policies from the center. It has imposed these not through an efficient administrative apparatus, but through authoritarian rule. Under periods of democratic rule governance appears to deteriorate, because in the absence of efficient institutions and structures with which to 'govern' short-term populist demands override long-term development perspectives. Central state strength counterbalances weak state authority and legitimacy until abuse of executive power rocks the boat. On a more positive note, the 1990s reform of economic policies has established greater technical capacity in key economic institutions.

5.3.3 *The Decentralization Process*

The recent decentralization process has changed the political dynamics within and between government organizations and with respect to vertical accountability between the electorate, the Congress and the executive. As pointed out in the table, it has resulted in a change of roles of the executive and the legislature with Congress now passing most of the new legislation. In relation to the mining sector, the signs include repeated changes to the revenue redistribution mechanisms for intergovernmental transfers, most noticeably the *Canon Minero*. Representatives of districts, provinces and regions in which mining activities are taking place have been most vocal in the debates around the distribution criteria and may have been lobbied by particular interest groups. The political landscape has also become more differentiated, noticeable for example in the 2002 regional government election where the opposition scored significant successes.

However, many observers have also noted that the decentralization process has been left rather incomplete and that progress has been particularly slow over the past two years. Halfway decisions have created at least some confusion – and a confused picture – concerning the overlap of responsibilities between central government agencies, in particular sector ministries, and regional government. Where responsibilities have been transferred, they often lack adequate and sufficiently predictable funding. This situation is illustrated in Box .

Box *The Dilemma of a Regional Mining Committee*

A regional committee of mining describes the practical problems that incomplete administrative and fiscal decentralisation has caused. Previously the committee was a regional department of the Ministry of Mines and Energy (MINEM) from which it was advised on its duties and responsibilities and provided with the necessary funding. In recent years, MINEM has transferred the responsibility for identifying specific duties and projects to undertake to the regional committee and funding is now received through the regional government, of which the regional committee of mining will become a part. Responsibility for broad policy guidelines and legal issues remain with MINEM. The regional committee has outlined its corporate plan, has indicated its personnel requirements and has also identified and prioritised a series of projects, including a plan and strategy for how to clean up "orphaned" mining projects from the period when the sector was run by state-owned enterprises. When it submitted its plan and strategy to MINEM and the regional government, both rejected responsibility claiming that they were either no longer or not yet responsible for funding the regional committee's activities. Left with no other option, the regional mining committee has taken its proposals to mining companies and NGOs to seek alternative funding from them.

5.3.4 *Challenges and Opportunities*

With respect to the political-administrative system of Peru, many challenges remain. The reformed system has not yet been completed or bedded down. The early arrangements (1990s) were incomplete, favoring central support to large- and

medium-sized companies, but limited improvements for other entrepreneurial sectors, particularly in the informal economy. It also involved political intervention in the legislative process and the judiciary. So public trust in the government continues to be weak. This is recognized by everybody, including the national government. Political observers continue to see weaknesses in the rule of law as a major shortcoming. They also lament that democratic stability is impaired by a weak party system and meager social capital, all of which impair the current political system. Checks and balances between the executive and the legislature are still not well functioning and only exist at the national, but not the sub-national level. Sub-national executive entities have limited capacity but increasing technical and financial responsibilities, the demarcations of which remain unclear. Supervision, oversight and management of sub-national government entities are weak and there are no identifiable initiatives about how these weaknesses will be addressed, and by whom.

- Decentralization is a major change to the Peruvian political-administrative system, and the processes by which it governs. These have exposed severe weaknesses in local capacity resulting from decades of underinvestment in institutional and administrative capacity building.
- These changes are creating overlapping responsibilities, which has led to confusion. This seems likely to be especially difficult for the regional divisions of the central ministries and will further complicate the challenge facing mining companies.
- There are tensions because the center is understandably reluctant to let go of more power, while the regions, provinces and districts lack the capacity to manage many of the functions, which in theory should be devolved to them. In many cases functions are being devolved but without the necessary funding.
- The governance vacuum at the sub-national level has forced the mining companies to deal directly with local communities, who also try to secure funding directly from the mining companies. In this negotiation process NGOs have played an increasing role. This has not always been a positive influence, especially if NGOs with international bases are driven by their own agendas. These agendas sometimes do not bear a clear relationship to what is truly wanted and needed by local communities and/or small and medium enterprises. The danger is that the result will be a bidding process whereby the terms of the last company – local community deal represent the starting point for the next negotiation whether for a new mine or for a re-negotiation of an existing agreement. Mining companies are forced to take a large role in this area, which is really the responsibility of government.
- There is great concern, but also consensus, *that regional and municipal governments urgently need to build capacity if the decentralization process is to succeed*. Otherwise it could mean a deterioration of an already low level of efficiency in public service delivery and, as a consequence, greater demands for more inter-governmental transfers, which would undermine aggregate fiscal stability.
- There are also concerns that as decentralization proceeds there could be less coordination between regions, which could have serious negative consequences for infrastructure projects, many of which do not respect regional or local boundaries. However, this concern would diminish, if the number of regions were reduced.
- The World Bank (2002, Chapter 5) expressed concerns that fiscal discipline may turn out to become a casualty of the decentralization process and stresses that the decentralization challenge is compounded by several factors, including vulnerable fiscal stances at both the aggregate and the local level, multiple governance issues afflicting local governments and an incredible institutional fragmentation in the social sectors in the delivery of services.

But there are also opportunities.

- Some municipalities have begun to organize themselves and have identified the need for undertaking capacity building initiatives. The mining industry has been very supportive of such initiatives, recognizing that increasing *Canon Minero* receipts will only render local benefits if local communities can undertake and sustain viable projects.
- The legal requirement that local government budgets are prepared with the participation of local communities to decide on priority projects has also been supportive⁵⁷. Local think-tanks and NGOs have capitalized on the opportunities created by the new legislative requirement to publish fiscal data, and have made positive contributions to increasing transparency in the financial management and policy decision-making processes of local governments. This includes regular printed and web-based publications on budgets, policy commitments and results, such as by the Grupo Propuesta (Vigila Peru) and Ventana Publica⁵⁸, and innovative initiatives, such as conducting a nation-wide competition on “good practices in government” by Ciudadanos-al-Dia to ignite positive incentives for improving national and sub-national public sector management⁵⁹.
- There is a broad consensus on the importance of rebuilding state institutions, developing sectoral policies and emphasizing social investment within a democratic and participatory framework. In the spirit of Peruvian economist De Soto’s writings, the decentralization process may lead to a greater integration of contradictory property right systems and the formalization of property of many who are currently excluded from the formal economy.
- Decentralization has created more space for dialogue between previously opposing parties, and *that this has most obviously developed in mining areas precisely because of poor relations in the past between local communities and mines*. As expressed by the Ombudsman, Peru was a society marked by exclusion, but in the past those excluded had little or no voice. Thus while conflict existed, it tended to emerge only as part of a violent revolutionary struggle. This was particularly relevant for mining. The local community had no way to reach the central government where decisions were being made. So to secure a veto over activities they were forced to go to “outsiders”, such as the NGOs, the Church or radical organizations.

5.4

FISCAL ISSUES, AT THE NATIONAL AND SUB-NATIONAL LEVEL

This section takes a closer look at Peru’s fiscal regime and public financial management issues (column 4 of the taxonomy) that underpin the political-administrative system, mining legislation and social cohesion. This section also supplements Chapter 3 and Chapter 4, which referred to the general performance of the fiscal regime and the positive turn-around in the past 15 years. This section specifically covers:

- aggregate public financial management performance;
- accountability for public spending; and
- budget implementation at the sub-national level.

⁵⁷ Responses have differed over whether this approach applies to the whole of the municipal budgets, or to the capital budget. It appears to be at the discretion of the mayors to decide which parts of their budgets are decided upon in a participatory fashion.

⁵⁸ Grupo Propuesta Ciudadana (www.participaperu.org.pe)

⁵⁹ Ciudadanos-al-Dia (www.ciudadanosaldia.org)

Peru's aggregate fiscal balances had markedly improved in the early 1990s but experienced a set back towards the late 1990s. The set back had partly to do with international financial crises and the El Niño phenomenon, but it has also to be borne in mind that the good performance in the early 1990s was assisted by large proceeds from one-off privatizations. The economy has again been performing well more recently. This has allowed the country to comfortably meet the aggregate fiscal targets that it has agreed with the IMF within the framework of a current stand-by arrangement. The Toledo government has been positively commended for achieving fiscal consolidation within the targets of the budget and its medium-term macroeconomic outlook.

Recent diagnostic assessments acknowledge that Peru has broadly pursued a number of major initiatives to improve its public financial management system and has increased fiscal transparency. The 2004 IMF Report on the Observance of Standards and Codes (ROSC), asserted that recent achievements have included improvements in budget formulation, partial phase-in of an integrated financial management information system (SIAF), introduction to an open procurement process, estimation of tax expenditure, adoption of a medium-term macroeconomic framework, and increased autonomy of the external audit function.

The World Bank's Public Expenditure Review (PER 2002) stressed that tangible progress in public expenditure management over the past few years has been impressive. This includes those achievements highlighted by the IMF ROSC, but also an upgraded budget management system, improved transparency of budget execution, the introduction of performance management contracts in state-owned enterprises and the adoption of budget provisions for a set of protected social programs.

However, both diagnostics also pointed out considerable institutional, organizational and administrative weaknesses. The ROSC emphasized the lack of stability and clarity in fiscal legislation, ambiguities in the demarcation of functions between central government and the rest of the public sector, inadequate information on contingent liabilities and quasi-fiscal operations, lack of a coherent civil service system, insufficient resources to conduct external and internal audits and unwieldy proliferation of tax preferences. In relation to fiscal decentralization, the IMF noted that Congress still has to assign clear spending responsibilities and revenue sources at different levels of government, and has to design a transparent mechanism of intergovernmental transfers and limits on internal borrowing. The World Bank PER points out that although fiscal rules had been legally enshrined in a Fiscal Prudence and Transparency Law since 1999, fiscal practice had not been able to fully meet them.

