4 Peru

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I. Introduction

Facing the Pacific Ocean, Peru is located on the West Coast of South America. It borders with Ecuador and Colombia to the North, Brazil and Bolivia to the East, Chile to the South, and the Pacific Ocean to the West. It has an approximate surface area of 1,285,216 km2 and the right to 200 nautical miles on the Pacific Ocean. Peru is divided by the Andes Mountains into three sharply differentiated zones: i) To the west is the **Coastline**, a desert belt extending along the Pacific coast that occupies about 10% of the territory. Here people engage in agriculture in oases developed at the mouths of 50 or so rivers fed by snowmelt from the Andes and their villages have developed further into cities; ii) The **Mountain** area, occupying about 30% of the territory, extends north and south along the Andes. People in this region, which has various altitudes and diversified climate conditions, engage in a variety of agriculture and stock farming. The western system of the Andes is a dry region without rain, while the valleys and heights at altitudes between 2500 meters and 4000 meters in the eastern have a dry season and a rainy season. The region is studded with a number of villages of indigenous Indios who have developed advanced agriculture (potatoes) and animal husbandry (llamas and alpacas). iii) Beyond the mountains to the east is the heavily forested slope leading to the **Amazonian** plains, occupying 60% of the territory, is a high-temperature, rainy region extending from the eastern slopes of the Andes to the region where the Amazon rises. Farming is conducted in comparatively high altitude areas, while low-altitude wetlands are sparsely populated and covered with thick forests having a variety of vegetation.

Peru has two official languages: Spanish and the foremost indigenous language, Quechua. About 45% of Peru's total population (27. 5 million in 2003) is indigenous, while mestizos make up about 37% and whites 15%. There are also small numbers of persons of Japanese, Chinese, and African descent. Most of the native inhabitants speak Quechua or Aymara (ancient language); they live in the Andes and retain much of their traditional way of life. Small groups of indigenous peoples live in the isolated rain forest of Peru and speak a variety of languages.

The religion of Peru is an inheritance of the Spanish conquest, for this reason, it is a mainly Catholic country (more than 80% of the population).

The Republic of Peru is democratic, social, independent, and sovereign. The State is not divisible and its government is unitary, representative, and decentralized. The government of Peru is organized according to the principle of separation of powers. Peruvian government is divided into three separate and independent branches: the Executive, the Legislative, and the Judiciary. The Constitution defines the jurisdiction of each branch, their members and the criteria for the selection of such members. **The Executive** branch comprises the President of the Republic and the Ministers of State. The President is elected for a five-year term and can only be reelected for another period of five years. **The Legislative** branch comprises the National Congress, which is unicameral with one hundred and twenty members elected for the five-year presidential period. **The Judiciary** arrives at independent decisions for the resolutions of cases in disciplinary, economic, and administrative issues. The judiciary has four levels: the Supreme Court, various Superior Courts, trial judges and justices of peace. The judicial system is organized according to Peruvian political divisions.

II. Overview of Macroeconomic Activity and Fiscal Position

Farming provides the livelihood for the majority of Peruvians, some of whom remain outside the money economy. The chief farm commodities produced are cotton, sugarcane, coffee, wheat, rice, corn, and barley. Large numbers of poultry, sheep, cattle, llamas, alpacas, and hogs are raised. The country has one of the major fishing industries in the world, mostly small anchovies that are processed into fishmeal for use as animal feed.

Peru has a large mining industry, the most valuable minerals being copper and silver. Gold, iron ore, coal, and phosphate rock are also extracted. Petroleum is produced along the northern coast and in the Amazon basin, and there is a large refinery at Talara. Peru's principal manufactures include textiles, consumer goods (clothing, footwear, and household appliances), processed food, cement, refined minerals (especially copper, zinc, and lead), and processed fish. There is a substantial tourist industry.

The main exports are fish meal, cotton, sugar, coffee, and minerals. The main imports are food, machinery, metals, chemicals, and motor vehicles. Economic development has been hindered by the country's poor transportation network, which has left large blocks of Peru isolated. High inflation and high foreign debt also hindered the economy throughout the 1980s. In the 1990s, Peru made great strides in paying off its international debt, soliciting foreign investment, and privatizing state-owned industries, even as its economy was adversely affected by the Asian financial crisis. Its chief trade partners are the United States, Latin America, the United Kingdom, Japan, and China.

Since 1990, the Peruvian economy has been involved in a deep process of structural reform, one committed to modernizing the country in the economic and institutional senses, while also attracting investment. To reach that goal the Government has promoted macroeconomic discipline, established market rules, dismantled the trade protection structure, reinserted the economy into the world financial circuit and brought about an all-encompassing deregulation of the economy.

II.1 Macroeconomic Activity

Peru’s economy is one of the most dynamic in Latin America, showing particularly strong growth over the past three years. During the 1990s, Peru was transformed by market-oriented economic reforms and privatizations, and met many conditions for long-term growth. From 1994 through 1997, the economy recorded robust growth driven by foreign direct investment, but stagnated from 1998 through 2001. Upon taking office in 2001, President Alejandro Toledo maintained largely orthodox economic policies, and took measures to attract investment. GDP grew 4.9% in 2002, 3.8% in 2003, and an estimated in 5% in 2004. Recent economic expansion has been driven by construction, mining, investment (particularly in the Camisea natural gas project), domestic demand, and exports. Inflation was 3.5% in 2004, and the fiscal deficit fell to 1.4 % of GDP. External debt decreased to 44% of GDP, and foreign reserves reached a record $12.6 billion by the end of 2004.

Peru’s economy is well managed, and better tax collection and growth are hiking revenues, with expenditures keeping pace. Private investment is rising and becoming more broad-based. The government has had success with recent international bond issuances, resulting in ratings upgrades.

Table 1 Macroeconomics variables (in percentage of GDP)

	1999	2000	2001	2002	2003	2004
			SAVINGS-INVESTMENTS			
Domestic savings	**18.3**	**17.3**	**16.7**	**16.9**	**17.3**	**18.5**
Public sector	1.7	0.7	0.7	0.7	1.2	1.8
Private sector	16.6	16.6	16.0	16.2	16.1	16.7
External savings	**2.9**	**2.9**	**2.1**	**1.9**	**1.5**	**0.0**
Investment	**21.2**	**20.2**	**18.8**	**18.8**	**18.8**	**18.5**
Public sector	4.9	4.0	3.1	2.8	2.8	2.8
Private sector	16.3	16.2	15.7	16.0	16.0	15.7
			BALANCE OF PAYMENTS			
Current account balance	**-2.9**	**-2.9**	**-2.1**	**-1.9**	**-1.5**	**0.0**
Trade balance	-1.3	-0.8	-0.4	0.5	1.4	4.1
Services	-1.3	-1.3	-1.7	-1.7	-1.4	-1.2
Investment income	-2.2	-2.7	-2.1	-2.6	-3.5	-5.0
Current transfers	1.9	1.9	1.9	1.8	2.0	2.1
Financial account	**1.1**	**1.9**	**2.9**	**3.2**	**1.1**	**3.3**
Private sector	3.3	2.8	1.8	2.7	-0.2	1.5
Public sector	0.7	0.5	0.7	1.9	1.0	1.4
Short-term capital	-2.9	-1.4	0.4	-1.4	0.2	0.3
Exceptional financing	**0.0**	**-0.1**	**0.0**	**0.0**	**0.1**	**0.0**
BCR net international flow (-)	**1.5**	**0.4**	**-0.8**	**-1.5**	**-0.8**	**-3.4**
Net errors and omissions	**0.2**	**0.7**	**0.1**	**0.1**	**1.1**	**0.1**
			NON-FINANCIAL PUBLIC SECTOR			
Current account saving	**1.7**	**0.7**	**0.7**	**0.7**	**1.2**	**1.8**
Capital revenue	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**
Capital expenditure	**5.0**	**4.2**	**3.3**	**3.0**	**3.0**	**3.0**
Public investment	4.9	4.0	3.1	2.8	2.8	2.8
Other capital expenditure	0.2	0.2	0.2	0.2	0.2	0.2
Overall balance	**-3.2**	**-3.3**	**-2.5**	**-2.3**	**-1.7**	**-1.1**
Financing	**3.2**	**3.3**	**2.5**	**2.3**	**1.7**	**1.1**
External financing	-0.2	1.2	0.9	2.1	1.4	1.5
Domestic financing	2.7	1.3	1.0	-0.6	0.3	-0.7
Privatization	0.8	0.8	0.6	0.8	0.1	0.2

Source: BCRP

A. International Environment

a) Balance of Payment

2004 was a particularly favorable year for the Peruvian economy's external accounts. Increased world economic activity, which translated into higher exports and an improvement in our terms of trade, was a determining factor in achieving a trade surplus for the third consecutive year. There was also a historically high level of current remittances from abroad. These were the main causes of the current account deficit falling almost to zero.

The current account showed a small deficit of US$ 10 million in 2004. This can be attributed on the one hand to the significant trade surplus obtained during the year of US$ 2,793 million (resulting from increased exports) and, on the other hand, to the considerable increase in current transfers, which amounted to US$ 1,461 million. Thus the positive contribution of the trade surplus and current transfers offset a deficit in services and factor income.

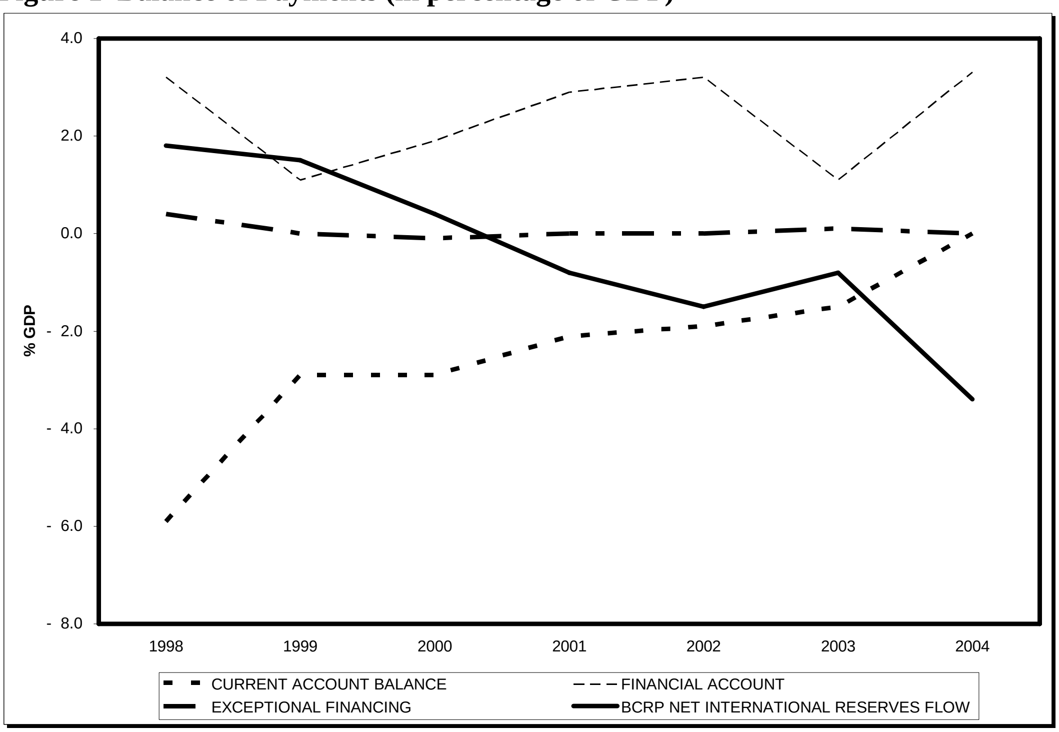
The trade balance of US$ 2,793 million was US$ 1,957 million higher than that achieved in 2003, because the US$ 3,526 million (39 percent) increase in exports was higher than the US$ 1,569 million (19 percent) increase in imports.

