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REASONS FOR SUCCESS OF THE MEXICAN BORDER INDUSTRIAL FREE ZONES ^{1/}

by

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INTRODUCTION

There is a new multi-faceted manufacturing business growing in the developing world today: it is labor-intensive (electronics/garments/shoes/toys/instruments, etc.), it employs a bewildering number of raw materials, components, and sub-assemblies, it serves many markets--principally the developed nations, but also the less-developed, it has attracted the participation of many companies, large and small, it takes place in many countries around the world. It has reached a stage where the United States market alone provides employment to some 400,000 factory workers in 22 developing nations and is growing at a compound rate above 40% per year.

The barriers to this new manufacturing business are the same as the traditional barriers to trade: 16th Century customs procedures, quotas, subsidies, central bank financial controls, immigration restrictions, and trade policy influences from Common Markets and other powerful groups--all of which interfere with the required planning, scheduling, and risk management of manufacturing enterprise. Production efficiency does not permit interruptions and uncertainties caused by trade barriers--or, put the opposite way, trade barriers prevent production.

Hence, the old Free Port which was a device to permit trade efficiency in the face of trade barriers has become the father of the Industrial Free Zone which is a device to permit efficient production of goods.

The Mexican Border Industrialization Program during the period 1965-74 solved some of the problems of unemployment and poverty along the United States Border by the use, in part, of industrial parks and free zones. Indeed, the principal promotional thrust of the Mexican program came from two competing industrial parks, one in a free zone and one outside, which put together powerful management teams and bore the main burden of convincing United States manufacturers to risk new investment in Mexico. In order to attract clients they created a new kind of industrial park--one which offers a wide variety of services to industry to help in promotion. This new so-called full-service industrial park or industrial free zone

can no longer be ignored as a competitive force in the worldwide development of labor-intensive industry. Together, these two parks achieved 30% of all that Mexico gained from the Border Industrialization Program.

We shall go into some detail later as to the nature of the new full-service industrial free zone which has emerged from Mexican experience. But first, let us look at the results of the overall program.

1. ACHIEVEMENTS OF THE MEXICAN BORDER INDUSTRIALIZATION PROGRAM

Between 1965 and 1974 Mexico achieved export value-added* approaching \$500 million annually (about one-fourth of all Mexican Exports) from its Border Program (Table I). It also obtained over 100,000 new direct manufacturing jobs (Table II), over 150,000 additional indirect jobs, and, most important, training of Mexican management and workers in high-technology competitive international business. I estimate in Table III** that the overall investment required in both the public and private sectors in Mexico to achieve this miracle was less than \$2000 per direct manufacturing job created and less than \$700 per total job created. Of this, two-thirds came from the private sector and only one-third from government investment in infrastructure and overhead. Each dollar invested produced annually \$4 of payroll, \$6 of exports, and \$12 of GNP.

Meanwhile, with respect to the price of unskilled labor, Mexico had progressed up the Development Stairway out of the Undeveloped

* Export value-added data are from U.S. Department of Commerce figures on imports under U.S. Tariff Articles 806.30 and 807.00 which permit duty-free return of U.S. metal articles sent abroad for processing and returned for further processing or of U.S. components sent abroad for assembly and returned.

** From MEXICO IN THE WORLD COMPETITION FOR MAQUILADOPAS - COSTS AND BENEFITS presented at the United States-Mexico Conference on Border Industrialization--The University of Texas at El Paso, April 17, 1975.

Table I

U.S. IMPORTS FROM LESS DEVELOPED COUNTRIES UNDER 806/807 (1970-74)

	Dutiable value (in millions of dollars)				
	1970	1971	1972	1973	1974
The top 10 (1974):					
Mexico	80	105	171	287	465
Taiwan	59	86	163	212	271
Singapore	16	33	67	124	152
Hong Kong	53	54	75	104	149
Korea	8	13	23	35	68
Malaysia	-	-	-	12	65
Brazil	1	1	4	12	47
Philippines	2	5	6	2	19
Haiti	2	3	5	8	14
El Salvador	-	-	-	1	8
Total	221	300	514	797	1,258
12 others	11	15	24	24	29
Total, all LDC's	232	315	538	821	1,287
806.30	11	24	43	100	170
807.00	221	291	495	721	1,117
o/o Mexico	34	33	32	35	36

Source: U.S. Department of Commerce.

Table II

EMPLOYMENT CREATED IN LDC'S BY U.S. 806/807 PURCHASES OF DUTIABLE VALUE^{1/}

Year:	Estimated level of employment (thousand employees)	o/o Mexico	Mexican Jobs
1970	58	34	20
1971	79	33	26
1972	135	32	43
1973	205	35	72
1974	322	36	116
LDC employment created, 1970-74	264	"	96

^{1/} Based on Mexican border development programme experience 1970-74 of \$4,000 of dutiable value per direct manufacturing employee.