In the last 30 years, the country has experienced three distinct economic periods. During the first period of expenditure expansion from 1970 to 1979, total government expenditure stood at 20% of GDP, with increases mostly driven by public investment. Then followed a second period of contraction, from 1979 to 1991, which was driven by a severe deterioration in tax collection and an economic performance that brought the public expenditure level down to 14.5%. A third period of accelerated expenditure expansion started in 1991, and pushed public expenditure up to the levels reached during the era of strong state intervention. However, this time current rather than capital expenditure drove the increase.

In a similar way to the revenue side of public finances, the volatility of fiscal expenditure variables has exceeded that of GDP growth. Expenditure volatility in the

1990s is explained by erratic policies affecting capital investment, debt payments, the public payroll and transfers. It has been seen as a major policy mistake that additional revenue resulting from the economic boom in the early nineties was not saved to counter the period of contraction that followed in the late 1990s (World Bank, 2002, Chapter 2).

Against this background, improving the distributive and operational efficiency of public spending within an overall sustainable resource envelope has remained a major challenge for the Peruvian government. This is a very difficult task, particularly given the political pressure to proceed with decentralization and the social necessity to improve service delivery at the sub-national level. The move towards decentralization has not been completed and, as previously hinted at, there are partially transferred and unclear responsibilities and uncertainty over funding for carrying out responsibilities. It is inherently difficult for the Peruvian authorities to balance fiscal stability at the national level with the devolution of administrative and fiscal responsibilities to sub-national government entities when the efficiency of spending is compromised at all government levels, but particularly at the sub-national level.

Experience elsewhere has shown that public financial reform components that have helped to restore aggregate fiscal stability have often not achieved greater operational efficiency and a more strategic allocation of public funds. This would appear to also have happened in Peru, for example, in relation to operating a cash budgeting system that impinges on periodical intergovernmental transfers, or setting up a medium-term expenditure framework that guides fiscal policy planning at the central government level but does not extend to medium-term financial planning at sub-national government levels. Some public financial management reform components have been completed at the national level, but have yet to be rolled out to the sub-national government level. This includes the integrated financial management system (SIAF), which poses a major challenge to be rolled out down to the level of the 1826 districts, including to those in very remote areas where IT support is limited.

In summary, reform achievements pursued at the top are not matched with equal improvements from the bottom up. The latter may not have received the same (international and national) attention as the former, but have compromised further improvements in the financial aspects of governance capacity. First generation structural reforms of the economy have certainly contributed fundamentally to restoring aggregate macroeconomic balances. But they now require complementary second generation reforms that tackle the role of government vis-à-vis the private sector from the perspective of setting an institutional framework and delivering public goods and services that serve both private sector activities and socio-political needs, and, most importantly, at all levels.

5.4.2 *Accountability for Public Spending*

In connection with the political-administrative system outlined in the previous section, structural features pose challenges to improving the accountability for the use of public funds at all government levels. A recent study on legislative budget oversight and public financial accountability in Peru's political system points at a series of structural factors that inhibit accountability in budget policy-making and budgetary oversight. Some of these are internal to how the Congress works, and others relate to the broader context of the governance system. A key finding is that

technical improvements are likely to be emasculated by adverse political dynamics and political economic constraints⁶⁰.

This creates the following dilemma: legislative oversight is currently weak and it is not immediately obvious that greater legislative involvement in public financial management decisions would immediately render more positive results, particularly with respect to fiscal discipline. It is these weaknesses that undermine democratic accountability and, with it, trust in and credibility of government institutions. This leaves government in a fundamentally weak position to enforce major administrative reforms and to positively expand its authority to sub-national levels where improvements in public service delivery are most needed. In summary, there is a delicate balance between executive power and legislative oversight. The dilemma is summarized as follows: *“Constitutional traditions, institutional arrangements and technical capacities greatly influence the role of legislatures in public budgeting and the effectiveness of the institutions of government accountability constraining expenditure discretion. In turn, the quality of the mechanisms of ‘vertical accountability’, in particular the nature of political regime and the coherence of the political party system, greatly influence the efficacy of the institutions of ‘horizontal accountability’ in public financial management.”* (Santiso, 2004, page 29.)

As mentioned in the previous section, participation and transparency in the compilation and implementation of district government capital budgets is now a legal requirement. However, interviewees have made conflicting statements on the role of the participatory budget on the municipal level. The Ministry of Finance maintains that municipal budgets would comprehensively underlie a participatory approach. But local government representatives suggested that mayors decide which part of the municipal budget would be subjected to participatory involvement of citizen groups, and that this may only affect a certain part of the capital budget and may be limited to seeking citizens’ input on prioritizing capital projects.

This mechanism for civil society participation in local government budget preparation is the only accountability mechanism at the local level. There appear to be no local legislative bodies (elected municipal councils with legislative powers) formally approving sub-national budgets and overseeing their implementation against the approved budget. Only Congress approves the overall budget, and thus the depth to which sub-national budgets are scrutinized would appear to be rather shallow. Recent diagnostics have pointed out that internal and external controls leave much to be desired in terms of oversight. So it would appear that executive bodies at the sub-national level have substantial discretion over the actual implementation of sub-national budgets. Taking the political and social context into account, it is by no means certain that greater involvement of the citizens and local interest groups, and strengthened fiscal accountability at the sub-national level, will immediately and automatically lead to better results.

On the national level, Peru’s endorsement of the Extractive Industry Transparency Initiative (EITI) and its agreements to participate as the first country in Latin America in the EITI pilot program is a positive development.

5.4.3

Budget Implementation, at the Sub-national Level

Although budget formulation and other strategic policy decision are highly centralized and budget authority resides with government entities in Lima, a large

⁶⁰ Santiso (2004) These issues have also been raised in recent IMF and World Bank background papers on the politics of public financial management reforms.

chunk of Peru's budget is executed through sub-national entities. It would appear that sub-national government entities have quite some discretion to modify the approved budget. At the same time – as mentioned above – they are not subject to formal budgetary oversight by sub-national legislative bodies. A major constraint on the budget formulation side is the high degree of expenditure inertia, which rests partly on constitutional rights, but partly also on the systems of earmarked transfers. Both of these features make it very difficult to change spending behavior and to gear budgeting towards achieving tangible results.

It has already been stressed that the PER (World Bank, 2002) expressed great concerns over the inefficiency of public spending. This concern was enforced by the results of a Public Expenditure Tracking Survey (PETS), which the World Bank conducted with special emphasis on social programs and expenditure in the health and education sector. These areas are key to the reduction of poverty and general improvements in socio-economic living conditions. The PETS has shown that there are major leakages in the transfer of funds to local governments and downwards. Leakages were most noticeable not between the center and the local governments, but from the local governments further down – as resources get closer to beneficiaries. This reflects a lack of control and audit mechanisms and very poor targeting of public spending. This means it is no surprise that local communities do not feel that public spending delivers results, and that they look for alternative means of generating tangible benefits, for example by asking private companies.

This finding relates directly to concerns over local governments' ability and capacity to utilize increasing *Canon Minero* transfers and other intergovernmental transfers to achieve sustainable benefits for their communities. For the *Canon Minero* there is an explicit legal stipulation emphasizing that these monies can only be utilized for capital expenditure, i.e. investment projects. Whilst on one hand this is a safeguard that public funds are not squandered on recurrent expenditure, it can cause serious imbalances if increased *Canon Minero* funds result in investment projects with recurrent expenditure implications that the respective community cannot fund through other recurrent transfers or local revenue. Locally raised revenue thus gains relative importance, although it involves nominally small amounts.

There is said to be an in-built mechanism that safeguards to some extent against local 'white elephant' projects and other wasteful spending on capital projects. This is the national public sector investment system SNIP (Sistema Nacional de Inversion Publica). The SNIP entails an approval process for public sector investment projects, which is intended to ensure that planned projects meet certain criteria on financial and technical viability. Responsibility for the approval of investment projects below the value of NS 6 million has already been delegated down to regional governments and covers the majority of public investment projects. However, one of the Peruvian NGOs monitoring government fiscal affairs has noted that regional governments have not attended to the same rigid standards as the central government applies. Investigations in 15 regions have shown that the central SNIP office would only have approved about 40% of projects that the regional governments approved⁶¹.

Recent investigations by another Peruvian think-tank have shown cases where municipal spending from the *Canon Minero* is clearly not geared towards developmental objectives but short-term and politically opportune projects. Box 5 summarizes the most pertinent issues around the *Canon Minero*, which pose great concerns as the transfers are expected to increase tremendously over the next few years.

⁶¹ Grupa Propuesta Ciudadana, op.cit.

Challenges for the Canon Minero and Other Revenue Flows

- Administrative and financial management capacity at the regional and local level is insufficient. The ability to strategically plan, implement and monitor programmes and projects and to effectively account for monies spent is weak. It is urgently necessary that regional and local capacity is built to manage and use *Canon Minero* and other revenue flows more efficiently and effectively. This includes the capacity to analyze the impact of policies, monitor performance and conduct expenditure reviews.
- Rules, regulations and processes applicable to the use and administration of public transfers to the regional and local level do not provide sufficient incentives to support integrated medium-term planning and budgeting for all public funds. Central government and the legislature have to do more to ensure that rules, regulations and processes encourage regional and local governments to take resource allocation decisions that serve the developmental economic and social needs of communities. This includes, for example, improving the medium-term predictability of transfers and muting volatility. It should also include the requirement to report and monitor performance in public service delivery and to establish national consensus on development priorities.
- Although fiscal transparency has been increased in recent years, there remain areas where public disclosure regarding the local management of resources requires more attention. Training for local and regional governments in how to record the acquisition and use of *Canon Minero* and other revenue is very important.
- Dissemination strategies for financial and performance information in order to hold public office holders to account need to consider that rural communities have very limited access to electricity and Internet. Alternative methods of information dissemination (for example, via the local media or public announcements) are necessary. Equally important are institutionalized procedures for community leaders to voice needs, opinions and discontent in a constructive manner.

