

Background

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Peru's Next President Should Continue Political and Free Market Reforms

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Abstract: *The United States and Peru have a strong and positive relationship that is helping to strengthen Peru's democratic institutions and speed its integration into the globalized economy. This April, Peruvian voters will choose a new president, who will hopefully continue efforts to curb corruption, strengthen property rights, and effectively combat narco-terrorism. Alternatively, if a leftist government is elected, it could slow reform or even return Peru to populist statism, stunting Peru's economic growth and development. In the run-up to the election, the Obama Administration should reaffirm by statements and actions that the United States wants Peru to stay the course on free market reforms, decentralize government power, and reject any attempt to return the country to failed statist policies.*

The election of Susana Villaran as mayor of Lima in October 2010 portends a possible resurgence of the left in Peru. Villaran, a self-styled "Peruvian Bachelet,"¹ claims the mantle of a moderate and democratic center-leftist, even though her Social Force Decentralist Party is allied with several far-left parties. Villaran's win raises the specter of a potentially successful alliance of leftist movements for the April 10 presidential election or the likely second round later in the month. This threat is personified by Ollanta Humala of the Partido Nacionalista Peruano (PNP), who is vying for the lead in the pre-election polls.²

Humala, whose varied career includes alleged involvement in an attempted coup, alleged human rights abuses, and a close loss in the 2006 presidential

Talking Points

- The United States and Peru have a strong and positive relationship that is strengthening Peru's democratic institutions and speeding its integration into the globalized economy.
- The United States enjoys trade surpluses with Peru and is Peru's largest foreign investor.
- This April, Peruvian voters will choose a new president who will either expand economic and democratic reforms or who could lead the country back into populist statism.
- The next president of Peru needs to continue reforms to curb corruption, strengthen property rights, decentralize Peru's governing institutions and make them more effective, and combat narco-terrorism.
- President Obama should make it clear that the United States is interested in a free and prosperous Peru, where poverty is reduced and jobs are created through private sector-led trade and investment.

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election, poses the greatest challenge to further liberalizing and growing Peru's economy.

The Presidential Candidates

Humala's far-left credentials are impeccable. Venezuelan President Hugo Chavez and Bolivian President Evo Morales endorsed him in the 2006 elections, and Humala has committed to limiting foreign investment and expanding state control over the economy.³ A Humala presidency would be disastrous for Peru, curtailing recent improvements in economic freedom and income growth. Even if Humala does not win, his party will likely gain control of several regional governments, a result that could pose a long-term threat to the next president of Peru.

Competing with Humala are several presidential candidates who would defend recent economic reforms. Recent polls show Keiko Fujimori, daughter of former President Alberto Fujimori, as the front-runner among the centrist and center-right candidates, but still behind Humala. Former President Alejandro Toledo is close behind. Former Prime Minister Pedro Pablo Kuczynski and Luis Castañeda, former mayor of Lima, also have significant backing.⁴

However, the strong showing of regional parties in the October 2010 elections highlights the underlying weakness of these presidential campaigns. The national parties are largely *caudillo* movements, serving mainly as vehicles for presidential candidates. They have only limited connections to local issues. This has left a vacuum that leftist parties, such as Humala's, have filled by allying with local movements. If the national center and center-right

Streamlined procedures for business formation, a more open trade regime, increasingly flexible labor regulations, and modest levels of government spending have been key components of Peru's blossoming economy.

political parties do not continue reforms begun by outgoing President Alan Garcia—including empowering local government and decentralizing national government structures so that more small businesses will join the formal economy—leftist movements will likely gain power, undermining Peru's democracy and economy.

Needed Reforms

The next president of Peru will need to address Peru's remaining institutional weaknesses: inadequate protection of property rights, an inefficient judicial system, and a lack of political will to tackle corruption. Although with an overall score of 68.6 in the 2011 *Index of Economic Freedom*, published by The Heritage Foundation and *The Wall Street Journal*, Peru currently enjoys a relatively high ranking (fifth out of 29) among the countries in the region. However, it scores considerably below the world average in the rule-of-law components of economic freedom: property rights and freedom from corruption.⁵

Peru has been declared one of Latin America's rising stars, thanks in part to its strong economic growth in recent years.⁶ This growth has substantially reduced the poverty rate from 44.5 percent in 2006 to 34.8 percent in 2009. According to the 2011 *Index of Economic Freedom*, streamlined procedures for business formation, a more open trade