Table III

THE COST/BENEFIT OF MAQUILADORA JOBS TO MEXICO

Basis: 1973 wages of US\$0.60 per hour

	ONE JOB (Pesos)	70,000 JOBS (Million Pesos)
THE BENEFITS		
Direct Payroll including fringes	16,525	1,157
Indirect payroll (2 additional jobs)	<u>16,525</u>	<u>1,157</u>
Total Payroll	33,050 (3 jobs)	2,314 (210,000 jobs)
Retail Sales (5 x Payroll)	165,250	11,538
GNP Contribution (Value Added)		
1 Maquiladora Job	50,000	
2 Indirect jobs	<u>50,000</u>	
Total	100,000	7,000
Exports 1 Maquiladora Job	50,000	3,500
Tax income to Government		
On Retail Sales (4%)	6,610	463
On Payroll		
5% income tax	1,653	116
15% Social Security	4,958	347
1% Education	331	23
5% INFONAVIT	<u>1,653</u>	<u>116</u>
Total Taxes	15,205	1,065
THE COSTS		
Investment		
Private Sector:		
Land 60 M ² @ \$50/M ²	3,000	210
Buildings 15 M ² @ \$750/M ²	11,250	788
Promotion	<u>2,000</u>	<u>140</u>
Total Private Sector	16,250	1,138
Annual Cost		
Public Sector:		
Estimated added personnel cost		20
Estimated added infrastructure cost		<u>100</u>
Total Public Sector		120

Cont'd....

Table III (Continued)

COMPARISON OF COSTS AND BENEFITS

Tax return to Government as per cent of Annual Cost:

$$100 \times \frac{\text{Annual Tax Income}}{\text{Annual Public Sector Cost}} = 100 \times \frac{1,065}{120} = 888 \text{ \%/year}$$

Return on Investment

Private Sector Investment	1,138
Five years Public Sector Cost	<u>600</u>
Total National Input	1,738 million

$$\text{Investment per job} = \frac{1,738 \text{ million}}{210,000 \text{ jobs}} = 8,276 \text{ pesos (US\$662)}$$

$$\text{GDP per peso of investment} = \frac{100,000}{8,276} = 12 \text{ pesos}$$

$$\text{Exports per peso of investment} = \frac{50,000}{8,276} = 6 \text{ pesos}$$

$$\text{Payroll per peso of investment} = \frac{33,050}{8,276} = 4 \text{ pesos}$$

Ocean (Figure I) rising from the level of El Salvador and Korea, past Hong Kong and Singapore, to the level of the United Kingdom and Japan. Mexico alone in the Western Hemisphere had recognized the opportunity presented by the United States market for labor-intensive manufactures and had proceeded singlehandedly to push the Western Hemisphere share of the United States Market to almost equal that of Asia in 1974 (Figure II) (It actually passed Asia in 1975). To be sure, Mexico had priced itself temporarily out of the market by the end of 1974 due to dramatic increases in the minimum wage, but the recent late 1976 devaluations of the peso have cut the cost of labor by about one-fourth and returned Mexico to a highly competitive position with respect to other nations.

But these recent developments are not a useful part of our story—at least for now—Instead, we are concerned with how Mexico got into this new export business in the first place.

2. THE REASONS FOR SUCCESS

Why was Mexico able to achieve such outstanding success?