In the context of weak public financial management capacities, the potential year-on-year volatility of *Canon Minero* receipts also poses a challenge. There are cash-management-related reasons, and there is also an 18 months delay in the distribution of the *Canon Minero* revenues compared to the base year in which the mining sector income tax has been generated. Another reason is that the normative basis for distribution has remained under political debate in the decentralization process. A further source of volatility is that corporate income tax is dependent on mining export profits and international economic activity and international mineral prices are inherently volatile. It is also worth mentioning that an increase in mining exports would not automatically result in an increase in amounts transferred, because the latter depend on the net profits of the mining companies. Hence there have been discussions around introducing a stability fund. However, this remains a politically contentious issue.

5.4.4

Fiscal Challenges Summarized

The fiscal challenges can be summarized as follows:

- Aggregate fiscal stability was restored in the 1990s, and has since continued, although the volatility of fiscal variables and the *ad hoc* adjustment processes that this requires remain of concern, particularly for the distributive and operational efficiency of public spending. Improving the latter is essential for improving public goods and service delivery for the benefit of society more broadly. While at

the aggregate level there have been significant improvements in some areas, serious weaknesses remain. It merits some thought whether some factors that led to the improvements achieved (i.e. executive decree authority) pose constraints to further improvements (i.e. vertical accountability and legitimacy).

- Initial steps towards political decentralization have not been fully matched by fiscal decentralization. Central government faces the difficult task of having to ensure aggregate fiscal control, whilst the delegation of responsibilities to sub-national entities requires allowing sub-national government entities greater room for fiscal maneuvers. The current system of central government transfers is complex, with substantial parts of transferred funds earmarked for programs that have rendered questionable results, and some elements or transfers are only partially transparent.
- Municipal governments in the vicinity of mining activities together with mining companies have been able to negotiate for higher intergovernmental transfers from the *Canon Minero* and regional governments have been promised the receipt of the newly introduced mining royalty. Frequent changes in the criteria for re-allocation indicate the politicization of the intergovernmental transfer system, without certainty that these revenue flows will lead to results that deliver real benefits to broader segments of the society, or that will enhance economic opportunities for the large amount of people that are still living in poverty. As a consequence, political pressures may easily provoke populist policy decisions and pressure on mining companies to contribute more to local communities and local government entities. Lack of clarity on the underlying principles of *Canon Minero* transfers furthermore leave the doors open for continuous renegotiations of commitments, and for political demands that target additional taxes on mining activities.
- Institutional and personnel capacity problems in the financial management and public administration of local communities and regional governments to undertake economically and socially sustainable spending, and possible structural imbalances of sub-national budgets due to the earmarked transfers. This undermines a comprehensive and integrated approach to sub-national financial planning and budget implementation and questions the efficiency of public spending at that level. This challenge links to a) structural problems in the political-administrative system, which historically has only allowed for weak accountability relations between the executive and the legislature; and b) the limited trust and credibility that the political-administrative system enjoys from the electorate. In particular, regional governments have not received the necessary capacity building to take care of increased responsibilities devolved with the decentralization process.

Relating this back to the crosscutting governance taxonomy, there are weaknesses and limits to state strength in accountability for public spending, particularly at the sub-national level. At the same time, a weak administrative apparatus undermines central government strength because of inefficient public spending. That is, the gains of technical capacity at the center are forgone by limited technical capacity at the sub-national level. These challenges also provide opportunities for informal institutions, such as systems of patronage, to override formal rules and regulations. From the perspective of social cohesions, poor public service delivery heightens social discontent and thus the search for other revenue sources, such as mining companies. And it can also undermine the predictability of fiscal policies that apply to tax legislation.

SOCIAL COHESIONS: SOCIAL TENSIONS, CONFLICT PREVENTION AND CONFLICT MITIGATION

The growth of the mining sector since the early 1990s, has undoubtedly generated social tensions and conflicts between mining companies and the communities where they operate, not least because of their high expectations of the companies. These suggest that social cohesion between different economic, political and social actors is low. The reasons why attitudes to mining tend to remain negative (in spite of the evident successes) are of course complex. Different interest groups invariably have different needs and objectives, strengths and weaknesses. The following issues seem to apply to at least some of Peru's mining areas.

- Perceptions and fears that mining affects water resources and pollutes the air, posing risks to local livelihoods and public health.
- Unfulfilled expectations (and perhaps promises) about employment and other benefits. People close to, but not employed, by the mine tend to feel relative deprivation due to the enclave character of housing estates and services for mining personnel.
- Local price increases arising from, and exacerbated by, differences in purchasing power.
- Insufficient communication between companies, communities and government entities in the process of licensing and prospecting.
- Lack of social legitimacy of formal property rights structures, as well as weak enforcement of environmental regulations (perhaps perceived) by government and a lack of trust in government to deal with community concerns.
- Lack of local organizational capacity by both the public and local government representatives to negotiate with mining companies and central government authorities and manage the local impact of mining activities.
- Absence of government entities to effectively deal with the social issues and concerns that arise from the different interests of mining companies and local communities and to overcome collective action problems to the benefit of all parties involved.

Because of persistent social exclusion and unmet social needs, many mining companies have been approached to deliver goods and services that should ideally be demanded from and provided by government. Providing better quality information about the contributions that mining investments make and engaging with communities from the start of a mining project's development may partially address some of the issues listed above. However, where interests and expectations are inherently different, it requires a legitimate political process to negotiate trade-offs and solutions that are accepted by all parties involved, as well as the organizational capacity to enforce and implement these⁶². Box 6 depicts a recent example that illustrates the weak position of the Peruvian government in dealing with such tensions and brokering between different interest groups.

Box 6

Social Tensions Around Mining in Peru

Communities affected by the Tintaya mine received support from Oxfam America and CooperAcción (a Peruvian NGO) to undertake a survey of land, environmental and human rights issues to summarize the communities' problems with the mine. As a result the Tintaya Dialogue Table was set up in 2001-2002 to mitigate increasing tensions. It involved the mining

⁶² This is also pointed out by Hernando de Soto (2000), who stresses that overcoming clashes between formal and informal institutions (including property rights) entail not only a legal challenge, but also a political one.

company BHP Billiton and representatives from the communities, from CooperAcción and Oxfam America, the National Coordinating Committee of Communities affected by Mining (CONACAMI) and its regional affiliate in Cusco (CORECAMI). Recently, a framework agreement (*convenio marco*) was signed between the province, communities and BHP Billiton, in which the latter committed to return to the communities land equivalent to the amount of territory that was expropriated by the state and acquired by the company, plus an additional 25-50% of land, depending on the quality of the land. Further components of the agreement include joint community-company environmental monitoring, the creation of a community development fund, which will be supported by BHP Billiton, and the requirement that the company needs to get the communities' prior informed consent before making decisions on future activities, such as expanding operations. There is awareness that the implementation of the agreement will not be easy, but the establishment of the Dialogue Table has generally been perceived as a success. According to Miguel Palacín, president of CONACAMI, "one of the reasons for the success of the Tintaya Dialogue Table was that the state was not present". Despite the agreement, new conflicts and demands arose in June 2005, when over 2000 people stormed the administrative buildings demanding that the \$1.5 million investment in social infrastructure agreed to in 2003 should be increased to \$20 million. This is unfortunate, as many parties had initially judged the agreement as a good solution.

The Tintaya example in Box 6 shows how the current situation has encouraged broader local negotiations between companies and local communities. But these in turn create an escalating bidding process that creates uncertainty, raises expectations to possibly unreasonable/unrealistic levels – and in short, have their own problems. Neither are they a guarantee for actually addressing the political, economic and social needs and expectations of the population.

It is reasonable to argue that local people are more likely to accept the negative aspects of mining in exchange for alternative economic opportunities, particularly through micro, small and medium enterprise development. (In support of this argument see the La Oroya experience in Box 7). But if the latter are not forthcoming – for reasons that may be completely unrelated to the mining sector – it can be expected that local communities will focus attention on large extractive companies and support every opportunity to give voice to calls for short-term compensation and redistribution.

Box 7

The La Oroya Mine

This mine had been failing to meet the environmental requirements that are contained in the PAMA. Between 1999 and 2002, the concentration of lead associated with the mine exceeded both World Health Organization and Environmental Protection Agency standards. In November, the owners – Doe Run – indicated that they would need another five years to meet the required standards. Concerned that the central government might close the mine, the local community took direct action blocking roads to force the government to agree to allow the time extension. Despite strong opposition from some NGOs and also some elements in the private sector, the government agreed. The World Bank (2005) was extremely critical of this decision since it undermined the system of environmental legislation and compromised MEM's role as the monitor and enforcers of environmental regulations. It also gave the mining company the (cheaper) option of mobilizing local support rather than investing in the necessary clean-up operations. However, what was even more interesting was that the community gave strong support to the mine despite the pollution. This could in part be explained by fears that they would lose jobs. But interviews with a number of observers of the events suggest it was also because the local management of La Oroya spent a great deal of time in the local community supporting alternative economic projects.

In summary, if institutions and governance structures suffer from limited capacity and legitimacy to mitigate tensions and settle conflicts in ways that satisfy both, aggrieved communities and mining companies, it poses a dilemma for both sides and leads to two perspectives.

- Companies feel that local people feign some of their anxieties in order to extract further benefits from the company, despite the company paying tax and other revenue to government.
- Local people do not concur with government decisions over property rights, because they feel the rights granted by central government to mining companies are not consistent either with their traditional rights, or with greater economic opportunities that improve their well-being, or because they have not been involved in the decision-making process and therefore have not been able to assess the pros and cons.