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1. Michelle Bachelet, a socialist, was president of Chile (2006–2010).
 2. John Quigley, "Peru's Sol Plunges Most in Year as Chavez Ally Climbs in Pre-Election Poll," Bloomberg, March 28, 2011, at <http://www.bloomberg.com/news/2011-03-28/chavez-ally-gains-in-deadlocked-peru-presidential-poll-before-april-vote.html> (March 28, 2011).
 3. Edwar Escalante and Stephen Johnson, "Populism Clouds Peru's Presidential Race," Heritage Foundation *WebMemo* No. 1028, April 5, 2006, at <http://www.heritage.org/Research/Reports/2006/04/Populism-Clouds-Perus-Presidential-Race>.
 4. Reuters, "Humala Extends Lead in Peru Presidential Race," April 1, 2011, at <http://www.reuters.com/article/2011/04/01/us-peru-election-idUSTRE7303A220110401> (April 1, 2011).
 5. Terry Miller and Kim R. Holmes, *2011 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2011), s.v., "Peru," at <http://www.heritage.org/index>.
 6. Simon Romeo, "Economies in Latin America Race Ahead," *The New York Times*, June 30, 2010, at <http://www.nytimes.com/2010/07/01/world/americas/01peru.html> (April 1, 2011).

regime, increasingly flexible labor regulations, and modest levels of government spending have been key components of Peru's blossoming economy.⁷

Despite this progress, further social, economic, and security reforms are desperately needed. Corruption remains a significant obstacle to investment and growth. This problem will only grow if narco-terrorism is not effectively combated. Structural impediments, such as Peru's burdensome and opaque bureaucracy and its highly centralized approach to governance, also inhibit economic growth.

Corruption and Governmental Reform

Government corruption creates an environment in which the government's coercive power can determine economic winners and losers, undermining economic growth and democracy. More than 50 percent of Peruvians consider corruption a greater threat than poverty.⁸ The central government, police, and justice system are considered especially corrupt, which undercuts their legitimacy and ability to enforce the rule of law. Corruption is perceived as pervasive in social and governmental institutions, especially by poorer Peruvians who have only marginally benefited from Peru's economic growth. This disillusionment with the authorities can translate into a loss of faith in liberalizing reforms and facilitate the rise of charismatic leftists who rail against the system. In the name of combating corruption and social justice, Humala and other leftists champion proposals maximizing the role of the state in all financial activities.

However, such "Bolivarian" statism would only increase corruption, which inevitably flourishes when economic power is centralized in the state's hands. Limiting the state's power so that it cannot expropriate land without warning or impose vast and nebulous regulations on businesses would

remove many rich opportunities for bribery. As President Gerald Ford once observed, paraphrasing Thomas Jefferson, "a government big enough to give you everything you want, is a government big enough to take from you everything you have."⁹

Historically, centrally planned economies have been breeding grounds for corruption. Russia and Venezuela are modern examples.¹⁰ The prescription for combating corruption in Peru is greater economic freedom, not a return to statism.

Peru's opaque and burdensome bureaucracy also stifles economic freedom. While the Garcia government has made significant economic and political reforms while maintaining a stable and healthy economy during the global financial crisis, it ignored the pressing need for government reform. The entire bureaucratic system needs restructuring. The current bureaucracy is bloated, expensive, and unable to respond to the pressing problems in education and health services, especially in undeveloped rural areas.

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The key to streamlining Peru's bureaucracy is to devolve power to regional and local government, increasing the accountability of Peru's bureaucracy and enabling regional and local government to target spending more effectively. Currently, local authorities have little capability to design projects and execute spending. Instead, the central government indulges in centrally planned, government-funded "white elephant" industrial projects and other types of waste.

7. Miller and Holmes, *2011 Index of Economic Freedom*, s.v., "Peru."

8. Proetica, Confederación Nacional de Instituciones Empresariales Privadas, and Ipsos APOYO, "Sexta Encuesta Nacional sobre percepciones de la corrupción en el Perú," 2010, at <http://www.proetica.org.pe/Descargas/Proetica-VI-Encuesta-sobre-Corrupcion.pdf> (April 1, 2011), and Isabel Guerra, "Citizens Believe Corruption on the Rise in Peru, Survey Shows," *Living in Peru*, August 18, 2010, at <http://www.livinginperu.com/news/12930> (April 1, 2011).