Table 2 Balance of Payment (Millions of US$)

	1999	2000	2001	2002	2003	2004
I. CURRENT ACCOUNT BALANCE	**-1,465**	**-1,526**	**-1,144**	**-1,063**	**-935**	**-10**
1. Trade balance	-655	-411	-195	292	836	2,793
a. Exports	6,088	6,955	7,026	7,714	9,091	12,617
b. Imports	-6,743	-7,366	-7,221	-7,422	-8,255	-9,824
2. Services	-663	-705	-890	-941	-854	-843
a. Exports	1,594	1,529	1,455	1,530	1,695	1,914
b. Imports	-2,256	-2,234	-2,345	-2,471	-2,549	-2,756
3. Investment income	-1,112	-1,410	-1,101	-1,457	-2,144	-3,421
a. Private sector	-549	-896	-550	-746	-1,275	-2,451
b. Public sector	-563	-513	-551	-711	-869	-970
4. Current transfers	966	999	1,042	1,043	1,227	1,461
Of which: foreign remittances	670	718	753	705	860	1,123
II. FINANCIAL ACCOUNT	**583**	**1,023**	**1,544**	**1,800**	**672**	**2,244**
1. Private sector	1,678	1,481	983	1,538	-105	1,027
2. Public sector	381	277	372	1,056	630	988
3. Short-term capital	-1,476	-735	189	-794	147	230
III. EXCEPTIONAL FINANCING	**24**	**-58**	**-1**	**14**	**64**	**26**
1. Refinancing	0	0	54	0	0	0
2. Debt relief	38	1	1	14	64	26
3. Net change in arrears	-14	-58	-56	0	0	0
IV. BCRP NIR (Increase with negative sign)	**775**	**193**	**-450**	**-833**	**-477**	**-2,352**
1. Change in Central Bank reserves	780	224	-433	-985	-596	-2,437
2. Valuation changes and monetization of gold	5	31	16	-152	-119	-85
V. NET ERRORS AND OMISSIONS	**83**	**368**	**51**	**83**	**676**	**92**

Source: BCRP

Figure 1 Balance of Payments (in percentage of GDP)



1) Exports

Exports totaled US$ 12,617 million, US$ 3,526 million (39 percent) higher than in 2003. This increase is explained by both traditional (US$ 2672 million or 42 percent) and non-traditional exports (US$ 855 million or 33 percent).

The growth in exports arises from both higher tonnages and better export prices. The average export price rose 21 percent, while export volumes were 15 percent higher. The price increase is explained mainly by higher average metal prices: gold (13 percent), copper (62 percent) and zinc (25 percent). On the other hand import prices (which increased 11 percent) reflected higher prices for oil and petroleum derivatives (25 percent), sugar (9 percent) and wheat (12 percent), while import volumes increased 7 percent. Higher prices for our exports and imports meant an increase of 9 percent in the terms of trade.

Traditional exports The growth of traditional exports during 2004 was favored by higher international prices that rose, on average, by 27.7 percent. This price effect represented additional income of US$ 2,227 million.

Sales of copper were almost double those of 2003, due both to increased volumes (19 percent) and a 62 percent increase in the average export price. The export sales of this metal amounted to US$ 2,446 million, US$ 1,186 million (94 percent) higher than in the previous year. It is worth pointing out that Peru is the world's third largest producer of copper and the second largest in the region.

Similarly, there was an increase in exports of gold (13 percent), refined silver (36 percent), lead (93 percent), zinc (9 percent), and tin (66 percent). Peru is the sixth largest gold producer, third largest zinc producer and second largest silver producer in the world.

Exports of molybdenum reached US$ 407 million, an increase of 330 percent making this metal, previously included under "other mining products" the fourth most important mineral export after copper, gold and zinc. The United States is the largest producer, followed by Chile and China, with Peru in fourth place.

Foreign sales of petroleum and derivatives amounted to US$ 646 million, an increase of US$ 25 million or 4 percent, associated with higher average export prices (16 percent), while fishmeal exports totaled US$ 954 million, a 29 percent increase compared to 2003, reflecting both higher Peruvian anchovy landings and better international prices. As far as agricultural exports were concerned, sales of coffee increased by US$ 109 million or 60 percent during the year as international prices rose.

Exports of non-traditional products amounted to US$ 3,476 million, a figure 33 percent higher than that of 2003, reflecting higher sales of textiles, agricultural & livestock products, iron and steel and jewelry, chemicals and fish products.

Under the heading textiles clothing exports increased significantly to account for 87 percent of total growth (from US$ 233 to US$ 269 million) due to the benefits arising from the ATPDEA. Total textile exports were valued at US$ 1 092 million, an increase of 33 percent compared to 2003. Exports of non-traditional agricultural & livestock products amounted to US$ 799 million, an increase of US$ 175 million (28 percent), mainly in fresh asparagus, paprika, and evaporated milk (the latter product going mainly to Central America).

Regarding chemical products, there was an increase in sales of cosmetics and polymers to the United States, Ecuador, Colombia and Bolivia; while in the metal products and jewelry, exports of copper, zinc and jewelry benefited from higher international prices. Exports of non-traditional fish products improved as sales of frozen shellfish and frozen fish increased, particularly hake.

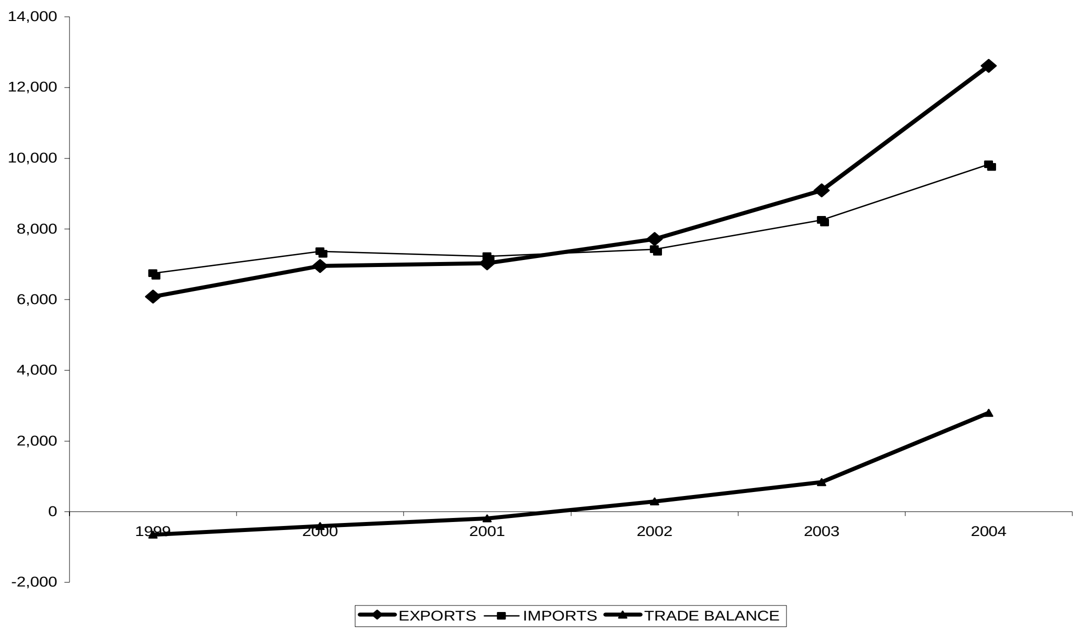
The dynamism of the export market was also shown by higher sales of timber and paper, which increased by US$ 42 million (24 percent); chemical products, which increased by US$ 99 million (31 percent); metal products and jewelry which increased by US$ 130 million (49 percent); nonmetallic minerals, up US$ 21 million (28 percent) and light engineering products, up US$ 36 million (36 percent)

Table 3 Exports (Millions of US$)

	1999	2000	2001	2002	2003	2004
I. Traditional Products	**4,141.8**	**4,804.4**	**4,730.3**	**5,368.6**	**6,356.3**	**9,027.9**
Fishing	600.9	954.7	926.2	892.3	821.3	1,103.7
Agricultural	282.1	248.9	207.5	216.2	224.1	325.2
Mineral	3,008.0	3,220.1	3,205.3	3,809.0	4,689.9	6,953.1
Petroleum and derivatives	250.8	380.7	391.3	451.1	621.0	646.0
II. Non-Traditional Products	**1,876.4**	**2,043.7**	**2,182.8**	**2,256.1**	**2,620.4**	**3,475.8**
Agriculture and livestock	**405.7**	**394.0**	**436.7**	**549.8**	**623.6**	**798.6**
Fishing	190.3	176.8	197.0	163.8	205.0	277.4
Textile	**575.4**	**700.7**	**664.2**	**676.7**	**823.3**	**1,092.2**
Timber,papers, and its manufactures	100.9	123.0	142.1	177.1	172.4	214.3
Chemical	194.8	212.3	246.6	255.9	316.4	415.0
Non-metallic minerals	51.4	46.7	57.7	68.0	73.5	94.0
Basic metal industries and jewelry	254.5	264.8	242.5	222.4	262.0	391.5
Fabricated metal products	76.3	96.6	160.0	109.6	99.4	134.9
Other products	27.1	28.8	35.8	32.9	44.9	57.9
III. Other Products	**69.3**	**106.7**	**112.6**	**89.2**	**114.0**	**113.2**
IV. Exports	**6,087.5**	**6,954.9**	**7,025.7**	**7,713.9**	**9,090.7**	**12,616.9**

Source: BCRP

Figure 2 Trade Balance (In millions of US $)



2) Imports

Imports increased 19 percent compared to 2003, reflecting both greater economic activity and higher prices for fuels and foodstuffs. Imports of raw materials and capital goods for industry also increased (21 and 16 percent, respectively).

Imports of fuels, lubricants and related products rose 27 percent during the year, because of higher average import prices (23 percent); while foodstuff purchases rose by US$ 161 million (29 percent), consisting mainly of rice and sugar to offset lower domestic production, as well as soybean, wheat, and maize. It should be pointed out that higher fuel and foodstuff prices meant expenditure that was US$ 398 million higher than in the previous year.

Table 4 Imports (Millions of US$)

	1999	2000	2001	2002	2003	2004
I. CONSUMER GOODS	**1,467.6**	**1,494.2**	**1,634.9**	**1,754.1**	**1,847.5**	**1,972.7**
Non-durable	**943.8**	**888.4**	**986.6**	**1,032.1**	**1,035.4**	**1,135.6**
Durable	523.8	605.8	648.3	722.0	812.1	837.0
II. RAW MATERIALS	**2,979.8**	**3,610.6**	**3,551.2**	**3,740.4**	**4,340.6**	**5,356.1**
Fuels	641.0	1,083.3	908.1	975.1	1,376.2	1,753.6
For industry	**2,153.6**	**2,315.2**	**2,414.2**	**2,516.5**	**2,686.4**	**3,254.3**
III. CAPITAL GOODS	**2,117.4**	**2,114.0**	**1,921.3**	**1,842.3**	**1,984.5**	**2,365.4**
Building materials	196.2	212.6	168.3	271.7	199.0	190.9
For agriculture	59.0	30.2	21.0	20.5	17.1	28.9
For industry	**1,385.5**	**1,430.4**	**1,360.8**	**1,227.0**	**1,424.7**	**1,655.2**
Transportation equipment	476.7	440.7	371.2	323.1	343.6	490.4
IV. OTHER GOODS	**178.1**	**147.2**	**113.3**	**85.0**	**82.4**	**129.9**
V. TOTAL IMPORTS	**6,743.0**	**7,365.9**	**7,220.6**	**7,421.8**	**8,255.0**	**9,824.2**

Source: BCRP

3) Services and Investment income

The deficit in the balance of services fell by US$ 11 million as the result of an improvement in the travel category. This was associated with a 15 percent rise in visitors, the incoming tourism sector reporting income of US$ 1,078 million, which represents an increase of US$ 138 million compared to the previous year. The deficit in insurance and reinsurance also fell by US$ 50 million, associated with smaller foreign premium payments as customers preferred to obtain reinsurance from local companies; foreign reinsures were charging more to cover losses incurred in previous years and a 7 percent fall in revenue abroad resulting from losses. The deficit in transport services increased by US$ 103 million because of increased import freight payments generated by higher foreign purchases and higher fuel prices. The deficit in other services was US$ 48 million compared to 2003 because of higher payments for business, professional and technical services made by direct foreign investors, principally oil and mining companies.