Institutions and governance structures that do not hold political representatives to account for addressing community's economic and social concerns invite arrangements that involve alternative social representatives and entities, including local and international NGOs, churches or political organizations. Without ignoring the important role that these organizations can play in representing citizens' interests, alternative arrangements may only be poor and partial substitutes. They are ultimately symptomatic of the inability of formal institutions and governance structures to act as brokers between different interest groups to derive a consistent and socially accepted legal system, public policies and a resource allocation that provides broader based economic opportunities and achieves social cohesion. Peru's contemporary political history supports this conclusion.

- There is severe segmentation within the party system and little ability to formulate program objectives. There are strong tendencies to focus on personalities and patronage, and a high level of voter volatility. Parties have made little progress in forging political and social integration, as well as economic inclusion. Efforts to develop cooperative and consensus-oriented patterns of interaction between the work force and entrepreneurs have languished⁶³.
- The ability of some parts of Peruvian society to organize is considered to be relatively high. But civil society organizations are also highly fragmented and have often taken on a confrontational position. There are insufficient institutional channels to voice concerns and discontent particularly at sub-national government levels.
- Period of authoritarianism and strong executive powers have not been conducive to horizontal accountability across the political-administrative system⁶⁴. This has undermined vertical accountability between central government, the Congress and the electorate. Central government strength at the expense of sidelining the legislature and party politics undermines a political process that translates the interests of different social actors into the formulation of the public interest in a manner that is widely recognized as legitimate. Thus central government strength has at times come at the expense of greater social integration and economic inclusion.

From the perspective of the crosscutting taxonomy of efficient governance we can now conclude that the unbalanced state strength of the 1990s backed by authoritarian traits disguised fundamental state weaknesses. Since 2001, this strength has been more balanced and there are now more legislative checks, but the effectiveness of public institutions to mediate between different interests may not have increased.

⁶³ Bertlesmann Transformation Index (2003)

⁶⁴ It is often pointed out that in contrast to Chile and Brazil, Peru does not have a professional civil service that would support horizontal accountability.

Political observers acknowledge that this reality has guided the policy agenda of the Peruvian government since the return to democracy in 2001. The current process of political change is closely intertwined with the political demands that have driven the decentralization process, which responds to the political promise to provide better and more equal access to public goods and services and to support economic opportunities and private sector development across different regions of the country. The recent government has also undertaken a number of initiatives to improve transparency and participation.

However, this process also involves a major re-engineering of public institutions. It is reflective of the inherent mistrust in public institutions and the limited legitimacy of central executive decisions. The risk is that tensions between central government, regional representatives in Congress and municipal governments create an environment where issues are easily politicized and solutions proposed in the short run may not lead to better long-term results.

From the perspective of social cohesion the Peruvian government is under pressure to:

- Successfully manage persisting social cleavages and ensure that public institutions at different tiers of government live up to people's expectations. This includes expectations regarding political participation and economic inclusion, but also vis-à-vis public sector organizations that often fail to implement policies and provide good quality public goods and services. Discontent remains high and unmet demands have been accompanied by generalized protest and a certain degree of social unrest⁶⁵.
- Consolidate progress made towards rebuilding more inclusive democratic institutions, not least through the initiation of the decentralization process⁶⁶. Explicit commitment to transparency in the financial flows to regional and local governments has already created space for greater citizen participation and there are various positive signs that this is increasingly exercised. But this also poses challenges. The competencies and the financial arrangements of regional and local government entities are not yet clearly defined, and thus it is unclear whether public policies and formal property rights will become more responsive to the needs of the poor.
- Ensure that the responsiveness to the needs of the poor does not undermine economic stability and investment-friendly policies. It requires genuine improvement in public service delivery and not redistribution through populist means. Unfortunately, facilitating a liberal market economy and competitive structures have not reduced the size of the informal economy, which remains very high⁶⁷. Property rights and public policies, including social policies, need to address inequalities and broaden opportunities for those at the margins in a way that supports private sector activities and entrepreneurship generating wealth. Decentralization of policy implementation requires the capacity of sub-national administrative entities to take on responsibilities for public service delivery.

Despite good efforts, mining companies continue to be regarded with suspicion. There is resentment against mine workers, not least due to visible differences in living standards. Mining companies have tried to reduce conflict and the potential thereof by dealing directly with local communities. In effect, companies are being forced to fill

⁶⁵ Sagasti, 2002.

⁶⁶ In the first open and competitive elections for regional governments in 2002 opposition candidates scored clear successes.

⁶⁷ See also ILO (2003)

the vacuum that the current system of governance leaves. But this highlights the limits to government capacity at different tiers of government and calls into question the success of the decentralization process.

The various examples where mining companies have negotiated compromises with local communities have set precedents that are creating incentives to engage in a bidding process whereby local communities' expectations are continually being raised. Some of these deals have taken place without any government involvement, others have been supported by central or municipal governments – if only by default. However, the long-term sustainability of this spending and its contribution to greater economic and social inclusion are by no means certain. Greater social cohesion requires that all parties involved view the decentralization process as an opportunity to agree on a governance structure that supports collective action and results in policy decisions that leave all parties better off.

The inability of government entities to respond to the needs and expectations of the population become apparent risks for the mining industry when:

- local communities demand that mining companies pay for goods and services, which the public sector would otherwise be expected to organize and deliver; and
- government responds to populist demands to introduce additional taxation rather than improve the property rights of the poor and the efficiency of weak public service delivery.

5.6

PRIVATE SECTOR DEVELOPMENT AND HUMAN CAPACITY

So far this report has found that despite the substantial aggregate macroeconomic and fiscal achievements since the early 1990s, poverty reduction and greater social and economic inclusion have not been forthcoming at a commensurate rate. The report has argued that trickle down mechanisms have not taken place because of constraints in the institutional and governance framework, particularly the political-administrative system and clashes between formal and informal institutions. Section 5.2 on mining legislation has also pointed out that policy reforms in the early 1990s were explicitly geared towards attracting foreign direct investment. It is however clear that many Peruvians would be better off if economic opportunities for the micro, small and medium size enterprise sector had also been improved. The informal sector has remained large and so have unemployment levels.

Chapter 3 has pointed out that direct and indirect employment of local people close to the mines is limited in comparison to the population of local communities, and that expectations regarding local job creation have not been met. Some mining companies have tried to address these expectations by providing local training and supplementary employment opportunities, as well as supporting economic diversification. But despite these and other initiatives the local content of large-scale mining projects remains limited, not least because it is a highly capital-intensive industry. On the other hand, interviews have shown that central government has not attempted to, or had an interest in, supporting or measuring local content in mining. This questions whether there are any appropriate policy incentives to promote the local content of large-scale (foreign or domestic) investment projects. Mining companies lament that there is little government support when they stretch out and try to promote local hiring, local purchasing and the promotion of small and medium size enterprises in the area of influence of mines.

Adopting the reasoning of Peruvian economist Hernando de Soto, weaknesses in the

property right system are a major stumbling block to increasing local content. De Soto points out that despite various attempts Peru has not managed to formalize the property of the many who now operate in the informal economy, and that this has been the greatest obstacle to economic empowerment. The effect is a very high value of capital in the informal sector, which due to lack of formal rights cannot be utilized efficiently to increase productive activities⁶⁸. De Soto and his colleagues at the Lima-based Institute of Liberty and Democracy (ILD) painstakingly documented the cumbersome procedures and red tape involved in formally setting up a small business or legally obtaining a home.

De Soto's findings correspond with that of a recent ILO study (2003), which found that the micro and small enterprise sector employs more than 60% of the total number of workers in Peru. In urban employment the share of these enterprises increased from about 55% in 1990 to 65% in 2000. The economic policy shift of the early 1990s encompassed various areas that affected smaller enterprises, including business registration, labor laws, taxation, trade policies, financing policies and enabling and innovation policies. But on the whole these reforms, as well as more specific laws for micro and small enterprise promotion, have not had the desired effects.

In addition to the lack of evidence that Peru's high level of informal employment has decreased, the ILO study found that:

- Job quality in the informal employment sector has deteriorated significantly, resulting in lower and less secure social security benefits and more informality in employment. Average incomes in the sector have fallen, and thus this employment growth seems to be driven by survivalist strategies.
- The sector has numerous and severe symptoms of precarious job quality, including low salaries, low levels of social security benefits, exclusion from unions, little or no training and often deplorable work conditions.
- The regulatory framework has little direct influence on the sectors' decisions concerning job quality and quantity, and the policy environment has either no, or a negative, effect on their employment decisions. In addition, the highly flexible labor framework discourages long-term employment relations, and thus it does not make sense for employers to spend money on workers when the expected labor relationship is short-term.

Irrespective of these realities, it is clear that much of the potential for job creation rests not with large but with smaller enterprises. Thus, if policies, institutions and regulations could provide a more positive environment for micro, small and medium enterprises, they could make a substantial contribution to employment creation, and thus poverty reduction.

What have been the obstacles? The ILO study suggests that many of the policy reforms in the 1990s have focused on large enterprises and have not sufficiently taken into account the needs of smaller operations. For example, labor market institutions were reformed to meet the needs of large business, such as limits on the freedom to associate and collective bargaining, but fail to cater for smaller business, for example, overcoming collective action problems and encouraging cooperation in the area of meeting training needs. Similar ambiguity applies to social protection. Where there have been attempts to specifically promote smaller enterprises, they have fallen short

⁶⁸ De Soto (2000). The estimate of 'dead' capital in the informal economy for 1995 was US\$74.2 billion - at the time 14 times greater than the value of foreign direct investment and twice as large as the total assets of the 1,000 largest private formal enterprises.

of implementation, largely because of lack of coordination between central and local governments.

The mining sector recognizes that the low level of skills around mines of both the local work force, as well as possible suppliers, is a major obstacle for increasing local content. There are many examples where mining companies are trying to support diversification and provide a stimulus for local inputs (labor and supply chain), but within government there appears to be little attempt, or any interest, to support or even measure local content. However, the promotion of local content and labor requires policy incentives and an institutional framework that encourages this. The same applies for mining led projects to support economic diversification in mining regions.