9. Gerald R. Ford, address to a joint session of Congress, August 12, 1974, at <http://www.presidency.ucsb.edu/ws/index.php?pid=4694> (March 28, 2011).

10. James M. Roberts, "Cronyism: Undermining Economic Freedom and Prosperity Around the World," *Heritage Foundation Backgrounder* No. 2447, August 9, 2010, at <http://www.heritage.org/Research/Reports/2010/08/Cronyism-Undermining-Economic-Freedom-and-Prosperity-Around-the-World>.

Regrettably, previous attempts to decentralize power have failed because of troublesome bureaucratic procedures governing the approval of regional spending and a lack of human capital at the regional level. Yet these obstacles are surmountable.

First, the central government should eliminate the requirement that regional and local spending must be approved by the central bureaucracy. The current system offers little true autonomy at the regional and local levels, maintaining the central bureaucracy's dominant position. The priorities and goals of investment projects are defined poorly, and the projects concentrate money in the Ministry of Economy and ultimately spur more rural unrest, undermining the government's goal of promoting competitiveness throughout Peru.

Instead of retaining the money in the central government, funding should be allocated to the

Devolving power to local and regional governments would increase development, especially in rural areas that have so far enjoyed only limited benefits from economic liberalization.

regional and local levels to be spent as they see fit, with the condition that these governing bodies meet certain goals, such as improved access to electricity or lower poverty levels. To improve accountability, regional and local government should also be required to publish the amount of funding received, how it was spent, and which part of the bureaucracy spent it. If the rules for obtaining and using funding are clear and transparent, civil servants at the local level could target spending more effectively and be held accountable for results.

Devolving power to local and regional governments would increase development, especially in rural areas that have so far enjoyed only limited benefits from economic liberalization. Devolving power would also reduce corruption. If local governments play a significant role in governance, justice admin-

istration, education, and provision of basic services will improve. Meanwhile, regional governments can streamline entrepreneurial procedures, eliminate regulations, and simplify the process of obtaining licenses and authorizations.

The next administration in Lima needs to initiate government reform soon after taking office. Only a popular regime in its first few months in office enjoys the legitimacy and consensus necessary to tackle such difficult and important reforms.

Property Rights

Expanding and strengthening property rights will be critical to attracting more investment and defusing potential social conflicts. Property rights are not well defined, especially in less-developed regions. While the government's land titling programs have made progress, not enough has been done. Individuals still face many limits on using property as collateral, and this impedes investment and growth. Furthermore, indigenous communities believe their rights and concepts of ownership are being ignored.

Logging of tropical timber has fueled social unrest in several regions, largely due to poorly defined property rights. Peru has not successfully created a process for recognizing the property rights of indigenous communities, even when they are directly involved in logging activities. This has led to social unrest. For example, when Garcia's administration pushed a law facilitating foreign investment in the Peruvian Amazon, indigenous groups launched mass protests in which they occupied oil installations, threatened to cut power to Lima, and killed several police officers.¹¹

These protests have threatened Peru's free trade agreement with the United States and frightened away potential foreign investors. While Peru's natural resources should be developed, indigenous groups must believe that their property rights will be respected, or social conflict will continue to obstruct the economic development needed to reduce poverty among the poorest citizens.

11. Simon Romero, "Protesters Gird for Long Fight over Opening Peru's Amazon," *The New York Times*, June 11, 2009, at <http://www.nytimes.com/2009/06/12/world/americas/12peru.html> (March 28, 2011).

Security and Narcotics Traffic

Peru's gravest security threat is narco-terrorism. A recent United Nations report raised the alarm, claiming that while "[t]he cultivation of the raw material for cocaine has declined significantly in Colombia," the situation in Peru was "worrying with the amount of narcotic grown there constantly rising."¹² Peru may soon earn the dubious honor of becoming the world's largest producer of coca leaves. This would seriously threaten Peru's security by providing funding for terrorist organizations, such as the Shining Path, in addition to fueling corruption and crime.¹³ Colombia's bitter experience in fighting the Revolutionary Armed Forces of Colombia (FARC) shows the devastation that the drug trade can unleash.