In the factor income account, the deficit increased from US$ 2,144 to US$ 3,421 million, due principally to higher profits accruing to the private sector (especially mining companies), which more than doubled from US$ 1,112 million to US$ 2,304 million and, to a lesser extent, the start of a cycle of international interest rate rises.

The total interest payable on Peru's foreign debt rose to US$ 1,173 million, equivalent to 1.7 percent of GDP and US$ 74 million higher than the figure for 2003, most of which consisted of interest on bonds.

4)Financial Account

A positive balance of payments financial account in 2004 (US$ 2,244 million) was a reflection of higher cash flows in private sector and public sector accounts and lower asset acquisitions abroad.

The **private sector financial account** amounted to US$ 1,027 million. Direct investment amounted to US$ 1,785 million, most of which (US$ 1,667 million) consisted of profits generated and retained by companies with foreign shareholders (principally in the mining sector). The balance of US$ 118 million consisted basically of a net flow of new investment, including US$ 423 million in the hydrocarbons sector, principally Camisea, offset by capital withdrawals by a large telecommunications company (US 220 million).

The net flow of long-term loans was negative (-US$ 408 million), as a result of fewer loans received and higher repayments in advance by the mining sector, while net investment in foreign assets fell from US$ 1,179 million to US$ 330 million, basically because the financial system invested less in assets abroad.

Table 5 Private Sector Long-Term Capital Flows (Millions of US$)

	1999	2000	2001	2002	2003	2004
I. Long-Term Capital Flows Excluding Privatization	**1,459**	**1,252**	**716**	**1,352**	**-115**	**996**
1. Direct Investment without Privatization	1,593	581	803	1,970	1,265	1,785
2. Long-Term Loans	158	970	204	-146	-166	-408
a. Disbursements	951	1,899	1,032	675	559	447
b. Amortization	-793	-929	-828	-821	-725	-855
3. Bonds (net)	-18	-48	-97	-153	-36	-4
4. Stock Market and ADR'S	-107	123	43	-9	1	-47
II. Privatization	**219**	**229**	**267**	**186**	**10**	**31**
III. Total	**1,678**	**1,481**	**983**	**1,538**	**-105**	**1,027**
Memo:						
Gross external financing	2,544	2,480	1,835	2,645	1,824	2,232
(in percentage of GDP)	5.0	4.7	3.4	4.7	3.0	3.3

Source: BCRP

The **public sector financial account** recorded a positive balance of US$ 988 million, a figure US$ 358 million higher than in 2003.

Disbursements amounted to US$ 2,535 million, while repayments were US$ 1,389 million. The net external assets account reflected an increase in international assets of US$ 159 million, basically as a result of investments by the government and COFIDE, as well as foreign deposits by the Consolidated Reserve Fund (FCR).

Short-term capital showed similar behavior to 2003, with a positive flow of resources amounting to US$ 230 million. This evolution by the current account balance and capital flows explained the increase in net international reserves of US$ 2,437 millions.

b) International Assets and Liabilities Position

The international assets and liabilities position shows that total foreign debt (public and private) in the medium and long term, amounted to US$ 28,348 million, equivalent to 41,3 percent of GDP. Although there was an increase in nominal debt of US$ 1,286 million, the debt burden with respect to GDP is less than in 2003. This reduction occurred in the percentage of both public debt (from 37.5 to 35.6 percent) and private debt (from 7.1 to 5.7 percent).

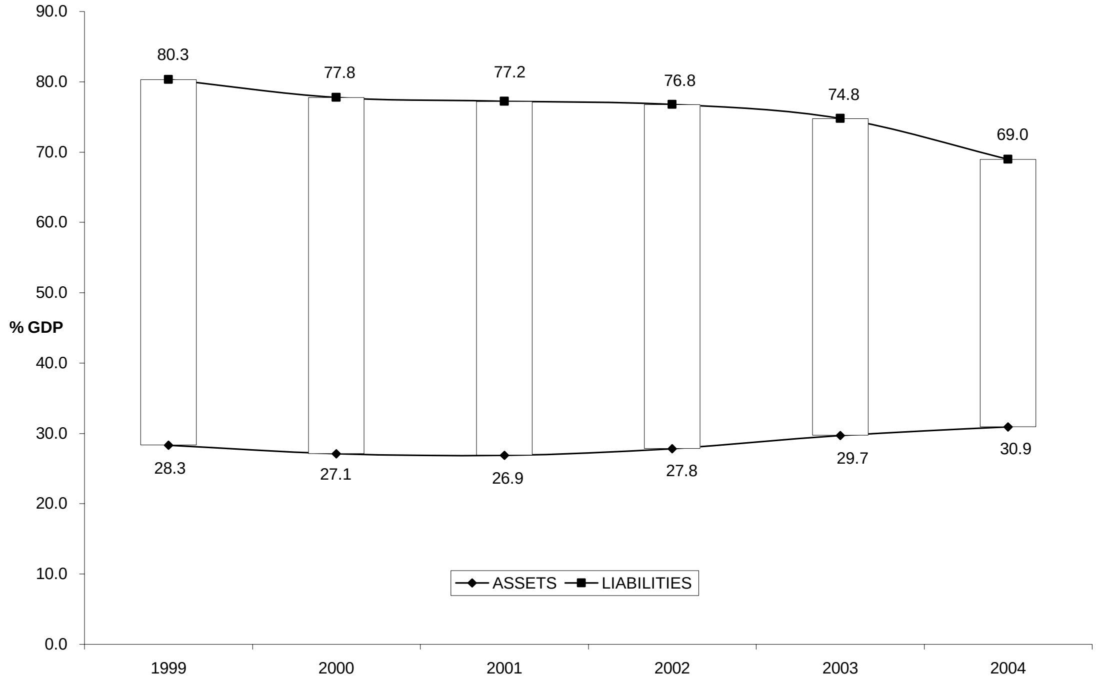
Furthermore, direct foreign investment in Peru amounted to US$ 13,310 million, equivalent to 19.4 percent of GDP while capital (US$ 2,952 million) represented 4.3 percent of GDP. Thus total liabilities abroad amounted to US$ 47,379 million.

Assets amounted to US$ 21,214 million, made up mainly of Central Bank assets (US$ 12,649 million), which rose by US$ 2,443 million, an increase that can be explained principally by the BCRP’s accumulation of US$ 2,437 million in net international reserves. NIR at the close of the year amounted to US$ 12,631 million.

The country’s liquidity position was thus strengthened further. International reserves represent 15 months’ goods imports, 2.5 times the foreign debt maturing in one year, and more than 4 times the monetary base.

The external position and various indicators of vulnerability abroad show that Peru has increased its ability to respond to any tightening of the international capital market or exceptional demand for foreign currency, and this has improved perception of country risk, reflected in improved ratings being awarded by ratings agencies.

Figure 3 International Assets and Liabilities



B. Domestic Environment

After growing at an annual average rate of more than 7.0 percent between 1993 and 1997, the Peruvian economy grew by 0.8 percent between 1998 and 2001. The growth during the 1993-1997 period occurred as a result of a combination of factors reflecting favorable external conditions, with a 14.7 percent rise in exports prices and larger foreign capital inflows. This scenario changed in 1998, a year in which three adverse shocks converged. The first was El Niño, with an intensity not registered since 1983. As in that year, it struck mainly agriculture, and livestock and fishing sectors1, while affecting directly the manufacturing based on raw materials, which declined 10.6 percent.

As a second adverse shock, terms of trade fell 6.5 percent, a lagged consequence of lower exports demand following the Asian Crisis of mid 1997 and was reflected in the reduction of gold, copper and coffee prices, which, as a group, fell by 11.0 percent. In addition, the Russian Crisis provoked an 18.1 percent contraction of capital inflows to the region.

In this context, private banks faced a sudden reduction in their foreign credit facilities, causing a contraction in the banking credit to the private sector, in spite of the dollar monetary regulation credits granted by the Central Bank and the 4.5 percentage points decrease in the average reserve requirement rate during the last quarter of 1998. Credit to the private sector in foreign currency dropped at an average annual rate of 3.7 percent between September 1998 and December 2001, in contrast with the 33.3 percent increase between January 1994 and September 1998. This credit contraction, which initiated in September 1998, implied an abrupt reversion of private sector financing, which worsened the recessive impact of the afore mentioned external shocks.

The effect of these shocks lasted until 1999, when the Brazilian currency depreciated 52.9 percent and a new 8.2 percent drop in the terms of trade took place. Episodes of financial turbulence with important pressures on the exchange rate occurred over this period of adverse macroeconomic shocks. Throughout these episodes, monetary policy was oriented to avoid validating depreciatory expectations, which could have lead to a depreciation-inflation spiral or strengthened negative impacts of the balance sheet effect. Therefore, control of banking liquidity in soles was maintained, which implied higher interbank interest rates.

In the fourth quarter of 1999 a recovery begun, with an increase of 4.2 and 1.3 percent in both consumption and investment, partially as a result of an expansionary fiscal policy, prior to the 2000 presidential elections, which led to an increase in the central government deficit from 1.1 to 3.2 percent of GDP.

This impulse in economic activity only lasted over the first two quarters of 2000, decreasing GDP by 1.8 percent in the third quarter and 3.0 percent in the fourth. The political events of September 2000, which led to the change of government, originated a fall of 11.0 percent in the consumers' confidence index and an 8.7 percent reduction in public expenditure (investment and consumption) between the last quarter of 2000 and the third of 2001, as an effect of a moderate fiscal adjustment.

Throughout the period 1998-2001 per capita GDP decreased 3.2 percent, while urban employment in companies with 10 or more workers fell 9.2 percent as measured by the Ministry of Labor and Employment Promotion. Net international reserves dropped by US$ 1,556 millions (-15.3 percent); credit to the private sector in foreign currency –the largest component of credit-declined 1.5 percent; current revenues of the central government as percentage of GDP fell from 16.0 to 14.4 percent and total imports were reduced in US$ 1,282 million (-15.1 percent).

The recessive features of this period also had a negative impact on the private sector financial performance, affecting both asset quality and profitability. While the ratio of non-performing loans to gross credits of the financial enterprises rose from 5.1 percent in December 1997 to 9.0 percent in December 2001, the net profit to equity ratio decreased from 15.4 to 4.5 percent. Simultaneously, the number of banks dropped from 25 to 15 in this period.

The sustained economic expansion, which started in mid 2001 continued throughout 2004. In 2003, real gross domestic product grew by 4.1 percent, one of the highest rates in the Region. This growth of GDP was mainly led by a 3.6 percent increase in domestic demand and a 5.8 percent increment in exports. GDP per capita rose 2.5 percent in 2003 and, still remains at levels similar to those of the early seventies, and by December 2004 Peru had experienced 42 consecutive months of growth. The rate of growth was 4.8 percent, driven by favorable conditions for the country's exports and increased domestic demand. The latter was associated in turn with macroeconomic stability, greater availability of financing, and lower interest rates. This economic dynamism was seen principally in non-primary sectors and generated increased employment both in Lima and in the interior, as well as rising family incomes.