This relates back to those governance structures and policies, which inhibit capacity constraints in the public sector, particularly at the municipal and regional level. The economic, public sector and public finance reforms that have been pursued at the central government level since the early 1990s have to be complemented with administrative and financial reforms at the very local level, particularly given decentralization. Mining companies have already started to contribute to capacity building at the local level. But this can only be a supplementary contribution and cannot (nor should not) happen in isolation. It really is a function that needs to be delivered by those empowered to 'govern' if long-term sustainability is to be ensured.

In summary, private sector development has been constrained by technical capacity, particularly at the local government level, but also the neglect of the institutional needs of smaller enterprises operating in the informal economy. Locations where foreign direct investment in capital-intensive industries can survive are not automatically good enough environments for smaller-scale entrepreneurship, where the employment potential is much greater, and through which important trickle-down mechanisms take place. One of the greatest constraints appears to be the clash between formal property rights and those that communities have created outside of the formal realm⁶⁹. Therefore, while large-scale mining companies are the focus of efforts/pressure to promote economic diversification and support small and micro enterprises, only public institutions can provide the necessary institutional and structural prerequisites to enable this.

Here lie the reasons behind the "success factors", but also the challenges and constraints of mining's contributions to economic growth and social development. State strength at the national level has helped to improve legislative and economic policy changes to turn around the macro-economy and facilitate foreign direct investment. But this has done little to improve the legitimacy of government and public institutions in general, and also the efficiency of government spending, in particular at the sub-national level. Thus state strength at the central government level has disguised weaknesses in institutions and governance structures linking state authority to people's economic and social realities, particularly at the sub-national level.

Improved technical capacity at the national level has contributed positively to better macroeconomic management and greater legitimacy of formal economic institutions, particularly aggregate monetary and fiscal policies. This has corroborated strong economic growth. But it has not yet been matched by improving administrative

⁶⁹ This is not simply a question of enforcing existing law, but to adapt formal law to existing realities and enabling those in the informal economy to use their capital more efficiently. The clash between formal and informal rights may also explain Peru's weak performance on the 'rule of law'.

capacity at the sub-national level, by formalizing the property of those operating in the informal economy, and by strengthening socially important economic institutions, such as labor market institutions and social policies. These are what have constrained trickle-down mechanisms from taking effect.

This case study of Peru has shown that the impact of mining on economic growth and poverty reduction is complex. It involves the interaction of economic, political and social influences at different levels, from the national down to the very local. Peru started a mining renaissance in the early 1990s, following a decade of severe economic and political distress, which also kept social development stagnant. There have been two cycles of strong, centralized governments that introduced major economic policy reforms guided by what ideologically seemed the right things to do. But results are then challenged when, under democratic rules, institutions and governance structures are ill prepared to aggregate different interests in a way that caters for both social needs and private enterprise development.

Opportunities lie in the fact that the basket of economic reforms achieved at the beginning of the 1990s have had the effect of (i) restoring aggregate macroeconomic balances and confidence in the national currency, and (ii) stimulating new mineral and other investments after many years of depleting the assets of investments made before the late 1960s. International and local mining companies met the challenge in a significant way when the commercial basis for mining activities was reinstated. Cause and effect are difficult to prove, but there is little doubt that the re-emergence of mining accompanied by huge foreign investment inflows have had a significant positive influence on the country's overall macroeconomic recovery, and its growth rates above the regional average since the early 1990s. There is also no evidence of a macroeconomic 'resource curse'. The mechanism and counter policies are by now well understood and managed.

Unfortunately, UNDP's Human Development Index indicators show persistently high levels of poverty and inequality, which have not fundamentally changed with economic recovery since the early 1990s. It is also not yet certain whether in social terms mining-affected areas have disproportionately benefited from economic recovery. This suggests that the benefits of higher investments and growth have not been shared across the population at large and that the policy and legislative changes that have facilitated larger-scale investments have not had a similarly positive effect on small-sized entrepreneurial activities. The size of the informal economy in Peru has remained very high, and perhaps has even been increasing. So the key question is what has constrained macroeconomic improvements from having a greater impact on social development and poverty reduction, particularly in rural areas? This report has thrown some light on these issues; the next few sub-sections attempt to capture the most important issues arising from them.

6.1

THE ROLE OF MINING IN ECONOMIC RECOVERY

Peru's legislative and economic policy reforms of the early 1990s triggered a renaissance of private investments in the mining sector, with a considerably number of large projects that have begun production since the later half of the 1990s. The general outlook for the sector for the availability and suitability of ore bodies is positive and, in addition to very significant amounts of foreign exchange earnings, the sector is projected to increase its share in GDP and government revenue as further new production comes on stream. It should be remembered that many of Peru's mining projects are still very recent and in the development phase.

Mining has contributed significantly to kick-starting the economy since the early

1990s, following a long period of economic crises. Critical improvements in macroeconomic policies and economic legislation have allowed the mining sector to become re-established as a thriving industry in an environment that has yet to be geared towards making it commercially viable and institutionally possible for other industries to invest, and to trade in international markets. Only very recently have there been encouraging signs that some diversification is taking place in agro-industry and textiles. The Peru experience suggests that the mining industry has been an important contributor to Peru's emergence from a situation of severe economic stress, and that this has undoubtedly improved the lives of many who are still considered to be poor.

The Antamina example has clearly shown that the industry is making substantial contributions to infrastructure developments and the provision of basic services around some mines. It is also connecting mining areas with ports and strategic highways. Other companies are following similar policies. It should be remembered that many operations in Peru are still in their infancy, and local and national contributions are expected to increase substantially in future years. However, the Antamina experience has also shown that despite good efforts mining companies face external constraints when it comes to the employment of local (as opposed to national) labor and offering greater shares of local inputs. It is very difficult for the industry to overcome these constraints unilaterally.

A major challenge for the mining industry is that public attitudes towards mining are often not positive, and have recently resulted in confrontational social conflicts. The underlying reasons for this are complex. Some relate to mining legacies, and others could be prevented if communication between companies and communities was improved right from the onset of mine development. However, it would also appear that mining operations often become caught up in the dilemma that Peru's institutions and governance structures have failed to allow local communities to effectively and constructively participate in political processes, that the formal legal system fails to recognize *de facto* property and rights, and that public service provision does not meet popular expectations. Many of these expectations are beyond what mining companies can, and arguably, should provide.

Recently, mining companies have had to negotiate directly with communities and those that claim to be their representatives on additional contributions provided at the local level. These arrangements have led to bidding processes where agreements reached in the short run do not appear to be stable in the long-term. In the language of game theory this is down to the lack of a legitimate and respected external enforcer, which in this case is the Peruvian government. Many survey results have shown that public institutions are the least trusted entities in Peru. In this situation, mining companies have come under pressure to provide goods and services, which are really the responsibility of government's social and industrial policies and the public sector at the sub-national level.

In summary, it would appear that the sort of macro policy reforms that were necessary for the mining industry to re-invest in Peru, have not been sufficient to satisfy social expectations, nor to improve the business environment and legislative framework for economic activity of smaller-sized and rural-based enterprises. The dilemma is that the central government strength in pursuing macro policy reforms is the mirror image of government's weakness in trust and legitimacy and its ability to implement policies and regulations at the sub-national level.

In line with recent research results, the report has identified 'governance' as a missing link in the transition mechanisms between macroeconomic improvements and social development and poverty reduction. But rather than looking superficially at aggregate indicators, the report has probed more deeply into the different dimensions of what it means to *govern*. Governance indicators have shown improvements in some areas, and, since 2001, particularly for democratic participation. But there is also the distinct lack of improvement in other areas, such as government effectiveness and the judiciary.

The more in-depth assessment of *governance* against the taxonomy developed in Phase 1 of this initiative shows problems in a number of areas and suggests that these are restraining the benefits of investments and growth to be distributed more evenly across the country and the social spectrum. Most noticeably:

- The political-administrative system points to various areas where current governance structures hamper the vertical public service delivery chain. In the past, political power was very centralized and did not encourage an accountability relationship between political representatives and executive decision-makers across the different tiers of government. Necessary economic and legislative reforms in the 1990s were much focused on central government capacity, and isolated certain administrative functions in well-functioning autonomous agencies, but neglected to improve the general efficiency of public administration and the legal system down to the municipal level.
- The process of political change that the country has been undergoing since 2001 is closely intertwined with the past dominance of executive power and the demand for decentralization and greater transparency. Decentralization and transparency are both necessary and welcomed. But they do not automatically guarantee better outcomes. This is particularly if sub-national executive responsibilities remain insufficiently defined and under-resourced, and if democratic political processes are unable to negotiate mutually acceptable trade-offs between different interests. Democratic political processes are hampered by current electoral rules, severe segmentation within the party system and limited ability to formulate programmatic objectives. This evokes tendencies to focus on personalities and patronage, and a high level of voter volatility. That decentralization is delayed reflects concerns that overall fiscal discipline may become a casualty of the process, given that regional and municipal governments require urgent institutional capacity building to translate inter-governmental transfers into public goods and services that improve economic opportunities and social conditions.
- Public financial management arrangements show that tax reforms in the early 1990s have not been matched by public expenditure management improvements across all tiers of government. Although there are significant improvements at the central government level, public service delivery and the operational efficacy of spending at the sub-national level remain very poor. Reform achievements at the top are not matched with equal improvements from the bottom up. In this context, substantially increased inter-governmental transfers from the mining sector (the *Canon Minero*) do not guarantee better short- or long-term outcomes. In fact, unless local and regional institutional and governance capacity is built rapidly, they could cause a local 'resource curse' syndrome.
- The legislative framework that has attracted foreign direct investment and the

private sector policies that have helped large companies to again become profitable in Peru have provided only limited opportunities for smaller local enterprises that have the greatest potential to meet employment expectations. One obstacle is the lack of formalization of the property of those entrepreneurs operating in the informal economy. Another has been that important social policy and labor market institutions have been dismantled rather than reformed, and this has inhibited constructive tripartite negotiations to overcome collective action and institutional problems.

6.3

SHORT-TERM GAINS OVER LONG-TERM IMPROVEMENTS?