To combat drug trafficking, Peru should copy the highly successful policies of former Colombian President Alvaro Uribe that combined security operations with increased economic development in rural areas. Reforms that increase the flexibility

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of Peru's labor regulations and enhance economic growth would promote job creation and offer an alternative to coca cultivation. Meanwhile, security forces should crack down on cocaine production and drug trafficking.

Peru would also benefit greatly from improved cooperation with the United States and the European Union. The U.S. could greatly reduce drug trafficking by continuing to provide Peru with

the necessary technology, intelligence, and financial resources to combat drug trafficking,¹⁴ while simultaneously working to reduce the demand for cocaine in the United States and Europe.

If the next president does not continue President Garcia's strong stand against narco-terrorism, the security of Peru's citizens and democracy may be threatened. President Evo Morales has already set a negative precedent in Bolivia by ending anti-drug cooperation with the U.S.

Next Steps

President Garcia will leave office having achieved much in his second term. His presidency made significant strides in reducing poverty and increasing per-capita income. Peru's commitment to free trade will provide a strong base for sustained economic growth, but the next president needs to keep Peru on the path toward sustained financial stability and growth.

When the next government takes office in July 2011, it will need to begin the next phase of reforms. Peru could still falter. Social conflicts, narco-terrorism, or government intervention in the economy are potential stumbling blocks. Only sustained economic liberalization and reform can extend freedom to every Peruvian and save the country from the Chavistas' "socialism of the 21st century."

Peru has been a long-term friend, ally, and business partner of the United States. The U.S.–Peru free trade agreement, ratified in 2007, has strengthened that relationship. The United States has enjoyed increasingly large trade surpluses with Peru and has become Peru's largest foreign investor.¹⁵ The election of a Chavez-style populist/leftist, such as Humala, would endanger Peru's gains.

12. U.N. News Centre, "Coca Cultivation Declining in Colombia but on the Rise in Peru, UN Agency Reports," June 22, 2010, at <http://www.un.org/apps/news/story.asp?NewsID=35096&Cr> (April 1, 2011).

13. James M. Roberts and Edwar Enrique Escalante, "Narco-Terrorism in Peru: The Return of Shining Path," Heritage Foundation *WebMemo* No. 2473, June 9, 2009, at <http://www.heritage.org/Research/Reports/2009/06/Narco-Terrorism-in-Peru-The-Return-of-Shining-Path>.

14. In fiscal year 2010, the U.S. gave Peru \$40 million in counternarcotics funding. U.S. Agency for International Development, "Fiscal Year 2012 Congressional Budget Justification: Foreign Assistance Summary Tables, Fiscal Year 2012," p. 9, at <http://www.usaid.gov/performance/cbj/158269.pdf> (April 1, 2011).

15. The U.S. trade surplus with Peru was \$371 million in 2008 and \$696 million in 2009. U.S. Department of State, Bureau of Western Hemisphere Affairs, "Background Note: Peru," September 30, 2010, at <http://www.state.gov/r/pa/ei/bgn/35762.htm> (March 30, 2011).

President Barack Obama should make it clear that the United States is interested in a free and prosperous Peru, in which economic growth reduces poverty and the private sector creates jobs. He could refer to his recent trip to Latin America during which he visited other successful democracies in Chile, Brazil, and El Salvador and express his hope that Peruvian voters would choose to remain in that group of upward-bound nations.

Only sustained economic liberalization and reform can extend freedom to every Peruvian and save the country from the Chavistas' "socialism of the 21st century."

The Obama Administration should make it clear that the United States expects Peruvians to act in their own best interests by electing a new government that will continue the free market reforms. The Obama Administration should engage the Peruvian people and encourage them to elect a new president who will:

- Address Peru's remaining institutional weaknesses, including inadequate protection of property rights, an inefficient judicial system, and pervasive corruption, and
- Devolve spending authority to regional and local governments, freeing them from the stifling central bureaucracy.

Conclusion

The strong and positive relationship enjoyed by the United States and Peru is a lynchpin in U.S. Latin American policy and important to the U.S.-led Pacific Rim free trade area strategy. It is vital that the Obama Administration take steps to encourage the next Peruvian president to preserve and strengthen Peru's democratic institutions and to speed its integration into the global economy.

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