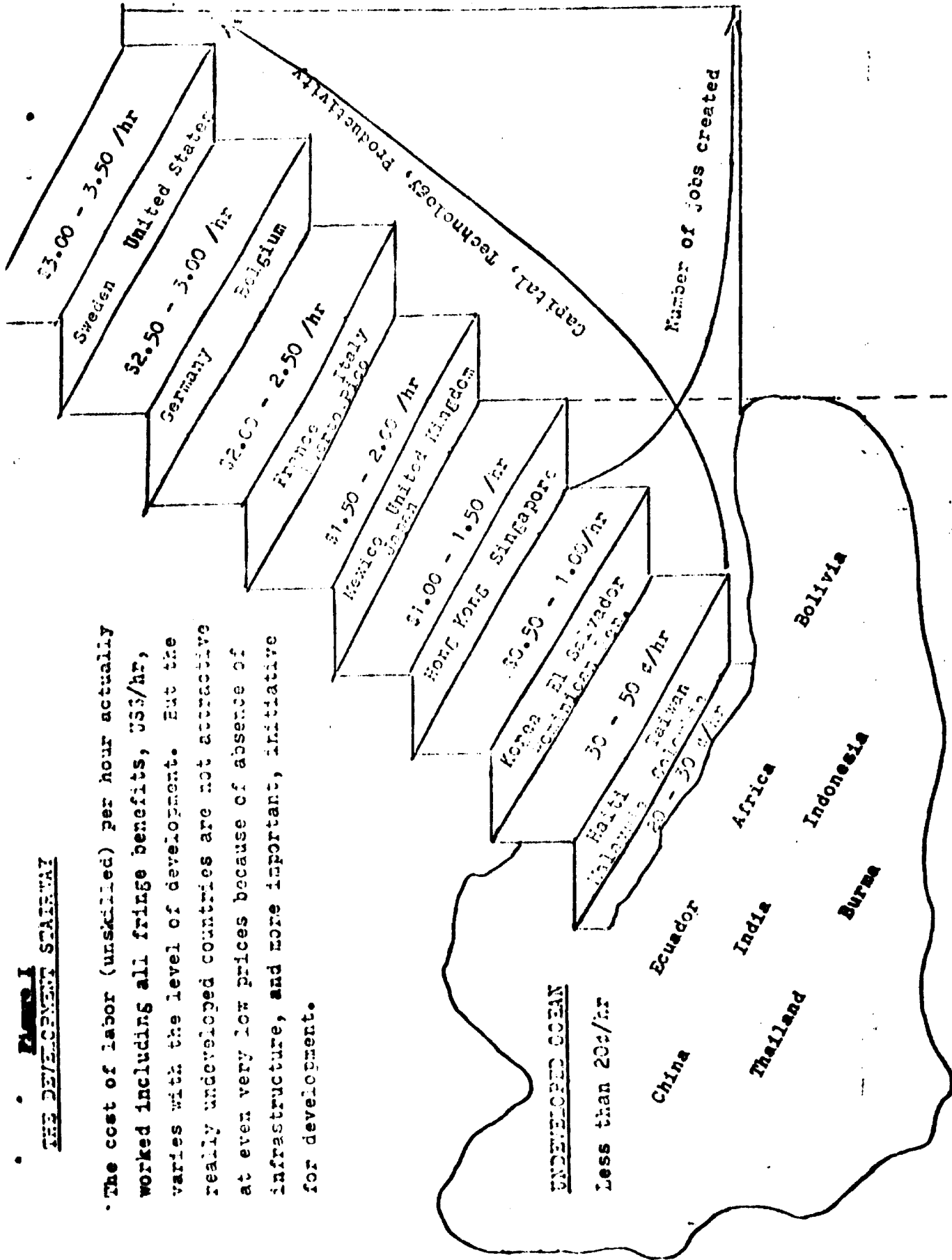
I believe the primary reason was that the situation along the Border permitted a serendipitous approach to attracting foreign industries by private initiative in its own interest—while Federal Government acquiesced or selectively supported the phenomenon but took no active role. (State government was also generally passive with the exception of Sonora). The Federal Government had studied the opportunity in 1964, and by an exchange of letters between the Secretary of Treasury and the Secretary of Industry and Commerce in 1965 had established the framework. The rest depended on the situation and the initiative—which was as follows:

(a) THE MARKET for labor-intensive goods in the United States was large and growing. It had been served from Asia and Europe for many years, but not from the Western Hemisphere (except Canada).

(b) THE LABOR SUPPLY was large and growing. It was composed principally of young women, but also many young men prevented from entering the United States to harvest crops by the collapse of the

Phase I
THE DEVELOPMENT STAIRWAY

The cost of labor (unskilled) per hour actually worked including all fringe benefits, \$53/hr, varies with the level of development. But the really undeveloped countries are not attractive at even very low prices because of absence of infrastructure, and more important, initiative for development.