Table 6 Gross Domestic Product (Millions of Nuevos Soles at 1994 prices)

Year	Gross Domestic	Population (Thousands)	GDP per Capita (Nuevos soles)	Inflation
1998	116,413	25,104.3	4,637.2	6.0
1999	117,446	25,524.6	4,601.3	3.7
2000	120,881	25,939.3	4,660.1	3.7
2002	127,086	26,749.0	4,751.1	1.5
2003	132,119	27,148.1	4,866.6	2.5
2004	138,474	27,546.6	5,026.9	3.5

Source:INEI, BCRP

Figure 4 GDP (Millions of Nuevos Soles at 1994 prices)

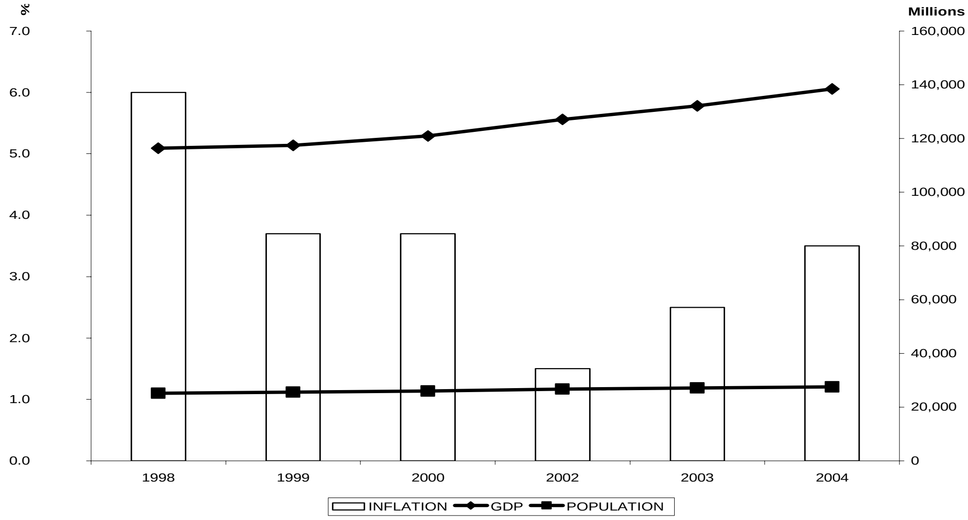


Table 7 Gross Domestic Product By Industry (Percentage change at constant prices)

	1,999	2,000	2,001	2,002	2,003	2,004
Agriculture and livestock	10.1	6.6	0.6	5.9	2.1	-1.1
- Agriculture	13.0	6.3	-2.3	6.1	1.6	-3.2
- Livestock	6.9	6.3	4.6	5.3	3.0	2.0
Fishing	28.2	10.4	-11.1	6.1	-12.5	30.5
Mining and fuel	13.1	2.4	9.9	12.5	6.8	5.4
- Metallic and non-metalic mining	15.9	3.5	11.1	13.6	7.7	5.3
- Natural gas and oil	-6.9	-6.5	-2.0	0.7	-4.3	7.1
Manufacturing	-0.7	5.8	0.7	4.1	2.4	6.7
- Non-primary industries	-4.7	4.9	1.4	5.1	3.1	6.9
Construction	-10.5	-6.5	-6.5	7.9	4.2	4.7
Commerce	-1.0	3.9	0.9	4.0	3.2	4.8
Electricity and water	3.0	3.2	1.6	5.5	4.9	4.6
Other services	1.7	2.0	-0.6	4.1	4.6	4.7
GROSS VALUE ADDED	**1.5**	**2.9**	**0.3**	**5.0**	**3.8**	**4.6**
Taxes on products and import duties	-4.5	3.0	-0.5	4.0	5.2	6.4
GROSS DOMESTIC PRODUCT	**0.9**	**2.9**	**0.2**	**4.9**	**4.0**	**4.8**
Primary sectors gross value added	12.5	5.9	2.6	7.1	2.9	3.1

a) Global Demand and Supply

Table 8 Global Demand And Supply (Percentage change at constant prices)

	1,999	2,000	2,001	2,002	2,003	2,004
I. TOTAL DEMAND	**-1.8**	**3.1**	**0.5**	**4.6**	**3.9**	**5.6**
1. Domestic demand	-3.1	2.3	-0.6	4.2	3.5	**3.9**
a. Private consumption	-0.4	3.6	1.4	4.6	3.1	**3.4**
b. Public consumption	3.5	3.1	-0.9	0.2	3.8	4.1
c. Gross domestic investment	-13.6	-2.7	-7.5	4.4	4.6	5.8
Gross fixed investment	-11.2	-4.9	-8.2	-0.7	5.4	8.5
- Private	-15.2	-1.7	-4.7	-0.1	5.6	**9.0**
2. Exports of goods and non-financial services	7.6	8.0	7.2	6.9	6.3	**14.7**
II. TOTAL SUPPLY	**-1.8**	**3.1**	**0.5**	**4.6**	**3.9**	**5.6**
1. GDP	**0.9**	**2.9**	**0.2**	**4.9**	**4.0**	**4.8**
2. Imports	-15.2	3.8	2.7	2.6	3.5	10.4

Source : BCRP

1) Consumption

Domestic demand grew by 3.6 percent in 2003 and 3,9 percent in 2004, driven by an increase in all its components, a pattern that has not been observed since 1997.

In 2003, private consumption contributed with 2.3 percentage points to the growth of domestic demand, and public consumption with 0.4 percentage points. The 3.2 percent increase in private consumption was related to the 3.9 percent increment of national disposable income and was reflected in such indicators as consumption goods imports, which rose 5.5 percent, led by a 12.5 percent increase of durable consumption goods imports. Other indicators such as consumer credit of financial enterprises and new vehicles sales showed also a positive trend, growing 24.7 and 3.5 percent, respectively.

In 2004, private consumption rose 3.4 percent during the year, in a context of increased national disposable income (5.5 percent) and employment (2.7 percent), with rates of growth of 2.4 percent in Lima and 3.6 percent in cities in the interior. Another factor that made this dynamism possible was a 22.9 percent increase in consumer loans by the financial system in a context of lower domestic currency interest rates. While in 2002 the average rate for consumer loans by banks was 47.9 percent and 41.8 percent in 2003, in 2004 it averaged 39.0 percent and by the end of the year it had fallen to 37.4 percent. Higher private consumption was revealed by a number of indicators, including a 6.8 percent rise in consumer good imports (non-durable goods rose 9.9 percent) and increased sales of new cars, which ended the year with 15,919 units sold, i.e., a 27.6 percent increase compared to the previous year. Public consumption rose by 4.1 percent, with public expenditure increasing 4.4 percent.

2) Investment

After falling between 1998 and 2001, private investment went up 5.3 percent, showing positive rates for two years in a row. The main public investment projects during 2003 were, among others, the rehabilitation, construction and improvement of roads; energy distribution infrastructure; water and sewage; emergency social productive project in 2004 rose 9.0 percent This dynamism was explained by higher company profits, factory expansions to meet increased local and export demand, greater investor confidence and higher demand for family housing.

Bank mortgage loans rose 14.1 percent in 2004. This was associated with State-sponsored housing programs MiVivienda and Techo Propio. The first of these programs continued to grow, as it had done in the previous two years. That fund made 7,960 loans valued at S/. 561 million in 2004, compared to 6,842 loans valued at S/. 437 million in 2003

Gross domestic investment in 2003 accounted for 18.4 percent of GDP, similar to 2002. Private investment was 15.5 percent of GDP, while public investment’ share rose from 2.8 to 2.9 percent of GDP. In 2004 Gross domestic investment was financed by increased domestic savings, which rose from 16.4 to 16.7 percent of GDP through a greater share of public savings. External savings fell from 2.0 to 1.7 percent of GDP.

Public investment was concentrated in the second half of the year 2004 and included significant central government consumption on road building and maintenance (S/. 773 million), new schools and school extensions and improvements (S/. 190 million), and regional government consumption on building, repairing and improving urban road systems (S/. 249 million).

b) Inflation rate

Inflation in 2004 was 3.48 percent. Supply shocks, such as increases in the price of oil and imported food stuffs and a drought that affected local agricultural production, temporarily forced inflation up during the first half of the year, to its highest annualized rate (4.6 percent) in July. Thereafter, a partial reversal of these shocks and an appreciation of Peru’s currency caused inflation to fall gradually until it once again met the explicit inflation target.

The nuevo sol appreciated 5.5 percent with respect to the dollar, closing the year at S/. 3.28. This appreciation, which occurred mainly in the second half of the year, was associated with a significant trade surplus, remittances from Peruvians living abroad, and low inflation expectations, which led economic agents to adjust their portfolios towards sol-denominated assets. In real terms, the Peruvian currency appreciated 1.5 percent during the year.

Inflation in 2004 was characterized by two phases; one, in the first half of the year in which it rose in response to supply shocks, both internal and external, after which annualized inflation reached a maximum of 4.6 percent in July; and a second starting in August in which it fell.

The increase in world oil prices from US$ 32.1 a barrel at the end of 2003 to US$ 53.2 in October 2004 and US$ 43.2 in December had a direct impact on fuel prices, urban bus fares and electricity tariffs. As far as fuels were concerned, an item contributing 3.9 percent to the basket of consumer products, the rise was 17.8 percent. In order to avoid an even higher increase, the Government promulgated Emergency Decrees 003-2004 and 010-2004 (in May and September, respectively), establishing a mechanism for stabilizing fuel prices through a reduction in the Excise Tax (ISC) and the creation of a stabilization fund. The reduction in ISC took place between June and August and between October and November in order to offset the rise in fuel prices. The application of this mechanism reduced inflationary pressure caused by supply shocks by 0.15 percentage points.

Imported inflation in 2004 was 11.3 percent, compared to 3.0 percent in 2003; Core inflation which excludes fuels, public services, public transport fares, and highly variable foodstuffs (such as chicken) from the Consumer Prices Index (CPI), registered an increase of 2.6 percent during 2004, lower than the increase in the CPI (3.5 percent). This, together with the 5.2percent increase in non-core inflation, reflected the transitory nature of the higher inflation rate, and Domestic inflation rose 3.66 percent during 2004, with 15 cities in the interior recording a lower figure than the average while the rest experienced higher than average inflation.

Table 9 Core And Non-Core Inflation (Percentage Change)

	Weight	1999	2000	2001	2002	2003	2004
I. CORE INFLATION	**68.3**	**3.94**	**3.11**	**1.06**	**1.69**	**0.77**	**2.63**
Goods	**41.8**	**2.57**	**2.47**	**0.66**	**1.76**	**0.29**	**3.19**
Food and beverages	20.7	-1.18	1.32	-0.59	2.07	-0.08	6.82
Textiles and foodware	7.6	6.69	2.57	1.94	1.06	0.91	1.36
Electrical appliances	1.0	7.20	1.83	-0.19	3.42	-1.91	-2.83
Other industrial goods	12.5	8.19	4.77	2.39	1.54	0.70	-1.24
Services							
Restaurants	12.0	5.88	3.68	1.29	1.28	1.25	1.78
Education	5.1	6.60	5.60	3.97	2.70	3.02	4.63
Health	1.3	6.85	4.68	3.02	3.31	2.19	1.18
Renting	2.3	8.45	3.43	-0.37	1.00	0.99	-1.57
Other services	5.9	3.65	4.28	2.14	1.02	0.85	0.48
II. NON-CORE INFLATION	**31.7**	**3.27**	**5.18**	**-2.82**	**1.16**	**6.21**	**5.20**
Food	14.8	-6.95	-0.43	-1.16	-2.35	5.24	1.85
Fuel	3.9	25.88	30.33	-13.14	15.60	8.94	17.77
Transportation	8.4	13.34	5.02	-0.02	0.11	10.99	3.49
Utilities	4.6	12.69	5.13	-2.73	1.96	-1.98	6.19

Source: INEI

c) Employment

Estimated urban employee rose 1.7 percent during 2003, increasing 1.9 percent in Metropolitan Lima and 1.2 percent in the other urban areas. During 2004 increased by 2.7 percent, urban employment grew in Metropolitan Lima, where the figure was 2.4 percent, and in other urban areas increase of 3.6 percent.

Employment growth was more vigorous in urban areas outside the capital, particularly in caused by increased industrial farming activity, especially production of export crops such as asparagus, grapes, paprika, artichokes, and peppers, among others.

In 2004 the estimated economically active population (EAP) in Metropolitan Lima according to the Permanent Employment Survey, was 4.1 million people, 2.8 percent higher than in the previous year. This increase in the EAP included the employed EAP, which increased by 2.8 percent and the unemployed EAP, which grew by 3.0 percent. Salaried employees (staff and workers) made up most of the increase in the employed EAP, growing by 5.7 percent. While the self employed, domestic workers and other non-remunerated workers contracted by 0.2 percent. The highest growth in employment (11.1 percent) occurred among the university educated, while employment among those with primary schooling only or lower levels of education fell 5.8 percent.