In the current situation, it would appear the incentives for shortsightedness on behalf of all parties involved are stronger than those that encourage mutually beneficial long-term policies. Much of the onus to overcome the underlying collective action problem rests on government and its development partners. But all parties carry unilateral responsibilities to support long-term solutions. Quite clearly, there is a collective action problem that undermines achieving a win-win situation, which would improve the socio-economic conditions of communities in Peru and minimize risks for companies. It would appear that:

- *Local communities* have little faith and trust in central or sub-national governments. A majority of Peruvians look back to a history of economic and social exclusion, irrespective of who claimed to be their political representatives. In this situation it makes sense for communities to focus on alternative channels of political representation and to take a confrontational position if this increases the likelihood of generating immediate benefits. The extractive industries are an obvious target, not least because of the economic stakes that come with sizable foreign direct investment, but also people can point to tangible environmental and social impacts. Even where short-term gains are achieved, the long-term results are likely to include, at best, a limited developmental impact of compensatory payments that are not tied in with broader strategic goals and, worst, confrontation between local communities and national security forces when the latter forcefully defend central government's interests to secure revenue sources.
- *Mining companies* generally have to assume the property rights and policy decisions agreed with central government represent the interests of the host country's population, and that these have been aggregated through a legitimate political process that ensures the relative stability of these rights and decisions. Companies expect that central government can enforce those rights and decisions. But with a large informal economy and limited political representation this is a risky assumption to make. Additional demands from communities are viewed as compensation for potential negative environmental and social impacts, and an extra cost and necessary evil to ensure business operation. Quick fix responses to social demands, such as visible capital spending on projects, increased inter-governmental transfers, or direct agreements with interest groups, are often preferred to longer-term tripartite negotiations and contributions to building local administrative and entrepreneurial capacity. The dilemma is that local interest groups will also prefer these solutions, because central government lacks credibility to play its role in achieving the latter, and because its sovereignty guarantees the legislative framework that favors large companies.
- *Government* is not well trusted and suffers a deficit in internal legitimacy. However, externally it is well regarded for having pursued the right

macroeconomic policies and for maintaining fiscal stability. Thus central government does not take a pro-active stance in pushing institutional reforms to decentralize and to relax central power when it is already suffering from limited administrative authority to ensure that the civil service at the sub-national level (and the judiciary) delivers on implementing government policies. Furthermore, democratic principles that have now been restored require that the Congress set the legislative framework for government decisions, particularly with respect to fiscal and budgetary policies. But whilst accountability between the executive and the legislature may have increased, it would appear weak and easily politicized between the legislature and the electorate. There are various examples that demonstrate the short sightedness of recent practical solutions.

Long-term solutions would point towards building governance structures and administrative capacity at the local level that feed back into the national policy process, and allow legitimate government authority to implement stable and predictable policies to the effect that results deliver increased economic activities and social development. National policy processes at present are somewhat disconnected from the local level. Increased economic activities have occurred only in certain sectors and locations, and government authority to implement social policies falls short at the sub-national level. This undermines political stability and increases business risks.

6.4

IMPLICATIONS

If institutions and governance structures represent the main constraints to increasing the socio-economic benefits of mining investments in Peru, two important questions are raised:

- What are the likely consequences for the industry (for business risks and policy predictability) of mining investments going ahead, even when institutions and governance structures are deficient in effectively 'governing' the host country's society?
- Should mining investments therefore go ahead?

The Peru experience suggests that incomplete institutions and governance structures can and do undermine the actions taken by companies to respond to their social mandate. Given that production in the mining sector is projected to increase significantly over the next few years, the social and economic pay-offs for a given corporate outlay could much increase, particularly if administrative and financial capacity, as well as the legitimacy of, policy processes can be improved.

In relation to the second question, the Peru experience would suggest that mining has contributed significantly to the macroeconomic successes that have been achieved since the early 1990s. This justifies the decision to go ahead. Macroeconomic stability is a necessary condition for more equitable economic growth and for social development, although it is arguably not a sufficient condition.

The policy message for both companies and governments (as well as donors and NGOs) is that better institutions and governance structures are a crucial condition for long-term sustainable development. Thus these should be explicitly addressed at both the national and sub-national level. The benefits from mining investments can be significantly enhanced if institutions and governance structures are improved. The partial and highly centralized economic policy reforms of the early 1990s were inherent to Peru's political, economic and social problems at the time, but they remain

incomplete. Democratic transition and decentralization are important socio-political processes to consolidate the gains that these reforms have brought, but also to complement them with those aspects that have so far been ignored. Unfortunately, there is no assured way to accelerate this process. However, mining companies can play a role in this process, both through their social involvement and their business position.

However, a particular aspect is the manner in which central government relates to regional and local government, and thus how further progress in decentralization will take shape. Current arrangements, as well as those preceding the decentralization process, have not delivered the regulatory and policy frameworks and the public goods and services that improve social development, reduce poverty and support local entrepreneurial activities. The *Canon Minero* and also the mining royalty will channel greater amounts of funds back to mining areas, but present arrangement give little confidence that these funds can be spent efficiently and with a long-term view, or that examples of a local 'resource curse' can be prevented. Furthermore, present arrangements raise serious concerns whether increasing funds will not fuel political disputes and conflicts over distribution, with little emphasis on what is actually delivered in return.

What is needed is a more strategic approach to the legislative, infrastructural, economic and social needs, particularly of rural areas, and how different funding mechanisms, including central government funding, locally raised revenue, donor funding, NGO contributions and mining companies' social corporate responsibilities, can complement each other in supporting these. A more strategic approach would put the onus on administrative and strategic planning capacities in local communities and a 'bottom-up' rather than the current 'top-down' approach. Mining companies and other stakeholders can contribute to building such capacity through partnership arrangements that are geared towards overcoming the current collective action problems and legislative constraints. For mining companies this requires a more proactive rather than reactive approach to building social matters into company strategies.

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ANNEXES TO THE PERU CASE STUDY

9.1 GOVERNANCE PERFORMANCE IN RECENT YEARS

During the 1990s, the international community has put increasing emphasis on the quality of *governance* as an independent variable that explains cross-country differences in socio-economic outcomes. In the context of the 'resource curse' hypothesis, a number of quantitative studies have suggested that improved governance structures and institutions correlate with better development outcomes. Researchers have made use of indicators on the quality of governance reported by a number of survey institutes, think tanks, non-governmental organizations and international organizations, and compiled on the basis of perceptions gathered from a large number of enterprises, citizens and expert survey respondents. This section reports on the quality of governance in Peru compared with other Latin American countries, as measured by the World Bank Governance Indicators and the UNU World Governance Survey. These indicators would most likely appear in the governance conditionality that the Extractive Industries Review (EIR) proposed.

9.1.1 *The World Bank Governance Indicators*

Since the late 1990s, the World Bank has compiled six governance indicators, which combine several hundred individual variables measuring governance perceptions drawn from 25 separate data sources by 18 different organizations. The indicators measure three dimensions of governance, each of which has two indicators:

The first dimension measures the *process by which governments are selected, monitored and replaced*. The indicator '*Voice and Accountability*' refers to the extent to which citizens of a country are able to participate in the selection of governments and also measures various aspects of the political process, civil liberties and political rights. '*Political Stability and Absence of Violence*' measures perceptions of the likelihood that the government in power will be destabilized or overthrown by possibly unconstitutional and/or violent means.

The second dimension measures the *capacity of the government to effectively formulate and implement sound policies*. '*Government Effectiveness*' summarizes perceptions of the quality of public service provision, the quality of the bureaucracy, the competence of the civil servants, independence of the civil service from political pressures, and credibility of the government's commitment to policies. '*Regulatory Quality*' focuses on the policies themselves, including the extent to which the government intervenes in the market (wage/price controls, trade barriers, import/export regulations).

The third dimension summarizes the *respect of citizens and the state for the institutions that govern their economic and social interactions*. '*Rule of law*' measures the extent to which agents have confidence in and abide by the rules of the society. These include perceptions of the incidence of violent and non-violent crime, the predictability of the judiciary and the enforceability of contracts. Finally, '*Control of Corruption*' measures the perception of corruption, which is defined as the exercise of public power for private gain. According to the framework, the presence of corruption represents a lack of respect for, and the legitimacy of, formal institutions and thus governance failure.

These composite governance indicators measure in numerical values from -2.5 (worst) to +2.5 (best) and are subject to margins of error, which are clearly indicated. It is stressed that the indicators are indicative and should not be used to infer precise

country rankings.

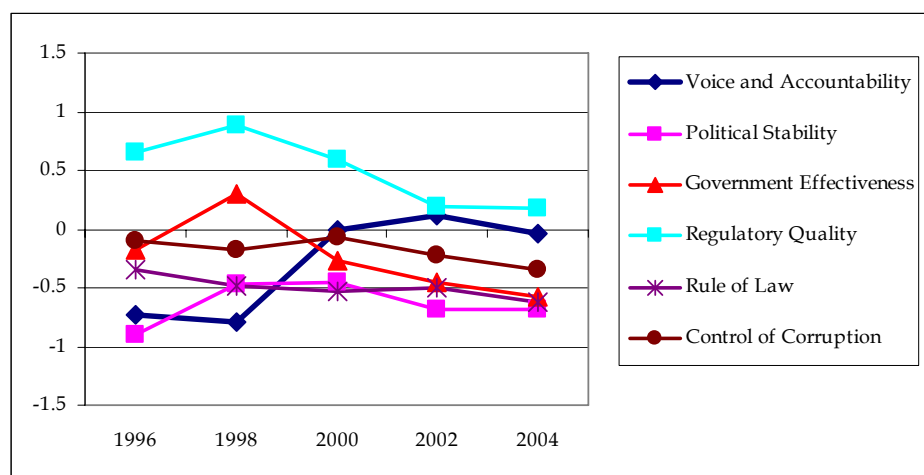
For Peru, the eight-year-period covered by the World Bank's governance indicators overlaps with major political changes from the last few years of the Fujimori government, to the transition government of Paniagua and the first two years of the Toledo government.