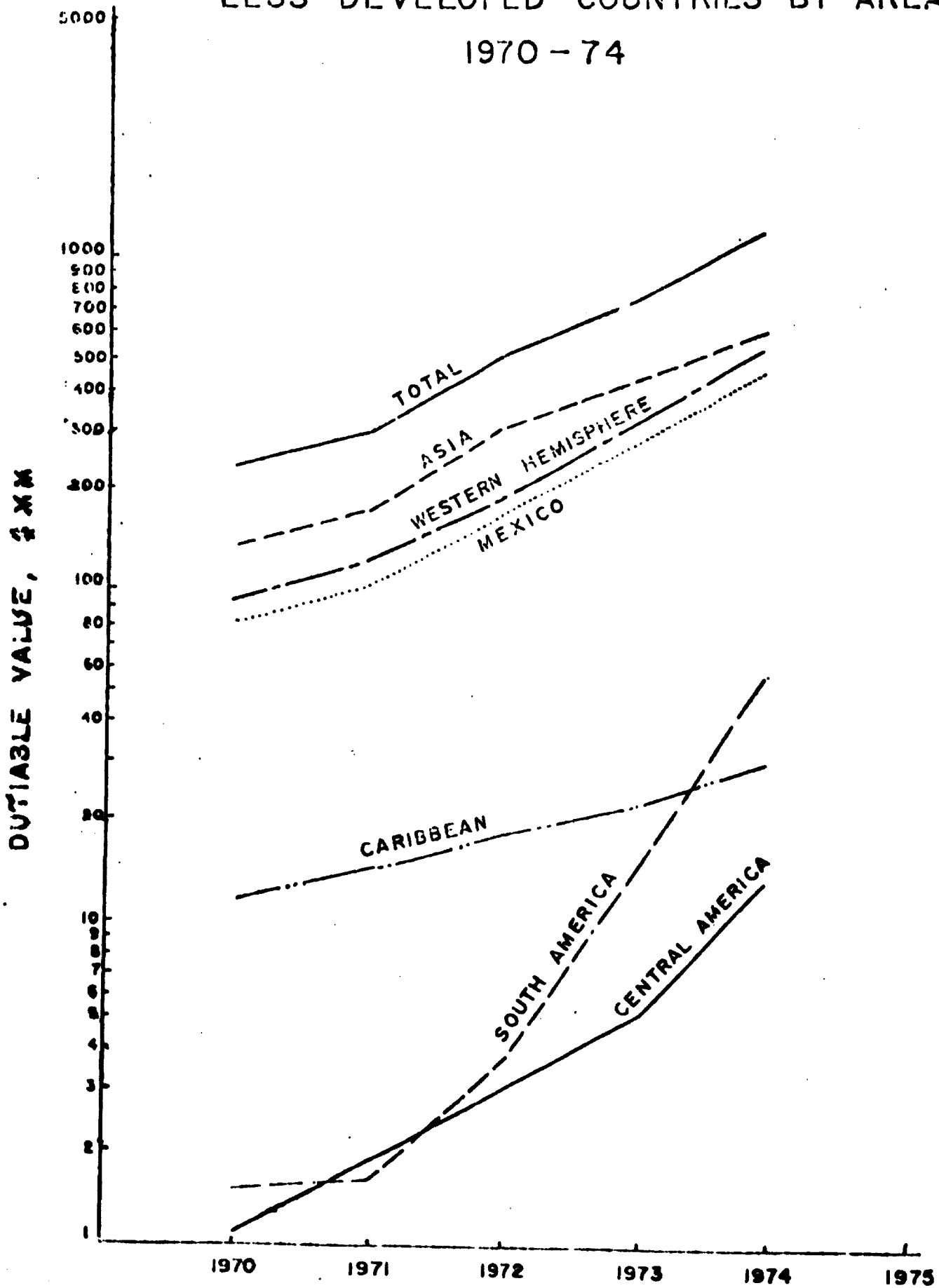


DEVELOPED COUNTRIES

UNDEVELOPED COUNTRIES (where manila foras go)

Figure II

U.S. TARIFF ARTICLE 807.00 LESS DEVELOPED COUNTRIES BY AREA 1970 - 74



Mexico/U.S. Bracero Agreement in 1965. (This agreement made during World War II had permitted many Mexicans to enter the U.S. temporarily.) These young people were absolutely unskilled, but were willing to work for low pay and had very favorable attitudes towards work. Later investigations showed them to be highly productive in comparison with U.S. workers when trained.

(c) THE FREE ZONES had been established many years before to permit the Mexican border population to import its needs from the United States since it could not be served economically by Mexican industry located 1500 miles away in the center of the country. Only one or two export manufacturing plants had been established to take advantage of the industrial possibilities of the Free Zones in twenty years time. The Free Zones were located in extreme Northwest Mexico including the entire State of Baja California and several towns in Sonora (including Nogales). The basic advantage of the Free Zone over the rest of the country was the simplicity and rapidity of entry and exit of goods. From an industrial development standpoint, the crucial factor was that a truck could cross from the United States into Nogales, Mexico in 30 minutes because of the Free Zone at Nogales whereas at Juarez, which had no Free Zone, it would take 2 to 5 days and a lot of red tape.

(d) THE INITIATIVE TO CREATE AND DEVELOP NEW INDUSTRIAL PARKS came from two distinct groups - one at the Nogales, Sonora Free Zone and the other at Ciudad Juarez, Chihuahua. Both groups were private corporations with strong leadership which used private funds of their own and from Mexican and U.S. banks -- and each regarded the other as a strong competitor, although they cooperated from time to time on common problems which arose with the Governments of the United States and Mexico.

The Bermudez Industrial Park at Juarez served a centrally located border city of 500,000 population directly opposite a United States City of similar size, El Paso, Texas. It was founded in 1965 on about 100 hectares of private land on the outskirts of the city. Initially it was a real-estate type park but later became a full service park by adding an incubator factory adjacent to park.

headquarters and providing many new services.