Unemployment in 2004 was estimated at 387 000 people, an increase of 11 200 compared to the previous year. The unemployment rate remained constant at 9.4 percent between 2003 and 2004.

Broken down by gender, the rate of unemployment among women increased (from 10.6 to 11.1 percent), while the rate for men fell from 8.5 to 8.1 percent. Broken down by age group, the rate for those above 45 years of age fell while that for those between 14 and 24 years of age the unemployment rate rose from 14.8 to 15.8 percent.

II.2 Fiscal Position

The trend towards consolidation of public sector accounts observed since 2001 continued in 2004, with a significant reduction in the fiscal deficit, which was equivalent to 1.1 percent of GDP, the lowest level since 1998. This performance was explained mainly by higher tax revenues associated with increased economic activity, improvements in world prices, the administrative measures designed to reduce tax evasion, and temporary tax measures introduced during the year.

The overall balance of the non-financial public sector recorded a deficit of 1.1 percent of GDP, a figure 0.6 percentage points of GDP lower than in 2003, thus continuing the downward trend in the fiscal deficit, which began in 2001.

The lower fiscal deficit was mainly the result of an increase in the primary balance (from a surplus of 0.4 percent of GDP in 2003 to 1 percent in 2004); and, to a lesser extent, a reduction in interest payments on public debt from 2.2 to 2.1 percent of GDP in the same period.

The fiscal deficit of S/. 2,465 million, equivalent to US$ 754 million, was financed basically by foreign borrowing amounting to US$ 1,078 million.

Disbursements amounted to US$ 2,474 million and included global bond offerings abroad and valued at US$ 1,295 million, unrestricted loans from multilateral organizations amounting to US$ 863 million and resources for investment projects of US$ 315 million. Repayments amounted to US$ 1,348 million.

Income from privatization was US$ 114 million and included the sale of the government’s US$ 67 million stake in the La Pampilla refinery (Relapasa) and treasury income from Las Bambas copper concession, which amounted to US$ 25 million, as well as installments from earlier privatizations.

Negative internal financing of S/. 1,528 million principally reflects the accumulation of deposits associated with global bond issues (to finance the 2005 budget) and net issues of sovereign bonds (placements minus those maturing) valued at S/. 1,191 million.

Table 10 Operations Of The Non-Financial Public Sector

	(Millions of Nuevos soles)						Percentage of GDP		
	1999	2000	2001	2002	2003	2004	2002	2003	2004
I. PRIMARY BALANCE	**-1,519**	**-1,561**	**-427**	**-214**	**927**	**2,400**	**-0.1**	**0.4**	**1.0**
1. Central Gov. Primary Balance	-1,815	-1,120	-1,230	-310	478	1,405	-0.2	0.2	0.6
2. Primary Balance of the Rest of the Public Sector	295	-441	803	97	449	996	0.0	0.2	0.4
II. IINTEREST	**4,104**	**4,614**	**4,266**	**4,282**	**4,606**	**4,865**	**2.2**	**2.2**	**2.1**
III. OVERALL BALANCE	**-5,624**	**-6,176**	**-4,693**	**-4,495**	**-3,679**	**-2,465**	**-2.3**	**-1.7**	**-1.1**
1. External financing	-346	2,288	1,755	4,144	2,928	3,604	2.1	1.4	1.5
2. Domestic net financing	4,651	2,461	1,804	-1,152	570	-1,528	-0.6	0.3	-0.7
3. Privatization	1,318	1,427	1,134	1,503	181	389	0.8	0.1	0.2

A. Government expenditure

Central government non-financial expenditure rose 4.7 percent in real terms in 2004 to reach 14.6 percent of GDP. The increase occurred principally in non-financial current spending (a real change of 5.2 percent) due to wage increases and higher spending on goods and services. Capital expenditure increased for the second year in a row, this time at a rate of 1.3 percent in real terms.

Wage increases were awarded mainly to workers in the education, interior, defense and health sectors, the judiciary and the public prosecutor’s department.

Spending on goods and services increased 8.0 percent in real terms level to 3.5 percent of GDP, similar to the level in 2003. The ministries of defense and the interior accounted for around half of this increase.

Current transfers fell by 0.1 percent of GDP compared to 2003 although in real terms it increased by 3.6 percent. The higher transfers went to local governments because of higher revenue from municipal promotion tax and resources associated with the Municipal Compensation Fund and the mining, hydroelectricity and forestry royalties; and to the Pensions Department (ONP) to pay pensions.

Capital spending amounted to 1.8 percent of GDP. Within this f igure, gross capital formation amounted to S/. 3,822 million (1.6 percent of GDP), which implies real growth of 4.8 percent.

Financial spending amounted to 1.9 percent of GDP, slightly lower (by 0.1 percentage points) than in 2003 because of the appreciation of Peru’s currency, which reduced the value in soles of the country’s debt repayments.

Interest due on external debt rose from US$ 1,070 million in 2003 to US$ 1,150 million in 2004, explained basically by an increase in bonds maturing (US$ 121 million), which was partially offset by lower debt payments due to international institutions. Interest on internal debt fell from S/. 469 million in 2003 to S/. 460 million in 2004.

B. Public borrowing

At the close of 2004, dollar-denominated public debt amounted to US$ 30,936 million, a figure US$ 2,040 million higher than in 2003, reflecting an increase in external debt (US$ 1,698 million) and internal debt (US$ 342 million).

The total public debt to GDP coefficient, a measure of the fiscal vulnerability of the Peruvian economy, fell from 47.5 to 45.1 percent. The reduction in this coefficient is explained in part by a lower borrowing requirement associated with the primary surplus generated by the non-financial public sector, as well as the combined effect of lower foreign and domestic interest rates and increased economic activity.

External public debt amounted to US$ 24,466 million, which represents 79 percent of total public debt.

Public debt falling due amounted to US$ 1,389 million, a figure US$ 161 million higher than in 2003. The principal creditors were the Paris Club and multilateral agencies to which US$ 723 million and US$ 571 million were paid respectively.

New medium-and-long term loans were made during 2004 amounting to US$ 2,384 million. Of this total, US$ 796 million were used to pre-finance part of the public sector requirement for 2005. Loans from the IDB (US$ 351 million), BIRF (US$ 254 million) and CAF (US$ 437 million) were agreed, repayable in periods in excess of 5 years.

Internal debt amounted to US$ 6,470 million, US$ 342 million higher than the balance in December 2003, resulting both from net public sector liabilities and the effect of the appreciation of Peru’s currency, which increased the value of this debt when expressed in dollars (by some US$ 255million).

At the close of 2004, net public debt was US$ 26,942 million, equivalent to 39.2 percent of GDP, a figure lower by 5 percentage points of GDP than that for 2003.

C. Aggregate Tax revenue

Central government current revenues amounted to S/. 35,381 million in 2004, an increase of 8.1 percent in real terms compared to 2003. This was 15.1 percent of GDP, reflecting a 0.2 percent improvement associated with an increase of 0.3 percent in tax revenue.

Broken down by tax, in GDP terms value added tax (IGV) was responsible for 0.2 percentage points, income tax accounted for 0.1 percentage points and the recently introduced financial transaction tax (ITF) for 0.3 percentage points. This improvement was offset by a fall in excise tax (ISC) revenue amounting to 0.2 percentage points of GDP after the rebate applied to fuels in response to increases in world oil prices.

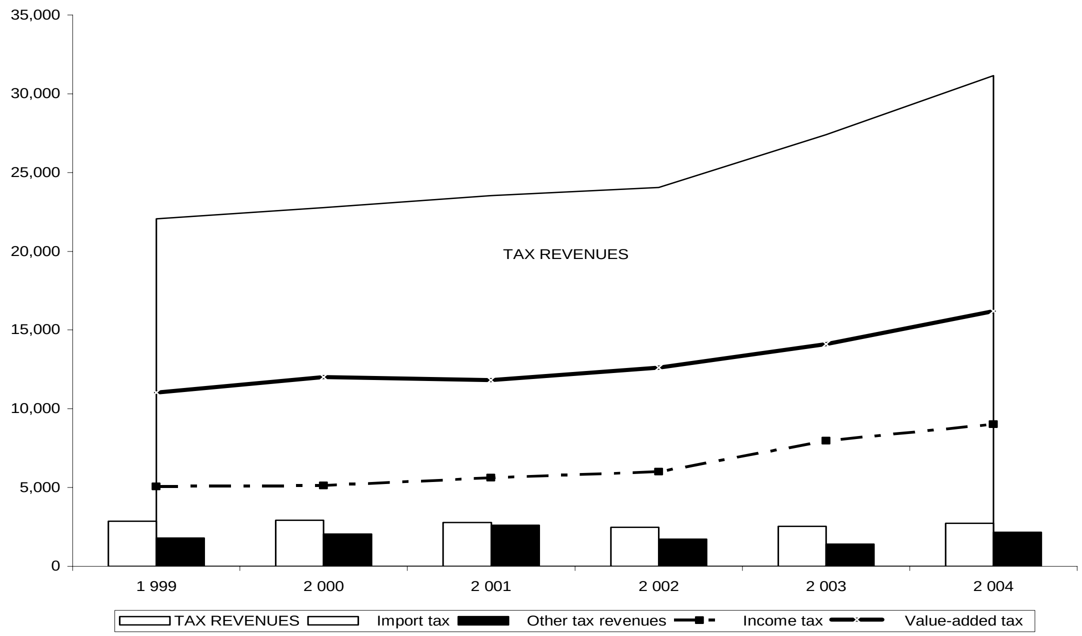
Lower profit transfers by public companies and lower income from interest resulted in a reduction in non-tax income of 0.2 percent of GDP.

Table 11 Central Government Current Revenues

	1999	2000	2001	2002	2003	2004	2001	2002	2003
							(Percentage of GDP)		
Tax Revenues	**22,072**	**22,769**	**23,541**	**24,062**	**27,405**	**31,144**	**12.1**	**13.0**	**13.3**
1. Income tax	5,072	5,130	5,630	6,011	7,971	9,026	3.0	3.8	3.9
2. Property tax	11	0	0	0	0	0	0.0	0.0	0.0
3. Import tax	2,857	2,921	2,786	2,483	2,550	2,744	1.2	1.2	1.2
4. Value-added tax	11,043	12,013	11,815	12,613	14,110	16,206	6.3	6.7	6.9
6. Other tax revenues	1,787	2,053	2,602	1,738	1,414	2,162	0.9	0.7	0.9
I. Non-Tax Revenues	**3,410**	**4,935**	**3,518**	**4,498**	**4,163**	**4,238**	**2.3**	**2.0**	**1.8**
II. TOTAL (I+ II)	**25,482**	**27,705**	**27,059**	**28,559**	**31,568**	**35,381**	**14.4**	**14.9**	**15.1**

Source: SUNAT

Figure 5 Central Government Tax revenue



III. Tax Structure: Institutions and The Reality

Several statutes regulate the Peruvian tax system. The Tax Code is the main legislative body that rules the tax principles, nature of taxes, the tax duty, the tax system, faculties of the Tax Administration, the Tax Court, tax proceedings, and penalizations to taxpayers. These premises guide the application of norms such as the Income Tax Law, General Sales Tax Law, Municipal Tax Law, Customs Act and other tax-related norms.

The Peruvian tax system has two basic components: a central government one and another administered by local governments.

The national taxes are administered by SUNAT - National Superintendence of Tax Administration, which is in charge of administering and applying tax collection processes and controlling internal and external taxes. For these purposes, SUNAT is organized into Several Intendances, including the National Main Taxpayers' Intendance, Regional Intendances, Zonal Offices and Remote Offices.

Local governments (municipalities) administers local taxes assigned to them by national laws (property tax, motor-vehicle tax, real-estate closing tax, pro-sports events tax), as well as municipal tariffs and fees for licenses, excise and duties. They may not create new tax laws.