Table A1 Peru's Governance Indicators from 1996 to 2004

	1996	1998	2000	2002	2004
Voice and Accountability	-0.73	-0.79	-0.01	0.11	-0.04
Political Stability	-0.9	-0.47	-0.46	-0.69	-0.68
Government Effectiveness	-0.18	0.3	-0.27	-0.46	-0.58
Regulatory Quality	0.65	0.89	0.59	0.19	0.17
Rule of Law	-0.35	-0.48	-0.53	-0.5	-0.63
Control of Corruption	-0.1	-0.17	-0.07	-0.23	-0.35

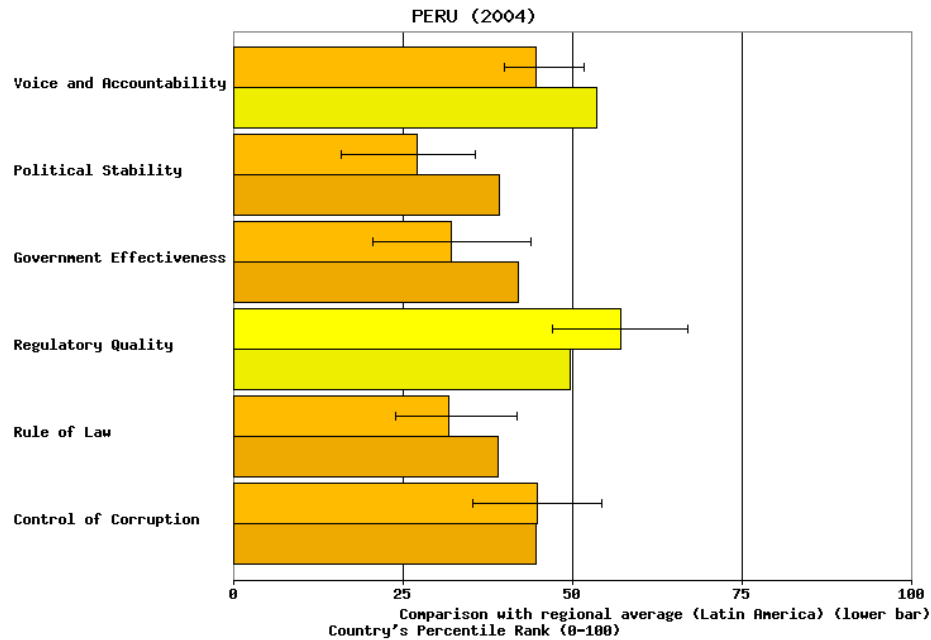
Table A1 and Figure A1 show that the two indicators measuring the capacity of the government to effectively formulate and to implement sound policies – ‘Government Effectiveness’ and ‘Regulatory Quality’ – saw some improvement from 1996 to 1998, which is the period when the Fujimori government faced increasing criticism for becoming more authoritarian. However, both indicators decline when the Fujimori government collapses and the transition government leading to Toledo's election in 2002 took over. The deterioration of government capacity appears to be mirrored by the improvement of ‘Voice and Accountability’ since 1998, which measures the process that selects, monitors and replaces governments. ‘Political Stability’ also improves to a lesser extent.

Figure A1 Peru's Governance Indicators from 1996 to 2004



The two indicators ‘Rule of Law’ and ‘Control of Corruption’ summarizing the respect of citizens and the state for the institutions that govern economic and social interactions remain roughly the same for the eight-year-period, with a slight decline in the two most recent years. The latter might be surprising, given that the Fujimori government collapsed over the Montesino's corruption scandal.

FigureA2 Peru Compared with Latin American Averages



In relation to Peru's absolute standards of governance, the data show continued deficiencies in all six indicators (remember that the maximum score is plus 2.5). Compared with other Latin American countries it would appear that Peru lags behind in the quality of the process by which governments are selected, monitored and replaced as measured by 'Voice and Accountability' and 'Political Stability'. Regarding the capacity to effectively formulate and implement sound policies, 'Government Effectiveness' shows that the Peruvian government is not as effective, but its 'Regulatory Quality' is a bit better than in many Latin American countries. The indicator 'Rule of Law', which measures citizens' and the state's respect for the institutions that govern their economic and social interactions, leaves most to be desired. Regarding the 'Control of Corruption', Peru would appear to perform at about the same level as its continental neighbors.

With the caveat that the statistical compilation of the WB Governance Indicators does not support a precise ranking of countries, Table A2 ranks Latin American countries by their aggregate governance values. It can be seen that Peru ranks quite a bit lower than many countries in the region, and certainly below Chile⁷⁰.

⁷⁰ Peru has recently been bypassed by Argentina and Nicaragua, which in 2002 had a lower overall level of governance.

Table A2 Peru Compared with Other Latin American Countries

Country	Population (million) /1	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory Quality	Rule of Law	Control of Corruption	Governance Totals /2
Chile	15.8	1.09	0.89	1.27	1.62	1.16	1.44	7.47
Puerto Rico	3.9	1.02	1.07	1.05	0.75	0.74	0.88	5.51
Costa Rica	4.0	1.11	0.98	0.49	0.67	0.57	0.78	4.60
Uruguay	3.4	1.00	0.49	0.52	0.30	0.42	0.50	3.23
Trinidad and Tobago	1.3	0.49	0.04	0.47	0.61	0.17	0.02	1.80
Panama	3.0	0.54	0.29	0.01	0.22	-0.04	-0.06	0.96
Mexico	102.3	0.36	-0.13	-0.02	0.55	-0.26	-0.27	0.23
Brazil	176.6	0.34	-0.13	0.02	0.19	-0.21	-0.15	0.06
Jamaica	2.6	0.54	-0.28	0.13	0.15	-0.32	-0.52	-0.30
El Salvador	6.5	0.26	-0.23	-0.22	0.56	-0.34	-0.39	-0.36
Dominican Republic	8.7	0.27	-0.01	-0.46	-0.28	-0.54	-0.50	-1.52
Nicaragua	5.5	0.06	-0.15	-0.71	-0.15	-0.65	-0.34	-1.94
Argentina	38.4	0.49	-0.24	-0.33	-0.81	-0.71	-0.44	-2.04
Peru	27.2	-0.04	-0.68	-0.58	0.17	-0.63	-0.35	-2.11
Bolivia	9.0	-0.01	-0.65	-0.63	0.05	-0.55	-0.78	-2.57
Honduras	7.0	-0.02	-0.69	-0.68	-0.33	-0.61	-0.71	-3.04
Colombia	44.4	-0.47	-1.69	-0.18	-0.12	-0.70	-0.16	-3.32
Guatemala	12.3	-0.39	-0.85	-0.87	-0.07	-0.96	-0.74	-3.88
Ecuador	13.0	-0.19	-0.83	-0.85	-0.60	-0.71	-0.75	-3.93
Paraguay	5.6	-0.23	-0.71	-1.07	-0.60	-1.09	-0.99	-4.69
Cuba	11.3	-1.88	0.18	-0.47	-1.81	-1.12	-0.62	-5.72
Venezuela	25.6	-0.46	-1.10	-0.96	-1.24	-1.10	-0.94	-5.80
Haiti	8.4	-1.50	-1.87	-1.90	-1.11	-1.66	-1.49	-9.53

Grey-shaded countries are mining countries as defined in the ICMM Phase 1 Report
/1 Countries with less than 1Mio inhabitants and associated countries (i.e. Guadeloupe, Martinique, Virgin Islands) have not been included
/2 Sum of five governance indicators

9.1.2

UNU World Governance Survey

As an alternative, the United Nations University's (UNU's) World Governance Survey proposes a political process approach to measure operational rules in use. It currently covers 16 countries, including the three Latin American countries of Peru, Chile and Argentina. The underlying UNU definition of governance focuses on the formal and informal rules of the political game. These constitute the framework within which political processes take shape. Table A3 shows how the political process is divided in to six institutional arenas.

- *Civil Society* links the smallest social units (i.e. families, communities) to the state. It is where values are formed and expressed and where interests are articulated.
- *Political Society* defines the area where citizens are represented and their views are aggregated into specific policy demands and proposals. The key components of political society are parties, electoral systems, national, sub-national or local authorities and the legislature. The legitimacy of the political society depends to a great extent on the credibility of individual legislators.
- *Government* as the executive is responsible for taking policy decisions and for establishing a political climate that ensures peace and security. This includes the relationship with the military, the prevention of extreme poverty and efficient management of the civil service.
- *Bureaucracy* is the administrative machinery that implements policies. It participates in formulating policies, implementing them and delivering public goods and services. Important aspects in this arena include the recruitment of civil servants, their accountability and decision-making processes within the

bureaucracy.

- *Economic Society* describes state-market relations. This includes the norms and institutions that regulate how enterprises and the self-employed operate, how property is owned and protected, how capital transactions take place and how trade is conducted.
- The *Judiciary* covers conflict and dispute resolution within the private sector and between private and public entities. This includes the rule of law but also affects informal mechanisms of conflict resolution.

Table A3 **Functional Dimensions of Governance and Their Institutional Arenas**

Process Dimension	Institutional Arena	Purpose of Rules
Socializing	Civil society	To shape the way citizens become aware of and raise issues in public.
Aggregating	Political society	To shape the way issues are combined into policy by political institutions.
Executive	Government	To shape the way policies are made by government institutions.
Managerial	Bureaucracy	To shape the way policies are administered and implemented by public servants.
Regulatory	Economic society	To shape the way state and market interact to promote development.
Adjudicatory	Judicial system	To shape the setting for resolution of disputes and conflicts.

The World Governance Survey is based on questionnaires completed by a wide spectrum of country representatives. It poses five questions in each of the six arenas, as summarized in Table A4 below. Respondents rate the specific issue using a 5-point response scale: very high, high, moderate, low, or very low. The index ranges from a minimum of 5 to a maximum of 25 points for each of the six governance areas. Table A shows the results for Peru in comparison with Chile and Argentina.