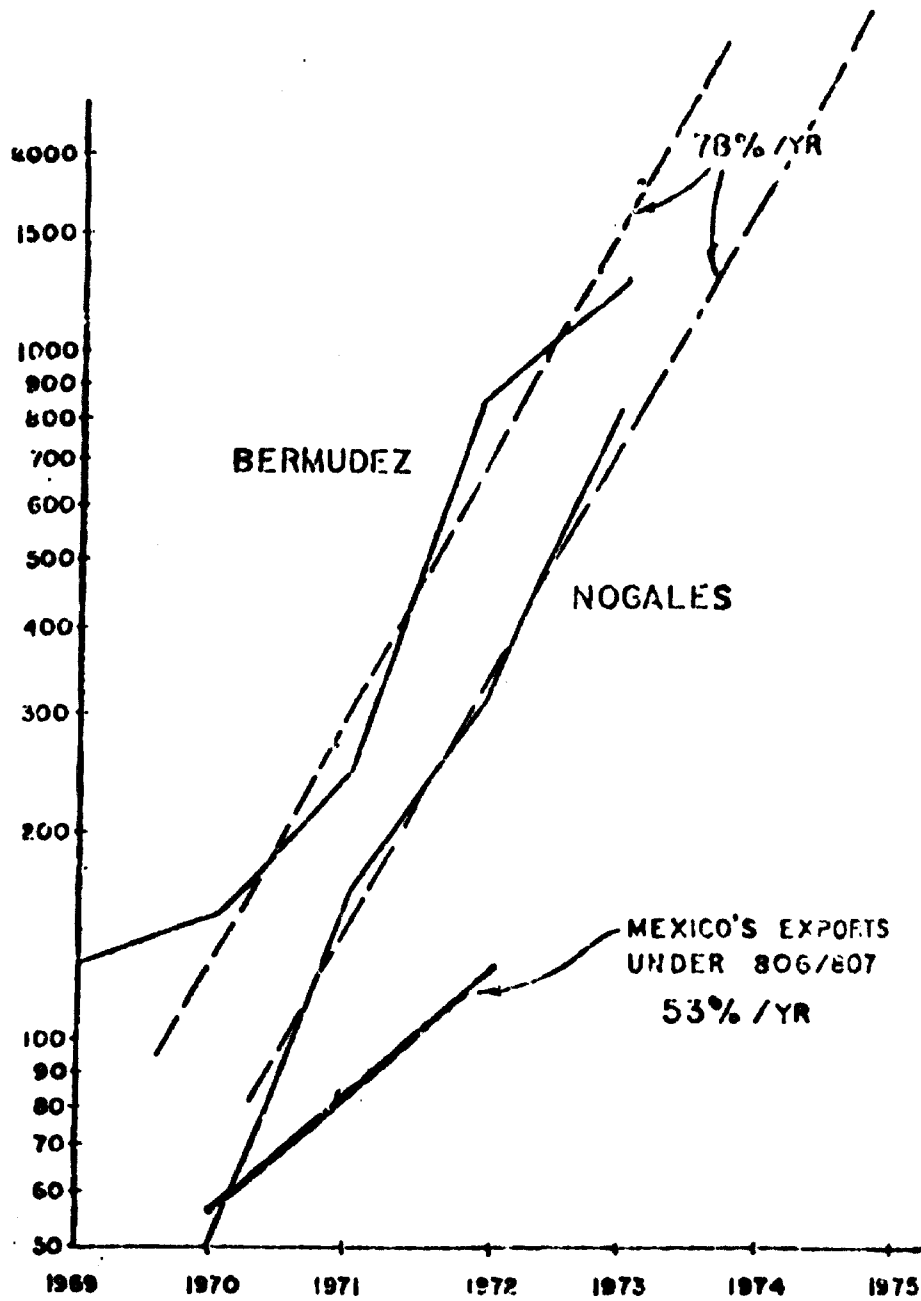
The Nogales Industrial Park started three years later in 1968 in Nogales, Sonora, population 70,000, opposite Nogales, Arizona with 8,000 and 60 miles south of Tucson, Arizona with 200,000. It was initially a consulting and promotion group which leased 50 hectares of municipal land for 30 years promising to turn back to the city at the end of the lease all the land, buildings and improvements thereon free—and paying rent meanwhile. This group took the lead in providing services under a system to be described later known as the SHELTER PLAN. It, too, established an incubator factory adjacent to its headquarters in order to offer better service to clients.

Even though Nogales started later, it quickly became a strong competitor because of the advantage of the Free Zone. Manufacturers otherwise attracted to the Bermudez Park could be enticed away by exposure to the long customs delays at Juarez—and were. Recognizing its competitive deficiency, the Bermudez group initiated a campaign in Mexico City to change the entire approach of Mexican Customs with respect to imports at Juarez. Within two years they were able to reduce truck crossing times at Juarez to 30 minutes and that particular competitive advantage of Nogales disappeared. In fact, the entire customs system of the country was changed to the point where Free Zones were no longer thought necessary to attract industry to the Border. As a result of this, the Nogales Free Zone was terminated in 1975 and the new customs rules were applied there as well.

Both industrial parks prospered and were successful in their communities. The Nogales Industrial Park created 6,000 direct jobs within its boundaries and helped attract another 9,000 direct jobs to Nogales through its consulting activities. The Bermudez Industrial Park created 12,000 direct jobs within its boundaries and helped attract another 6,000 direct jobs to Juarez through its promotional activities. In comparison to the growth of Mexican exports in this high-growth industry of 53% per year, the two industrial parks grew in space leased at 78% per year as shown in Figure III

Figure III

GROWTH OF TWO FULL-SERVICE INDUSTRIAL PARKS



This is not to say that these two industrial parks were the only organized promoters in Mexico--quite the contrary--Mexicali developed because of a good but small industrial development group in the State Government which spread individual companies around the city. No industrial park was established until later when a private real-estate type park was formed which is now getting business. Tijuana developed without any planning and had the poorest experience on the border, even though it achieved significant employment, because of poor quality factory buildings and dismal working conditions in the slum areas--this in spite of the fact that it was next to California where ample opportunity to attract industry presented itself. Both Tijuana and Mexicali are in the Baja California Free Zone which continues to the present but will probably be terminated by the Federal Government of Mexico in the near future.

Along the Texas border a number of real estate type parks were developed through private initiative, particularly those at Reynosa and Matamoros. The Mexican Government established a small new park at Piedras Negras in 1973. In the interior, the Chihuahua Industrial Park and the new State Free Zones of Durango and San Luis Potosi were begun in 1975 in an effort to attract industry away from the border to lower wage cost areas of higher unemployment. The private parks outside the free zones were helpful to the Bermudez Park in its efforts to change customs procedures--and they benefitted from the results. From this effort came the Asociacion Mexicana de Parques y Ciudades Industriales, A.C., a non-profit association to which all important industrial parks in Mexico now belong which is used to solve problems with the Mexican Government.