Taxation in Peru is determined by domicile rather than by residence. An alien will be considered as domiciled in Peru by civil law if Peru has become his/her regular residence. for this purpose, the alien must have a resident visa, however, in order to be considered domiciled ,for tax purposes, an alien must be either resident or simply present in Peru for two continuous years. Absences of up to 90 days in each calendar year do not interrupt the continuity of residence or presence. Since the two-year period is computed from date to date (i.e., the two year period may be completed in the middle of a fiscal year) the domiciled status applies to the taxpayer as from the beginning of the following fiscal period. After being resident and being present for at least six months in Peru, a non-domiciled foreign national is allowed to apply for domiciled tax status as from the following fiscal period.

III.1 Government Taxes

A. Income Tax

The Tax to the Income burdens the rents that come from the capital, the work and the joint application of both factors, being understood like such those that come from a source durable and susceptible to generate periodic income, the capital gains , the imputed rents, including those of enjoyment or enjoy, established by the law and others incomes that come from third, established by law.

It is an annual tax levied on all income earned by taxpayers resident in country, regardless the nationality of individuals, companies' place of incorporation, or location of the income source. Non-resident taxpayers are subject to income tax only with respect to their Peruvian-source income.

In the case of enterprises, the aforementioned tax applies to any gains or profits derived from transactions with third parties, as well as from the exposure to inflation calculated at the end of each fiscal year.

For tax purposes, taxpayers are classified as a resident and non-resident, depending on whether they are residents of Peru as defined by the applicable regulations in the law; and individuals and legal entities and others not considered legal entities according to the Income Tax Law. The tax basis and rates differ according to taxpayer classification.

Resident taxpayers pay taxes on their annual worldwide income, in advance and in monthly installments. Nonresidents are taxed automatically at the source, and they and their permanent establishments in Peru pay taxes only on Peruvian source income.

In the case of business, the tax in reference applies to any gains or benefits originating from transactions with third parties, as well as from "inflation exposure calculated as of the close of each business year".

It is worth mentioning that as from 1994 the income accruing from dividends or any other form of distribution of the profits of companies shall not be regarded as taxable income.

According to Peruvian income tax law, the income of a husband and wife must be reported separately. Income from jointly owned assets may be distributed equally to each spouse or may be allocated totally to one of them. Income of children in common under age must be reported by the spouse with higher income, unless income from joint assets has been allocated to one spouse only, as discussed above. In this case, the spouse to whom the income has been allocated must also report children's income.

For purposes of the income tax, taxable incomes are classified into five categories, depending on source as follows:

First: Incomes earned from real estate properties leasing, subleasing and transfer of goods.

Second: Other capital incomes (interests, royalties, etc.)

Third: Income from commerce, industry and other activities as provided by law.

Fourth: Incomes derived from personal independent services.

Fifth: Incomes earned from personal dependent work Individuals

The tax applies to all of an individual's income, totaling all different classes of income earned by him, except for Third Class income, which is to be declared and paid independently.

The Income Tax paid by resident individuals and corporations, as well as by the permanent establishments of non-resident individuals and corporations, is determined and paid within the three months following the end of the annual fiscal year. Taxpayers must make advanced Income Tax payments with regard to income generated during the fiscal year.

Table 12 The Income Tax rates

Individuals	Corporations
Resident – Worldwide Income	
Until 21 UIT 15% 21 UIT until 54 UIT 27 % in excess of 54 UIT 30% 1/	27 % (2003) 30% (2004)
No resident – Source Income	
30%	Interest from external credits 4.99% Other Interest 2/ 1% Leasing of ships and aircrafts 10% Royalties 30% Other incomes 30 %

1/ Including earnings of first, second, fourth and fifth income categories
2/Paid abroad by banking and financial companies established in Peru, derived from their foreign lines of credit used in the country

a) Individuals

Table 13 Individual Income Tax

Individual Income Source	Gross Rent
First Category	1. Rent agreed in cash or in species by renting of estates, including his accessories, as well as amount agreed by services provided by renter and the amount of the tributes that takes to its position the renter and which legally corresponds to the landlord. 2. Rent produced by the lease or the temporary cession of rights and movable or immovable things.
Second category	1. The interests originated in the positioning of capitals, nobodies is their denomination or mode of payment, such as the produced ones by titles, certificates, debentures, privileged or general bonds, guarantees and credits in money or values. 2. The royalties in cash or species is considered originated by the use or the privilege to use patents, marks, designs or models, planes, processes or secret formulas and right of author of literary, artistic or scientific works, as well as all by the cession in use of the training schedules for computers (software) and by the information relative to the industrial, commercial experience or scientific 3. The life rents. 4. The dividend and any other form of distribution of utilities 5. The attribution of utilities, rents or gain of capital 6. The gains of capital
Fourth category	1. The individual exercise, of any profession, art, science, office, or activities not including specifically like Rents of Third Category 2. the performance of functions of: Director of companies, Receiver, Agent chief executive, Manager of businesses, Executor, similar activities, among others, the diets are included that perceive the regidores of the Municipalities.
Fifth category	1. The lent personal work in dependency relation, including positions public, elective, or no. The pays, wages, allocations, emoluments, premiums, diets, allowances, advantages, Christmas gifts, commissions, compensations in money or species, expenses of representation and, in general, all repayment by professional services are included. 2. The participation of the workers, or who come from the annual allocations or any other benefit granted in their substitution. 3. The allocations or diets that are perceived like repayment by effective attendance to the different types from sessions within an institution 4 Being officials government who for reason of the service or special commission are in the outside and perceive their salaries in foreign currency, will consider taxed rent of this category, solely the one that would correspond to them to perceive in the country in national currency according to its degree or category. 5 Any other entrance that has its origin in the personal work.
Foreign source	The contributors domiciled in the country will to each other add and compensate the results that throw their producing sources of foreign rent. Solely if from these operations

	is a net rent, this one will be added to the Net Rent of Peruvian Source. In the compensation of the results that throw producing sources of rent of foreign source to that the previous paragraph talks about, it will not be taken into account the losses obtained in countries or territories of loss or null imposition. If were total a net loss of foreign source, in no case, this one it will compute to determine the tax

Gross Rent (G.R.)	**(-)Deductions**	**Rent Net (R.N.)**
First Category	(-) 20% de G.R	**= Net Rent of Source Peruvian**
Second Category	(-) 10% de G.R. i	
Fourth Category and Fifth Category	(-) 20% de G.R. ii	
	(-) 7 UIT iii	

i This deduction of 10 % is not applicable for the dividends nor for any other form of distribution of utilities
ii Until the limit of 24 UIT. This deduction is not applicable to the perceived rents to perform functions of director of companies, receiver, agent chief executive, similar manager of businesses and executor iii Of the Rents of Fourth and Fifth categories they will be possible to be deduced, annually, a fixed amount equivalent to seven (7) UIT.

b) Corporations

As a general rule, all revenues that are obtained by the company from their business activities during the fiscal year are considered income for taxation purposes. These companies may deduct from their gross income, all expenses incurred to produce income and maintain its source.

There are not accepted as deductible expenses: Personal expenses, Income Tax, fines and any other tax sanction, certain donations, amounts invested on infrastructure or permanent improvements on such provisions or reserves that are not admitted as deductible by Law, intangible amortization except for those with a short lifetime; commissions paid to foreign agents in excess of the amount normally paid in their country, expenses based on invoices not fulfilling formal requirements stated in the Invoices Regulations; The General Sales Tax the Municipal Promotion Tax and the Extraordinary Solidarity Tax that levy the gratuitous transfer of property, expenses incurred in some operations connected with tax havens

Companies domiciled in Peru include and compensate their revenues from their foreign source income. Only if these result in a net income, they will be added to the Peruvian source income. Net losses from a foreign source cannot be included, and cannot be compensated for income tax purposes. This procedure does not include revenues from foreign sources that are obtained from tax havens.

Regarding domiciled companies, tax losses can be carried forward for four (4) years following the year the company obtains a net income, applying these losses to the income obtained during this term. Once this period is completed, the possibility of compensating the remaining losses with profits is lost. No loss carry-backs are allowed.

B. General Sales Tax

General Sales Tax is designed according to the mechanism of Value Added Tax (VAT), It is a general consumption tax on the in-country sale of personal property, imported goods, services received or rendered in the country, construction contracts and the first-time sale of real estate by the builders. The tax is applied only to the value added in each stage of production and the exchange of goods and services and a tax credit is allowed for the tax paid in the previous stage. This tax, which is at a rate of 16% which becomes 18% by application of the Municipal Promotion Tax, is levied at the source and is paid monthly.

Local Improvement Tax (Impuesto de Promoción Municipal) .- This tax is applicable in the same instances and manner as the General Sales Tax. The rate is 2%. Hence, it acts as an increase on the General Sales Tax rate.

The General Sales Tax paid on the acquisition or importation of goods or services, or under building contracts, shall constitute tax credit against the gross tax.

Non-taxable Items

The following transactions, among others, are not subject to the General Sales Tax:

- Export of goods and services. The Law contains a list of operations regarded as service exports. It is worth emphasizing among these consulting, technical assistance, temporary assignment of industrial property, data processing, financing, insurance and reinsurance operations, etc.
- Transfer of used goods by individuals or enterprises not engaged in business activities.
- Transfer of goods resulting from the reorganization or transfer of companies.
- The amount equivalent to the CIF value, in the transference of foreign goods performed before customs clearance.
- Royalties payable under the license contracts entered into by PERUPETRO to authorize the exploration and exploitation of hydrocarbons.
- Building contracts executed abroad.

C. Selective Consumption Tax

An excise tax is applied on the sale of fuels (gas, gas-oils, diesel), alcoholic beverages, cigarettes and tobacco, beer, vehicles, soft drinks (including mineral water), and to gambling, chance and lottery games, raffles and other related activities. Tax rates are variable and for some items this tax is applied by charging a fix amount per unit sold.

Excise tax is paid following the same procedure of the VAT, except for excise taxes on gambling, lottery, and related activities which are withheld upon price payment.

The Selective Consumption Tax rates range between 10% and 30%, depending on the type of goods involved, excepting the rates applicable to fuels, which are higher.

D. Tariffs

Peru has implemented an open and liberal foreign trade policy to make the domestic industry more efficient and competitive, to increase commercial flows, investment and employment and to reduce inflation. Among the more significant measures related to foreign trade, the simplification and reduction of a number of tariff levels, once in force, undoubtedly stand out.

The tax basis for customs duties is the CIF (Cost, Insurance, and Freight) value of the goods imported to Peru

At present, there only exist two CIF ad-valorem rates for import tariffs: 12% and 20%. Some goods taxed at 20% are subject to a 5% surcharge. There is also a special 8% rate for certain merchandise received in the Tacna Free Trade Zone (Tacna). Certain imported foodstuffs are subject to an additional specific customs duty. There is no export tax.

Table 14 Tax Exemptions

Tax	Exemptions
Income Tax * until 2005	▪ Capital gains obtained from the trading of stocks and securities on the Floor of the Stock Exchange, including those obtained in Products Stock Exchanges authorized by CONASEV. ▪ Compensation for length of service, as contemplated in the Law. ▪ Any type of fixed or floating interest rate, in national or foreign currency, paid on deposits with national financial institutions, as well as capital increase of deposits and other charges in national currency generating adjustable Certificates of Deposit. ▪ Interest on deposits and charges made by financial or banking institutions, as well as interest accruing from bonds acquired by banking and financial entities, are not included. ▪ Interest on and adjustment of principal accruing from mortgage bonds in accordance with the relevant laws.