The respondents' assessment across all six governance areas for Peru improves noticeably from 1996 to 2000. In comparison, respondents' assessment of governance in Chile and Argentina for this period shows little change. The 2000 Survey was carried out after Fujimori had fled the country and reflects the political optimism of that period.

Particularly impressive are improvements in *Political Society* (the legislative) and *Civil Society*, where respondents felt that both the role of the legislature and civil participation in the public policy process had improved. In these arenas Peru had also caught up with Chile and Argentina. Noticeable improvements were also felt in *Judiciary* and *Government*, although gaps remain obvious, particularly compared with Chile.

Smaller improvements are recorded for *Bureaucracy* and *Economic Society*. The 1996 levels in both of these had already been close to those of Argentina. However, with regard to *Economic Society*, the lag compared with Chile has remained greatest. It is followed by lags regarding *Government* and the *Judiciary*, where Chile has shown its greatest improvements. Overall, it would appear that Peru remains weakest in *Bureaucracy* and *Judiciary*. The quality of the *Bureaucracy*, followed by the *Judiciary* and *Political Society*, remain the weakest points across all three Latin American countries.

Table A4 **Governance Arenas, Data Codes and Questions**

Arena	Questions and codes
Civil Society	FREX: To what extent do citizens have the freedom of expression? FPAA: To what degree do citizens have the freedom of peaceful assembly and association? DIPO: To what extent is there discrimination in politics? GFPD: To what extent do governments facilitate public discussion on major shifts in policy? CIRE: To what extent to citizens respect the system of rule-making?
Political Society	LREP: To what extent is the legislature representative of society? COPP: To what degree is there real competition for political power? PUPR: To what extent does the policy-making process fairly reflect public preferences? LEFU: To what extent does the legislative function affect policy content? LEAP: To what extent are legislators accountable to the public?
Executive	PSEC: To what extent is the government committed to ensuring the personal security of citizens? STOL: To what extent is the government committed to ensuring an adequate standard of living for citizens? NATI: To what extent are leaders encouraged to make tough decisions that are in the national interest? MISU: To what extent does the military accept its subordination to a civilian government? PRIC: To what extent is the government committed to peaceful resolution of internal conflicts?
Bureaucracy	HICS: To what extent are higher civil servants part of the policy-making process? MEBA: To what extent is there a merit-based system for recruitment into the civil service? ACCO: To what extent are civil servants accountable for their actions? DEPR: To what extent are there clear decision-making processes in the civil service? EAPS: To what extent is there equal access to public services?
Economic Society	PRPR: To what extent do persons in public office promote respect for property rights? REFI: To what extent are economic regulations applied equally to firms in the economy? COTR: To what extent is obtaining a business license associated with corrupt transactions? CPPP: To what extent is there consultation on policy between public and private sector actors? GLTR: To what extent does government take the new rules of global trade, finance, and technology flows into account when formulating policy?
Judiciary	JUCI: To what extent is there equal access to justice for citizens? DMJS: To what extent are there clear decision-making processes in the judicial system? JUOA: To what extent are judicial officials accountable for their actions? ILHR: To what extent are international legal norms in the human rights field being incorporated into NJPC: To what extent are non-judicial processes in place for fair resolution of conflicts?

Table A The World Governance Survey for Peru Compared with Chile and Argentina

		Civil Society					Political Society					Government							
		FREX5	FPAA5	DIPO5	GFPD5	CIRE5	sum	LREP5	COPP5	PUPR5	LEFU5	LEAP5	sum	PSEC5	STOL5	NATI5	MISU5	PRIC5	sum
1996	Argentina	3.89	4.43	3.00	1.77	2.46	15.5	2.14	3.46	2.21	2.36	2.20	12.4	2.60	2.51	2.41	4.17	3.77	15.5
	Chile	3.37	4.10	2.57	2.53	3.77	16.3	2.70	3.63	2.77	3.30	2.30	14.7	3.43	3.33	2.70	2.43	3.93	15.8
	Peru	2.05	2.89	3.16	1.65	1.77	11.5	1.92	1.92	2.24	1.76	1.46	9.3	2.22	2.54	2.57	1.59	2.35	11.3
		Bureaucracy					Economic Society					Judiciary							
		HICS5	MEBA5	ACCO5	DEPR5	EAPS5	sum	PRPR5	REFI5	COTR5	CPPP5	GLTR5	sum	JUCI5	DMJS5	JUOA5	ILHR5	NJPC5	sum
1996	Argentina	2.83	1.63	2.03	1.80	2.57	10.9	2.74	2.17	1.83	3.13	3.56	13.4	2.43	2.01	1.99	3.51	2.77	12.7
	Chile	3.03	2.43	2.63	2.87	3.20	14.2	3.83	3.77	3.77	3.25	3.98	18.6	2.50	2.50	2.63	3.13	2.43	13.2
	Peru	2.76	2.14	1.84	1.68	2.57	11.0	2.84	2.59	2.62	1.97	3.11	13.1	1.46	1.43	1.49	1.70	2.16	8.2
		Civil Society					Political Society					Government							
		FREX	FPAA	DIPO	GFPD	CIRE	sum	LREP	COPP	PUPR	LEFU	LEAP	sum	PSEC	STOL	NATI	MISU	PRIC	sum
2000	Argentina	3.97	4.49	2.77	1.86	2.43	15.5	2.17	3.51	2.33	2.77	2.20	13.0	2.69	2.66	2.40	4.23	3.89	15.9
	Chile	3.70	4.27	3.43	2.87	3.60	17.9	2.73	3.93	2.83	3.40	2.40	15.3	3.70	3.63	2.87	3.20	4.20	17.6
	Peru	3.43	4.05	3.19	2.81	1.97	15.5	2.27	3.46	2.84	3.27	2.00	13.8	3.03	2.64	2.51	2.97	3.38	14.5
		Bureaucracy					Economic Society					Judiciary							
		HICS	MEBA	ACCO	DEPR	EAPS	sum	PRPR	REFI	COTR	CPPP	GLTR	sum	JUCI	DMJS	JUOA	ILHR	NJPC	sum
2000	Argentina	2.94	1.70	2.11	1.86	2.77	11.4	2.74	2.36	1.91	3.16	3.54	13.7	2.43	2.16	2.21	3.80	2.91	13.5
	Chile	3.00	2.47	2.83	2.93	3.37	14.6	3.87	3.83	3.80	3.50	4.18	19.2	2.67	3.00	3.03	3.70	2.67	15.1
	Peru	3.00	2.16	2.54	2.14	2.65	12.5	2.70	2.78	2.88	2.41	3.16	13.9	1.92	1.78	2.05	3.68	2.68	12.1

Note: The maximum score on the sums in the table is 25.

It is not possible to directly compare the results of the UNU World Governance

Survey with those for the WB Governance Indicators. However, individual questions underlying the WGS can broadly be re-grouped to correspond with the six World Bank governance indicators. When doing so, as suggested by the authors of the UNU WGS, the results are to some extent similar to those derived by the World Bank⁷¹. Answers relating to questions around *'Voice and Accountability'* and *'Political Stability'* are significantly more positive, whilst improvements regarding the other four indicators are more moderate, particularly for *'Control of Corruption'* and *'Regulatory Framework'*.

9.1.3

Implications

Both time series cover only a short period. They show that the political transition at the beginning of the 21st century has led to more participation and trust of society in the political process (*'Political Society'* and *'Voice and Accountability'*) and has also improved political rights. But real improvements remain outstanding in the workings of the public service and administration (*'Bureaucracy'*, *'Government Effectiveness'* and *'Regulatory Quality'*) and the legal system (*'Judiciary'* and *'Rule of Law'*). It is these improvements that are key in delivering better services to people and enabling them to take advantage of economic opportunities. They are also key elements in the transmission link between revenue from mining activities paid to central government and the social and economic benefits that citizens receive in return.

The governance indicators have two drawbacks:

- They tell little about the underlying socio-political processes that have driven the changes seen in Peru's governance performance. They do not explain how these processes have resulted from, or caused, institutional change and what the opportunities for further institutional change might be. Thus, governance indicators raise important questions, but do not give answers.
- They do not distinguish between the vertical tiers of government (national, regional, provincial, district) and thus shed little light on how weaknesses in public authority reach down the vertical government chain to impact on the overall quality of the governance system. Identifying vertical weaknesses within the public administrative system and how these relate to political structures and processes is crucial for overcoming collective action problems and redesigning incentives to achieve better results.

⁷¹ Hyden, G., Court, J. and Mease, M. (2004)

Ministry of Energy and Mines

March 22, 2006

Dear Mr. Mitchell,

This is in response to your request for comments regarding the content of your organization's Resource Endowment Project report on the Peruvian case study.

In general, we agree with the overall assessment that Peru's political and economic reforms of the last ten years or so have been very effective in attracting and fostering significant injections of capital and know-how into many successful productive activities, which in turn fostered macroeconomic stability that is ever crucial as foundation for a country's development.

Unfortunately, we also agree that in the case of Peru these reforms were still not sufficient in ensuring true development leading to poverty alleviation and social advancement. Therefore, as the study argues well, the dilemma and challenge for this and future governments will be to mirror the successful macro policy reforms in place, with the ability to implement policies and regulations at the sub-national levels.

In this sense, the study is particularly helpful in pointing key issues and aspects that deserve special attention. I particularly concur with the assertion that only a long-term outlook should lead to sustainable solutions, and that this outlook should be the shared responsibility of everyone in Peruvian society, not just government and industry. Indeed, the primary thing we should be doing in the short-term in Peru is to get started working on long-term strategies and policies.

The risk of doing nothing is great and especially apparent in these times of very high mineral commodity prices.

In closing, on behalf of the Government of Peru I would like to commend the initiative that led to this seminal study which demonstrates that natural resource endowment, economic development and social advancement, can and should be complementary concepts.

Sincerely,

Glodomiro Sanchez Mejia
Minister of Energy and Mines