It is fair to say, however, that the Bermudez and Nogales parks were the leaders in the development of the Mexican Border. They were established earlier, had substantial funding, attracted managers who could get things done--so their impact on the program was much more important than the rest.

3. REAL ESTATE TYPE INDUSTRIAL PARKS VS FULL-SERVICE TYPE INDUSTRIAL PARKS

From the Mexican experience related above it is now possible to draw a crucial generalization as to the competitive capacity of the full-service park in comparison with the real estate type park. First—a definition of the two. As shown in Table IV the real estate type park is limited to those functions which directly relate to getting adequate space built for a manufacturer in an industrial park—and little more. The full-service type park is a promotion-oriented manufacturing and service establishment which is designed to attract clients through demonstrating that it will be possible for the manufacturer to operate successfully in the park and in the country in which it is located. It is a "culture-shock absorber" designed to lower the risk of the new manufacturing enterprise, improve its cash flow, and help it get into business quickly. Through the fees it charges (which are economical in comparison with costs in developed nations for labor-intensive production) it is able to sustain the critical costs of promotion without which no industrial park succeeds.

4. THE NEED FOR PROMOTION

Insufficient funds for promotion and unwise promotional expenditures are probably the principal reasons for failure of industrial parks and free zones to "take off". For lack of understanding of the promotional process, many who draw up budgets for industrial free zones and parks seem willing to spend millions of dollars on infrastructure, roads, buildings, street lighting, drains, fire protection, communications services, even financial and computer centers—yet to cut promotional budgets to a few thousand dollars thinking that a brochure or two will serve to attract companies. I support sound budgeting for necessary infrastructure—especially if it is built stepwise as needed, but what good is a building or a fence if it never attracts customers?

The second most difficult problem is the lack of patience on the part of industrial park investors to wait for promotion

THE FULL-SERVICE PARK

REAL ESTATE-TYPE PARK

LAND
BUILDING
ELECTRICITY
TELEPHONE
WATER
DRAINAGE
FIRE PREVENTION

SERVICE-TYPE PARK

ALL ABOVE - PLUS

TEMPORARY FACTORY SPACE
EMPLOYEES
SUPERVISION
MAINTENANCE SERVICES
CUSTOMS AND CROSSING SERVICES
IMMIGRATION DOCUMENTS
ACCOUNTING AND CONTROL
PERMITS
CREATION OF MEXICAN COMPANY
TRAINING OF PLANT MANAGER
IN LABOR RELATIONS
ADMINISTRATION
CUSTOMS AND CROSSING
REPRESENTATION WITH GOVERNMENT OF
MEXICO AND UNITED STATES

to do its work and begin to bring in customers. On the average at Nogales it took two years after the potential client visited the park before he was operating in his own factory in the park--and it sometimes took a year or two to get him to make the first visit. The bulk of the promotional effort is follow-up of leads--solving client problems as he studies the park--working out feasibility studies--reducing park costs, transport costs, and finding other ways to make the park more competitive. Of course, it is necessary to make the park known to its potential market through brochures, participation in industrial conventions, and contacting clients through direct mail, telephone and personal calls, but most of the work involves competent professionals assisting clients in problem-solving.

All this costs money--and requires great patience. At Nogales we spent one million dollars on promotion for five million dollars of construction over a six year period. At least \$500,000 of promotional cost occurred in the first three years while construction reached \$500,000 only at the end of the period--in other words, one dollar of promotion for each dollar of construction by the end of the third year. In the end promotion costs amounted to about \$160 per direct manufacturing job created at the Park, but they were much higher than this at the beginning.

5. THE SHELTER PLAN - AN EXAMPLE OF SERVICES OFFERED BY A FULL-SERVICE INDUSTRIAL PARK

The Nogales Park developed a system of services to attract customers which made it highly competitive with other competing locations--it frequently overcame nearby real estate type parks offering lower rental cost because of the value of these services to the client. In all at least thirty companies used the Shelter Plan at Nogales during the period 1971-74. Therefore, it is worthwhile to spend time looking at the details of the Shelter Plan to see what services were offered.

Corporate use of the SHELTER PLAN was not confined to smaller companies, although it is of great benefit to them. Instead, many of the largest corporations in the United States availed themselves of the Plan—including Pockwell, General Electric, Samsonite, Memorex, and Teledyne.

What is it about the SHELTER PLAN which has attracted the interest of all these important companies? Simply, that risk of a new venture is reduced, corporate management is better trained in how to do business in the new country, selection and training of personnel to high levels of productivity is speeded up, and positive cash flow is frequently generated early and in considerable amount.