General Sales Tax	▪ Domestic sales and the import of certain goods specified in the Law, until December 31, 1996. It is worth mentioning, among these, fish and other fishery resources, farm produce, books and certain textile fibbers. ▪ Supply of the services listed in the Law, until December 31, 1996. These are passenger and cargo transportation, life insurance policies and certain credit services. ▪ Industrial enterprises established in Borderline Areas or in the jungle. In these cases, the Municipal Promotion Tax is 18%.
Selective Consumption Tax	▪ Imports and sales of diesel or residual petroleum to concessionaire companies providing electric power services and self-generating companies until December 31, 1999. In both cases, concessionaire and self-generating companies must be authorized by Supreme Decree. ▪ Imports and sales of coal and/or natural gas, until December 31, 1999. ▪ The aforementioned tax exemptions shall remain in force until December 31, 1996. ▪ Moreover, the income earned by banks and financial and credit institutions is not subject to this tax.

III.2 Municipal Taxes

A. Real Estate Equity Tax

This tax is a local one that taxes the value of real estate equity. Companies can deduct it from the income tax. The rate is progressive and goes up to 1%. Mining concessions' real property, among others, is not subject to this tax.

The Real Estate Property Tax is a local tax applied on the total value of real estate property owned by the same person within the same local jurisdiction. The tax base is determined on the value of the real estate property declared by the owner. The corresponding rates are applied according to a progressive scale.

B. Business Licenses

The Operating License Fee is a local tax that must be paid upon obtaining the Operation License before the Municipality where the premises of the business are located, in order to operate an industrial, commercial, or service establishment.

The fee is paid only at the moment the license is required (afterwards, it is only necessary to file an annual form before the Municipality). It will only will be necessary to pay a new fee if the activity of the company changes.

The Operating License Fee rate is obtained from applying a pre-established percentage that will depend on the nature of the business activity.

C. Transfer Tax

This tax, also municipal, applies to the transfer of urban and rustic property, whether paid for or free of charge.

The taxpayer is the person acquiring the property, and this cannot be otherwise agreed for tax purposes. Rate The rate is 3% and is applied to the property valuation corresponding to the year in which the transfer is made. It must be paid within the month following the date of transfer.

D. Vehicle Property Tax

Vehicle property tax is applied to the ownership of cars, trucks and estate cars up to 3 years old. The tax payer is the individual or business proprietor of the relevant vehicles.

Rate The rate is 1% of the vehicle's value. In any case, the tax cannot be less than 1.5% of the Taxable Unit (UIT) in force at January 1 of the taxable year. Official vehicle values are published each year.

III.3 Peru Taxpayer's Registration System – "RUC"

The Superintendence of Tax Administration (SUNAT) Register System includes information about every juridical person and individual, undivided estate, joint venture or other collective association, Peruvian or foreign, domiciled or not in the country, that according to current laws is required to pay taxes.

Unique registry of Taxpayer (RUC) it is the computer system in charge of the SUNAT that contains the data of identification and the tributary obligations of the contributors of the tax administered and/or collected by the SUNAT, it contains information about economic activities, as well as the information of their people in charge.

The number of RUC, it is the number of eleven (11) digits that it identifies to the contributor before the SUNAT, as soon as to this its inscription is confirmed to him, in this registry. It is of obligatory use for any management that is made before the Tributary Administration and other dependencies of the Public Administration that the SUNAT establishes. This number has permanent character and is of exclusive use of its holder.

In order to register in the RUC, the contributor it must previously know the rent that it generates, the tributary regime and/or the tribute that corresponds to him like retaining agent.

The taxpayer must register in the RUC, whenever they initiate their activities, within the 30 days following calendars to the date of their inscription.

It is understood by beginning of activities, to the date in which the contributor and/or person in charge begin to generate taxed or exonerated income, or acquires deductible goods and/or services for effects of the Tax to the Rent.

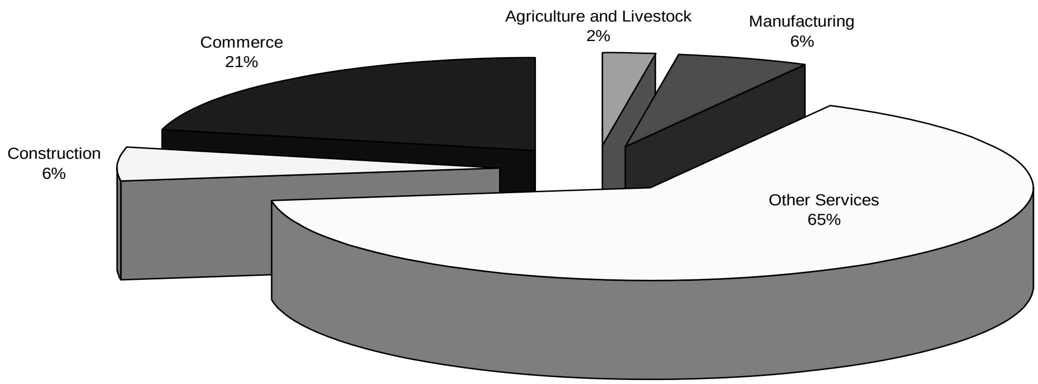
There is no obligation to be register in the RUC to :

- The natural people who perceive exclusively rents considered of fifth category according to the norms of the Tax to the Rent.
- The natural people, conjugal societies, and undivided successions that they perceive exclusively I interest originating of conducted deposits in the Institutions of the authorized National Financial System in the Supervision of Bank and Insurances.
- Not domiciled whose rents are subject to retention in the source.
- The natural people who make in occasional form imports or exports of merchandise, whose value FOB by operation does not exceed thousand dollars American (U.S. $1,000.00) and whenever they at the most register up to three (3) imports or annual exports.

The proceeding of inscription in the RUC is personally made, by the holder or his legal representative in our Centers of Services to the Contributors and dependencies in the national scope, in where is the fiscal address that the contributor declares. The SUNAT reserves the right to verify the fiscal address declared by the contributor.

Additionally, the conjugal societies or undivided successions must exhibit the original one and present/display the simple photocopy of the game of civil marriage or the game of death of the cause, according to corresponds.

Figure 6 Registered Taxpayer According to Economic Activity



Modifications of Data by Internet .- The contributors will be able to update or to modify the following information of the Registry through this page Web, using the Virtual form 3128 N° - "Modification of Data of the RUC by Internet":

- Commercial name
- Economic and/or secondary main activity
- Code of profession or office
- System of emission of tickets
- System of accounting
- Number of fax,
- Fixed and movable telephone numbers (cellular).
- Electronic mail
- Fiscal address and
- Condition of the building declared like fiscal address

III.4 National Tax Administration – SUNAT

The National Superintendence of Tax Administration (SUNAT), was established through Act 24829 of June 7, 1988, and in accordance with its General Law approved through Legislative Decree No. 501 as a Decentralized Public Institution of the Economic and Finance Sector, having Public Law legal status, own corporate equity and functional, economic, technical, financial and administrative autonomy. It is responsible for managing, applying, overseeing and collecting internal taxes (with the exception of municipal taxes), contributions to social security, tariffs and taxes set forth by the customs laws, controlling international traffic of goods within the customs territory, preventing and repressing customs offenses, as well as for proposing and participating in the establishment of regulations concerning tax provisions.

In addition, the SUNAT will provide services to taxpayers in order to promote and facilitate compliance with their tax obligations.

SUNAT – Customs Merger .- Supreme Decree N° 061-2002-PCM of July 12 of 2002, provided for the merger through absorption of the National Superintendence of Tax Administration –SUNAT (absorbing entity) and the National Superintendence of Customs - CUSTOMS (absorbed entity).

Likewise, Supreme Decree N° 115-2002-PCM of October 28, 2002, provided for the approval of the new Regulation of the SUNAT Organization and Functions that entered into force on January 1st, 2003.

Labor Regime .- The labor system applicable to the staff at the SUNAT is that related to private activity workers, with the only exception of the persons that, in a timely manner and pursuant to the pertaining regulations, have chosen to remain within the scope of the labor system of the Public Sector, governed by the Legislative Decree N° 276.

A. Organizational Structure

SUNAT has the following organizational structure:

Main Direction:

- **National Superintendence of Tax Administration .-** The National Superintendent of Tax Administration, represents SUNAT within and outside the country in all acts, contracts or agreements signed by it.
- **Associated National Superintendence of Internal Taxes .-** The Associated National Superintendent of Internal Taxes assists the National Superintendent of Tax Administration on the achievement of institutional purposes regarding internal taxes. He is delegated the functions of the National Superintendent in case of temporary absence or impediment of the latter.
- **Associated National Superintendence of Customs Duties .-** The Associated National Superintendent of Customs Duties assists the National Superintendent of Tax Administration on the achievement of institutional purposes regarding customs duties. He is delegated the functions of the National Superintendent, if it were expressly designed for the National Superintendent of Tax Administration, in case of temporary absence or impediment of the latter.

Main Direction Committee

Organ of Control:

- Internal Control Office

Assistance Organs to The National Superintendence:

- General Secretariat
- Tax and Customs Administration Institute (IATA)

Operative Organs:

Depending On the Associated National Superintendence Of Internal Taxes

- Main National Taxpayers Intendancy (IPCN)
- Regional Intendancy of Lima (IR Lima)
- Regional Intendancies (Decentralized)
- Zonal Offices (Decentralized)

Depending On the Associated National Customs Superintendence

- Border Control and Prevention of Smuggling Intendancy (IPC y CF).- The Border Control and Prevention of Smuggling Intendancy is responsible for regulating, conducting and coordinating the actions, plans and programs to prevent, detect and repress smuggling.
- Fiscal Supervision and Customs Duties Collection Management Intendancy (IFGRA).- The Fiscal Supervision and Customs Duties Collection Management Intendancy is responsible for designing and executing the programs, procedures

and actions regarding fiscalization, customs revenue and recovery of debts related to customs duties.

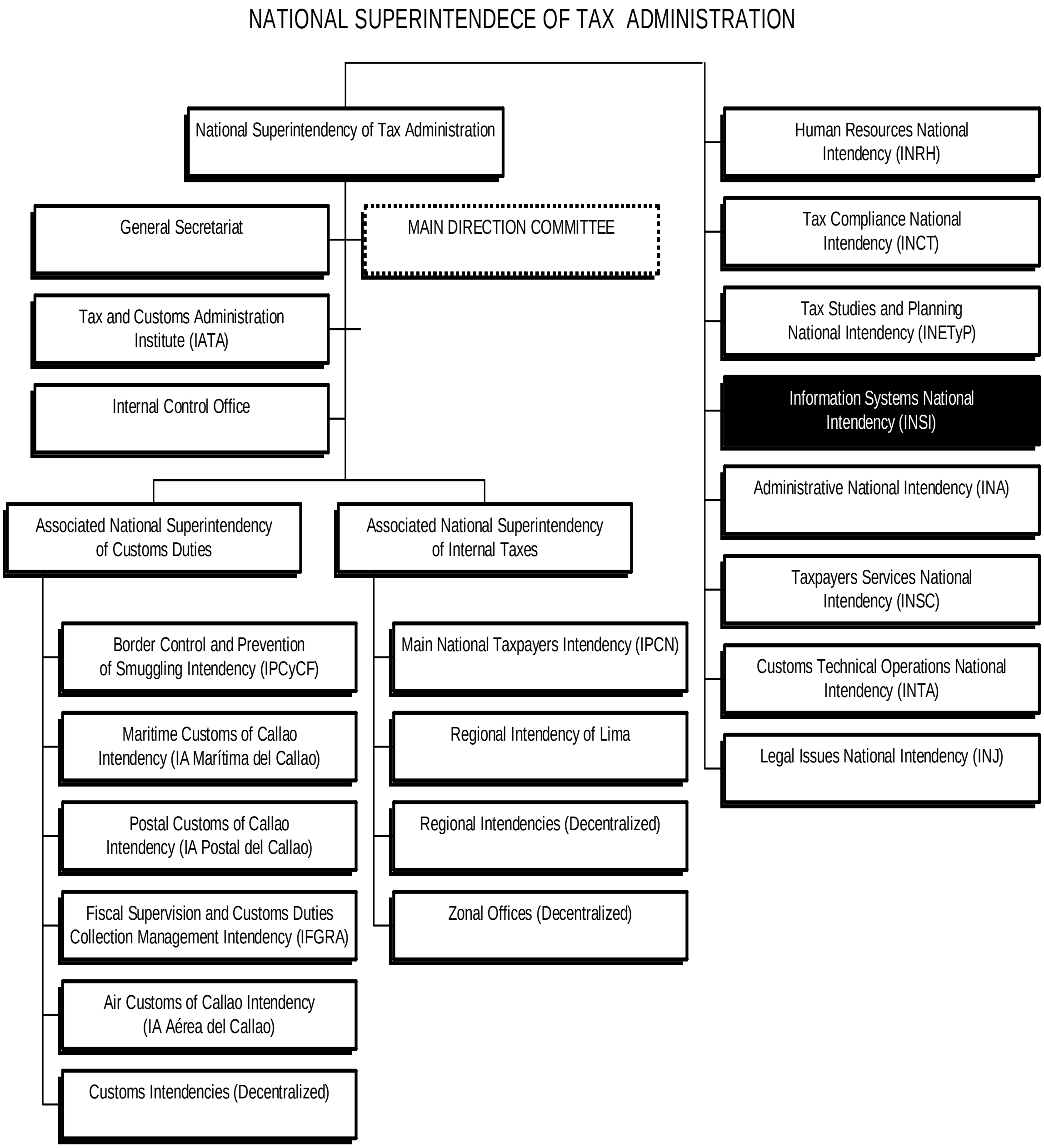
- Maritime Customs of Callao Intendancy (IA Maritime del Callao)
- Air Customs of Callao Intendancy (IA Aerial del Callao)
- Postal Customs of Callao Intendancy (IA Postal del Callao)
- Customs Intendancies (Decentralized)

These last four organs refer to Customs Intendancies, which are the operative institutions that, within their respective jurisdictions, are responsible for managing the tariff schedules and customs operations and for the collection of duties and other applicable taxes. They are responsible for overseeing and verifying the application of due legislation governing foreign trade and of the international conventions and treaties in force, applying fines and solving claims within their attributions as first line institutions. They are also responsible for reporting acts that are presumed to be customs crimes for their due process.

Supportive Organs

- Administrative National Intendancy (INA)
- Tax Compliance National Intendancy (INCT)
- Tax Studies and Planning National Intendancy (INETyP)
- Human Resources National Intendancy (INRH)
- Taxpayers Services National Intendancy (INSC)
- Information Systems National Intendancy (INSI)
- Legal Issues National Intendancy (INJ)
- Customs Technical Operations National Intendancy (INTA)

Figure 7 SUNAT Organization Chart



V. Country-Specific Fiscal issues

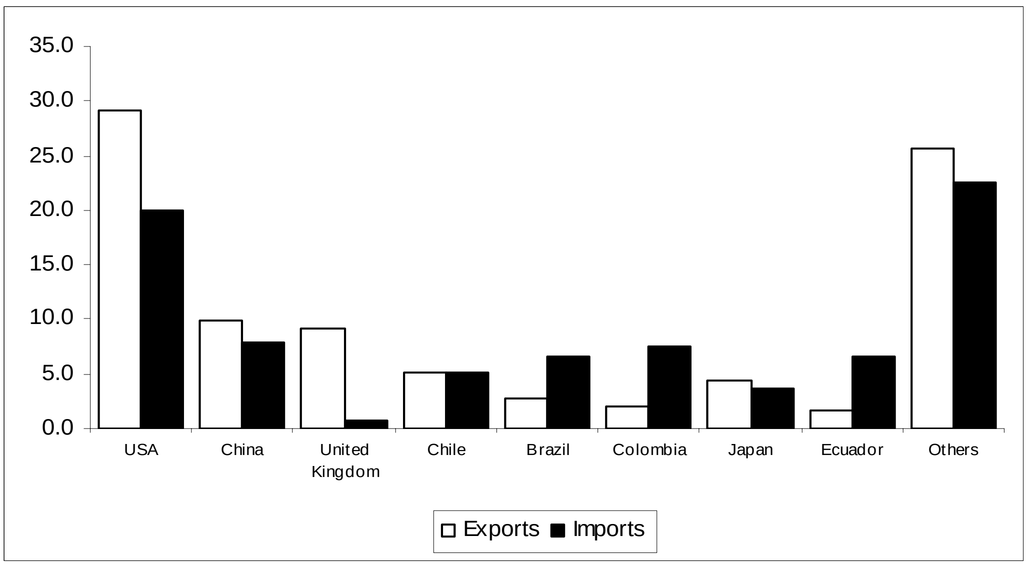
A. Trade by country

The terms of trade recorded their highest increase for 10 years (9.0 percent). Economic growth among our principal trading partners was 4.7 percent; the United States and China produced noteworthy figures (4.4 and 9.5 percent respectively) and, together, these two countries accounted for 34 percent of Peru's foreign trade

Exports to the United States - our main trading partner - grew by 51 percent, due not only to economic growth, but also to temporary benefits granted under the Andean Trade Promotion and Drug Eradication Act (ATPDEA). There was an important increase in sales of textiles and agricultural & livestock products, the main sectors that benefit from this agreement.

Meanwhile, China overtook the United Kingdom as Peru's second largest export market that accounted for 9 percent of total trade . Other important trading partners are United Kingdom, Chile, Brazil and, Colombia. All these account for 25 percent of our commercial trade.

Figure 8 Direction of Trade



B. Exchange rate

The nuevo sol appreciated 5.5 percent in 2004, closing the year at S/. 3.28. This came after four years with the exchange rate around S/. 3.50 to the dollar, with daily fluctuations between S/. 3.40 and S/. 3.65 over this period.

During the year, the multilateral real exchange rate (an indicator that takes into account domestic inflation and that of the country's main trading partners, as well as changes in the value of their currencies) fell by 1.5 percent because the nominal appreciation of the Nuevo sol (5.5 percent) was offset by the differential between the variation in the external prices index (7.9 percent) and domestic inflation (3.5 percent)

Table 15 Nuevo Sol variation during 2004 (Against main commercial partners currencies)

Country	Nominal	Real
USA	-5.5%	-5.7%
Euro zone	2.9%	1.4%
Japan	-1.8%	-4.9%
Brazil	1.7%	5.8%
United Kingdom	4.2%	4.2%
Chile	-1.0%	-2.0%
China	-5.5%	-6.5%
Colombia	9.8%	12.0%
Mexico	-5.0%	-3.5%
Argentina	-6.3%	-3.9%
South Korea	7.2%	6.7%
Taiwan	-0.2%	-2.0%
Venezuela	-21.3%	-9.3%
Canada	2.0%	0.6%
Bolivia	-8.3%	-7.3%

Source: BCRP

C. Customs Regulations To Stimulate Exports

1) Procedures pertaining to goods entering temporarily for further processing.- Pursuant to Article 70 of Legislative Decree No. 809, these procedures for temporary entry allow foreign goods to enter a customs area free of customs duties and other import duties as long as they are to be exported within 24 months at the most, after having undergone transformation or manufacturing processes and if the aforementioned goods are physically part of the product exported
2) Replacement of merchandise free of customs duties. In accordance with Article 78 of Legislative Decree 809, merchandise equivalent to that which, after being adapted for local use subsequently undergoes a process of transformation, manufacturing and is then incorporated in an export, is automatically exempt from customs duties and other import taxes as provided by the Procedures regarding replacements.
3) Drawback system.- Pursuant to Article 76 of Legislative Decree No. 809 (General Customs Law), drawback is a customs procedure that allows the total or partial restitution of customs duties levied on imported merchandise included in goods exported or consumed during their production process. There are not yet any official regulations for this procedure. In the meantime, the applicable regulation is the Simplified Regulation Regarding Procedures for the Restitution of Customs Duties, approved by Supreme Decree No. 104-95-EF on June 17, 1995. Export companies that import or receive imports through third parties of merchandise incorporated or consumed in the production of exports, as well as merchandise manufactured with imported goods or raw material acquired from local vendors, are eligible for drawback system benefits.
4) Temporary import.- Under Article 63 of Legislative Decree No. 809, the temporary import procedure allows the entry into the country of foreign merchandise, as specified by a Ministry of Economy and Finance Resolution, with no customs duties or other import taxes, as long as such merchandise is for a specific purpose in a specific place and is re-exported within the specified time frame-maximum of l2 months-without having undergone any kind of modification other than normal depreciation from usage. Included in the aforementioned merchandise is machinery, equipment and instruments used directly in the process of production or while rendering services, except for vehicles used in the transportation of cargo.

D. Social security and pensions

The employer contributes 9% of total payroll to the National Health System. This contribution provides employees disability, illness, maternity and death benefits, as well as medical care. According to the new Health Care Law, the National Health System will be complemented by the health programs and plans that the employers may grant to their workers with their particular health services or with private Health Care Companies (EPS) that shall be authorized to carry out such activities. The employers may elect the healthcare plan or program for their employees; however, they shall previously submit it to their vote. Employees that should desire to remain or enter the National Health System may do so.

The employers that provide healthcare through the complementary plans and programs are also obliged to pay the 9% contribution to the National Health System. However, employers may use a portion of the expenses incurred in healthcare as credit against the 9% contribution.

Employees contribute with 13% of their salaries to the National Pensions Systems (SNP) which is managed by the National Pension Office (ONP).

Employees affiliated to SNP, at their choice, can switch to the Private Pension System (SPP). This system is operated by private entities (AFPs) authorized to manage pension funds. They provide employees retirement and disability pensions and funeral costs. Employers are responsible for withholding employees' contributions to AFPs from monthly salaries and depositing them with the AFP elected by each employee. The maximum withholding is 11.8% of gross remuneration.

V. Conclusion : Where We Stand and Where We Go?

Despite the economic growth of the past few years, recurrent taxation reforms have been insufficient to meet the needs of the population in terms of both the quality and the quantity of public services. Although tax administration has made important advances over the last decade, the efficiency and effectiveness in tax collection needs to be further improved. Taxpayers continue to perceive the tax system as being neither credible nor legitimate. There is a perception of horizontal inequality and a lack of transparency in the mechanisms used, and there is a perception that the general needs of the population are not being met, neither in terms of quality nor in quantity.

Peru has a tax effort notably inferior to those found in more developed countries, but it is on par with the other economies in the region. Tax pressure decreased sharply in the 1980s and tax collection reached its lowest levels falling from 15.8% in 1980 to 7.0% in 1989. As a result of the reform of the early 1990s, this curve was reversed and the tax effort grew until 1997, only to later drop again to 12% in 2002, a similar level to when the reform was initiated. This drop is explained by the combined effects of the economic slowdown, the use of tax stability agreements, and the proliferation of incentives, exonerations or special tax treatment.

The Peruvian system is one of the simplest in the region in terms of the types of taxes it manages. There are basically four: a general sales tax (IGV), income tax (IR), selective consumption tax (ISC), and duties on imports.

However, and although the basic design is simple, frequent changes in the taxation rates applied have made the system increasingly complicated, burdensome and less transparent.

During the past decade, the income of local governments accounted for close to 13% of the total central government income. Transfers were the most important component for municipal governments (46% on average), followed by non-tax income (35%), which represented more than twice the amount of tax income. It is interesting to observe that in the second year of decentralization in Peru (2004), 77% of public finances remain centralized in the national government, meanwhile the regions register 22% and there is a further 8% at the local level.

The income structure of local governments has not varied much more than what was observed during the past decade. In terms of tax income - taking as proxy ordinary resources generated by each level of government - local governments only account for 0.04% of the national total. This situation shows the need to strengthen the ability of local governments to generate their own income, to promote greater local tax effort, and enhance transparency and accountability.

The principal source of tax income is the general sales tax (IGV), with income tax (IR) a distant second. While the amount of income tax has increased, it does not even account for half of the amount raised by the general sales tax. In terms of tax rates, the most significant variations are for personal income tax. In the past decade, the minimum rate has more than doubled (from 6% to 15%) and the maximum rate has fallen (from 37% to 30%) to match the rate applied to corporations, which had remained unchanged.

There is a clear argument that the tax effort in Peru is weakened by the large, informal economy. Henceforth, the level of tax collection is far below what it ought to be.

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