(A) THE COST OF FEAR

Establishment of a new overseas manufacturing facility is regarded with fear by many managements--especially those which have considerable experience in such activity. Careful planning from the Board level down is proclaimed--and corporate bureaucratic expense rises in proportion to the size of the company and the size of the overseas venture. International legal and accounting firms are consulted, visits to top government officials in the new country are made by two or three tiers of corporate management, and in due course a Board resolution establishes permission for the Corporation to create a new company in the new country--and finally begin its manufacturing experiment. At this point the corporation is ready to face its real problems of how to manufacture and ship products using local people--how to deal at the practical level with the new government--and how to control and manage the activity with trusted managers of great experience from the home office who may have little knowledge of how to operate outside of the home office. In these matters RISK is high, even for experienced firms--and the time it takes to get into business is long.

(B) WHAT IF IT DOESN'T WORK?

Suppose it is discovered that local factors impede productivity-- that the best manager from the home office is a failure in getting production to acceptable levels where he can't speak the language--that the product sent abroad was too complex to begin with--that laws in the new country or home country block or delay imports or effect taxes--or result in labor violations and penalties--or just plain stoppages--that too much time elapsed before marketable quantities of products were available. What to do? Well, the parent corporation can pour in more money, or it can liquidate the new foreign company, and write off the considerable expense.

(C) HOW THE SHELTER PLAN CONTROLS RISK

Under the SHELTER PLAN no corporate commitment is made to the new country. In fact, in the new country, the corporation doesn't exist and therefore has no legal, taxable, or bureaucratic standing.

The secret is that the corporation has made a contract with a United States firm which supplies certain services, space, and employees in the new country for six months to enable the corporation to try out manufacturing on a pilot-plant basis using its own management and key equipment, but with no permanent ties to the new country until feasibility of the new production is fully demonstrated. The cost of SHELTER PLAN services is charged on an hourly basis for the number of workers employed and the contract can be extended or terminated under pre-set conditions. Thus, the corporation knows what it is getting into from the beginning and is in a position to better manage its risk.

Instead of incurring heavy staff work and payments to outside lawyers and accountants to establish a new company overseas before knowing how well it will produce, the corporation pays only for sending a manager and some equipment and raw materials to the new country in which it may or may not later establish a permanent facility. Thus RISK is reduced.

(D) MANAGEMENT TRAINING

The SHELTER PLAN insulates the manager initially from day to day routine permitting him to concentrate his full attention

on training new workers. If he does not speak the local language, he is provided with an assistant who is bilingual and who helps him with the training process. Once training has proceeded to the point where acceptable product is emerging from the production unit, the manager is trained to handle his own import/export functions with local customs officials. He is given practical training in local labor law and practice and encouraged to meet with labor officials so they get to know him and he them. He becomes a part of the local managers group from the beginning so he can be aware of outside problems and solutions as they are being devised by other companies. He meets local businessmen and begins to be active in improving the business climate of the country. The training he receives and the people he comes to know can be invaluable in his corporations' later decision to stay or leave--and can reduce the cost of staying considerably.

(F) LABOR

The SHELTER PLAN contractor in the new country hires personnel for training under the new contract with the corporation. These workers are subject to screening as to aptitude and attitude, take a physical exam, and their records are reviewed by the corporation's manager before they are hired by the SHELTER PLAN contractor. They are hired from the beginning to eventually become employees of the corporation if the corporation finally decides to create its own new firm in the country. They agree to transfer to the new corporation at no penalty whenever it requests them providing their seniority is recognized as of the day they are first hired by the SHELTER PLAN contractor. The initial group of employees, once trained, becomes a source of supervisors and lead workers for expansion. If acceptable productivity and quality standards are met, more employees are hired and trained and more product at high margin results. If the corporation decides to commit to the country, then a new company is formed in the country and a building contracted for it. During construction, the SHELTER PLAN operation grows through increases in space and training capacity until, when the

corporations' own building is ready, the entire operation is transferred to the new building and the workers officially become part of the corporations' labor force. The process proceeds smoothly all the way from a low-risk pilot operation to full scale manufacturing in the corporations' own plant.

(F) POSITIVE CASH FLOW DURING START-UP

Once a company has contracted for the SHELTER PLAN, its expenses are limited to paying the hourly cost of the PLAN and investing in moving a manager and shipping certain key equipment and raw materials. After this modest cash commitment, it begins to receive finished product produced during training activities by the SHELTER PLAN contractor. Sale of this product can result in a positive overall cash flow fairly early in the experimental phase providing investment is carefully controlled and volume is sufficiently high--or a high profit margin exists.

To illustrate, the current cost of SHELTER PLAN facilities and labor at the San Cartolo Industrial Free Zone in El Salvador at a level of 50 employees, is \$1.50 per hour actually worked at the plant of the SHELTER PLAN contractor, MANEXPO. This is about \$3.00 per hour under the cost in the United States for space and labor. This margin of \$3.00 is generated every time the product is sold. A product which utilizes 100,000 hours of labor per year (50 workers) has a margin of \$300,000 per year to apply to the modest investment and costs of transport and customs duties.

In the present financial situation, this positive cash flow can make an important difference to companies which have not yet gone ahead with necessary expansions or improvements in productivity to enhance profitability of their operations.

Because overhead costs can be spread over several clients at one time, Shelter Plan rates are competitive within the Zone for a manufacturer employing up to about 100 persons. Above this size it is generally attractive for a client to form his own corporation (with the help of the Shelter Plan staff). As clients grow and leave

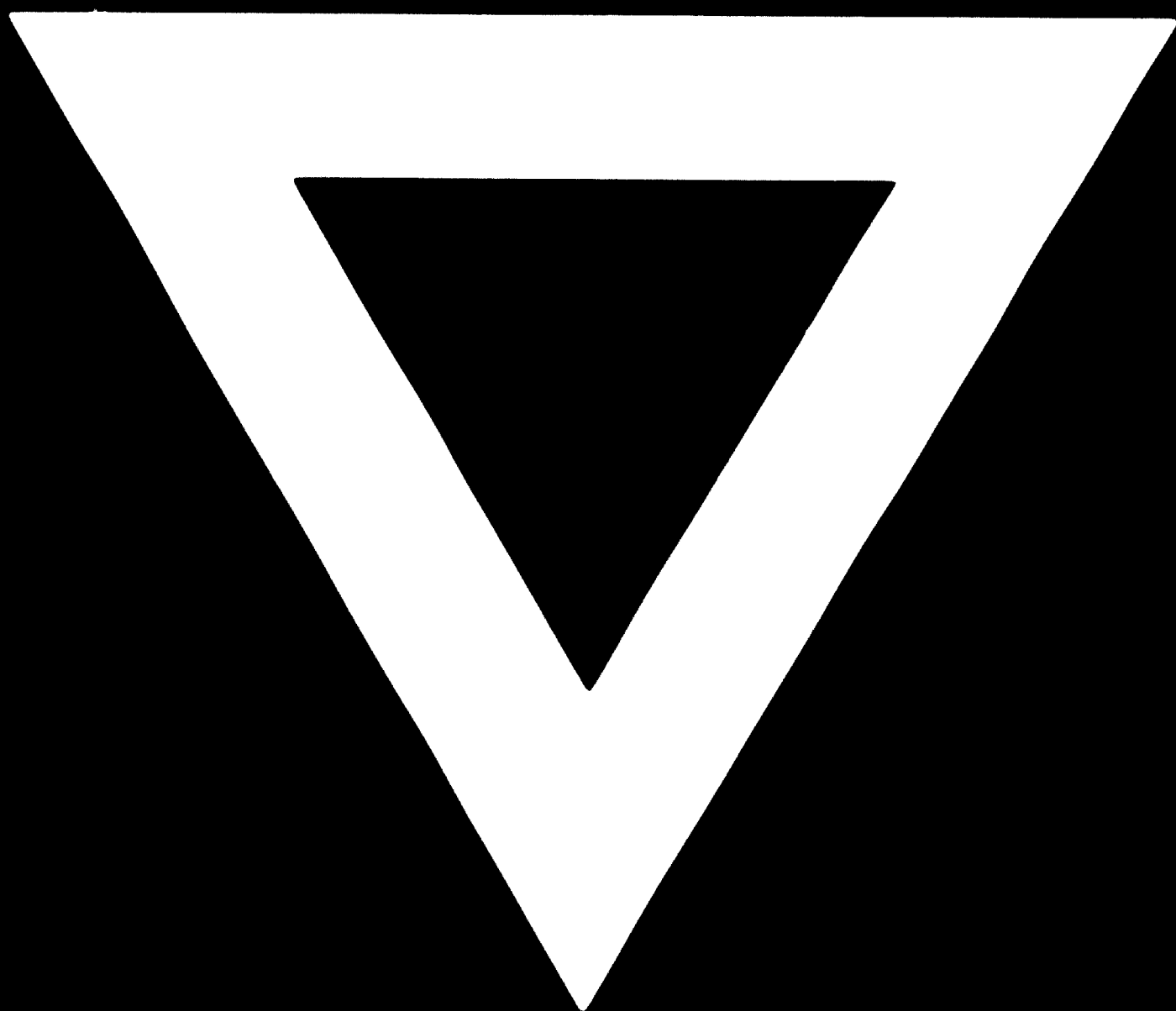
the Shelter Plan others must be found to take their place in Shelter Plan buildings--this is entirely consistent with the objectives of the Zone in which the Shelter Plan operates and the result is a happy blending of the operating function of the Shelter Plan with the promotional needs of the Zone. Income to the Zone from Shelter Plan operations helps defray the high promotional costs of the Zone.

(C) NEW INDUSTRIAL DEVELOPMENTS IN THE MEDITERRANEAN BASIN

In 1970 the imports of labor-intensive goods by European Countries were about equal to those of the United States. We have not investigated current imports but there is no reason to believe that Europe has not grown as rapidly as the U.S. and now offers a vast market for development by a few strategically placed Industrial Free Zones around the Mediterranean Basin specializing in labor-intensive manufactures. Comparison of the jobs created by the United States market in Table II with the needs of the European market would indicate the possibility of creating five to ten such Zones in the next decade--with each rising to an employment level of 10,000 jobs. The market is there, the return on investment is high, the ability to provide jobs and improve technology transfer is great using the Pill-Service type Industrial Free Zone I have described--WHERE AND WHEN DO WE BEGIN?



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