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ADVISORY SUPPORT TO MITINCI ON FREE ZONE POLICIES
A REVIEW OF THE PERUVIAN EPZ PROGRAMME

SI/PER/93/801

PERU

Terminal report*

Prepared for the Government of Peru
by the United Nations Industrial Development Organization,
acting as executing agency for the United Nations Development Programme

Based on the work of Thomas Kelleher and Jean-Marie Burgaud, experts in
development, promotion and management of export processing zones

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INTRODUCTION

The purpose of the project SI/PER/93/801 was to provide advice to the Government of Peru on various aspects of free zone development including (i) policy issues, (ii) institutional arrangements for the development and operation of free zones, and (iii) ways and means of attracting investors.

There is an underlying assumption that free zones are a feasible option for Peru at this stage in its development process, and that the Government of Peru wants to use the free zone as a method of encouraging investment (both domestic and foreign) in the export manufacturing and trading sectors. Apart from foreign exchange earnings and employment creation, the free zones are expected to contribute to the Government's efforts to decentralize economic activity away from Lima. All six proposed free zone sites which have been selected by the Government are in regions outside Lima along the Pacific coastline with port facilities. The sites in question include Ilo, Matarani, Pisco, Chimbote, Trujillo and Paita. The sites at Paita and Ilo are viewed as possible links between the Pacific basin countries and many parts of the interior of Latin America.

A large number of Export Processing Zones are in operation around the world but only some have been successful. Many lack a suitable investment climate, experience difficulties in operating under complex laws and regulations or face problems of management, inappropriate location or high costs. An inadequate understanding of the basic preconditions for operating an EPZ and the role of the EPZ as one of the options among export policy instruments have led to more failures than successes.

A crucial issue therefore is the proper understanding of the nature, function, potential and limitations of free zones as a policy instrument. Chapter 1 deals with this issue, drawing on experience with free zone development in many parts of the world, including other countries in the Caribbean and Latin America. In providing policy advice on free zone development, it is

necessary to understand the economic climate in which the proposed zones will operate. Consequently, a brief review of the Latin American and the Peruvian economy is given in Chapter 2.

The Peruvian free zone programme is reviewed in Chapter 3. The conclusions and recommendations are covered in Chapter 4. The conclusions and recommendations were discussed by the consultants during their stay in Peru with senior CONAFRAN officials, as well as senior Ministry officials including Mr. Jaime Armando García Díaz, Vice Minister for Industry, and UNIDO Country Director, Mr. Carlos Alberto Goulart.

It was not possible in the time available (3 weeks) to review in depth the proposed free zone sites. Five of the six proposed sites, plus the ZOTAC site at Tacna were visited. The consultants spent one to two days each at Paita and Ilo. Visits to other sites were limited to one or two hours. It was not possible to visit the Matarani site. However, the consultants did meet the President of the Arequipa region (where Matarani is situated) and had discussions with him on the subject. An itinerary and list of meetings is set out in Annex 2.

The terms Export Processing Zone (EPZ) and Free Zone have been used interchangeably throughout this report. Essentially, what they refer to is a limited geographic area, surrounded by a fence and controlled by the customs, where investors can import equipment and materials free of duties and taxes, process the materials and export the finished product. Some domestic sales may be permitted at full or concessionary duty rates. Brief definitions of common types of free zones are given in Annex 4.

CHAPTER 1
FREE ZONES AND ECONOMIC DEVELOPMENT

1.1 The Export Processing Zone (EPZ) - its role

An EPZ is a policy/promotion instrument used by countries when they are beginning their efforts to attract foreign (and domestic) export-oriented manufacturing investment. The EPZ, properly planned and developed, provides (i) streamlined operating procedures; (ii) good infrastructure; and (iii) an EPZ Authority who will assist investors in obtaining various approvals and permits.

The arguments or justification for an EPZ in the early stages of a country's attempts to promote export-oriented foreign investment are:

- (i) The country's infrastructure is underdeveloped and the concentration of services in a well chosen site, close to international communications (transport and telecommunications) and support facilities is desirable.
- (ii) Customs procedures for import/export are often complex and difficult and can be simplified in a free zone; and
- (iii) There is a need for a dedicated promotion oriented organization to assist the investor in completing the necessary formalities.

As the country's infrastructure develops, customs procedures are streamlined and bureaucracy becomes more attuned to the requirements of export industry, the need for special arrangements in the form of an export processing zone diminishes. Export manufacturing industry can be accommodated in a range of standard industrial parks where bonded facilities are available.

In practice this is how the situation evolved in those countries which pioneered the EPZ concept, e.g. Ireland, Korea and Taiwan. The EPZ played an important role in the early years (first 5 years) of those countries attempts to attract export manufacturing industry. Zone exports increased in absolute terms and as a percentage of total manufacturing exports. After some time new export-oriented industries were established in industrial parks with open bonded facilities throughout the country. The country's non-free zone manufactured exports increased dramatically and the EPZ share of total manufacturing exports declined. Table 1.1 illustrates the point.

TABLE 1.1
Free Zone Exports as a % of National Total

Years	Ireland			Korea		
	(1) Shannon	(2) Country Total	1 as % of 2	(1) Masan	(2) Country Total	1 as % of 2
	in M £Ir			in M US\$		
1951-63	24	149	16			
1965	23	81	28			
1966	32	100	32			
1967	33	112	29			
1970	40	193	21			
1971	34	220	16	1	1,067	0.1
1972	36	282	13	10	1,624	0.6
1973	47	400	12	70	3,225	2.2
1974	53	544	10	182	4,460	4.1
1975	54	617	9	175	5,081	3.4
1980	131	2,250	6	674	17,504	3.6
1986	238	6,105	4	1,149	34,714	3.3
1991	385	10,526	4	1,586	71,870	2.2

In recent years the concept of the export processing zone has expanded. Special zones or facilities are being created together with special incentive packages to cater for the requirements of international service industry and research and development activities.

Another trend in free zone development which has accelerated in recent years is that of private zones, the reasons being that (i) in many countries privately owned/managed zones have outperformed their public sector counterparts, as many Government run zones have failed to provide a businesslike management, and (ii) there is a shortage of investment funds from Government sources.

1.2 Free Zones and Industrial Development

Creating an industrial infrastructure which can produce efficiently a range of high value industrial products with modern machinery and a skilled workforce, requires a series of co-ordinated policy initiatives covering labour, fiscal and trade policy, transport, training, education, finance, infrastructure and investment promotion. At the level of the zone, close co-ordination and planning between investors and the people and institutions involved in (i) zone promotion and development; (ii) transport development; (iii) provision of infrastructure; and (iv) education and training is essential. Only with this co-ordination and planning can the zone evolve from a place for a low skilled labour intensive workforce to a centre for investors employing highly skilled personnel using modern equipment and facilities, and with strong links to the local and national economy.

This evolution can take up to 20 years. However, this evolutionary process from low to high skilled workforce does not happen automatically. Many of the zones established over 20 years ago have failed to evolve. They continue to employ an unskilled workforce. The first zone in the Dominican Republic was established in 1969. The emphasis there is still on low cost, low skilled labour intensive activity. In Mexico the first Maquiladora factories were established in the late 1960's. There have been some limited improvements in workforce skills and linkages with the domestic economy. The evolution in many other long established zones has been limited. The Mauritius free zone established in the early 1970's is still heavily dependant on low skilled garment activity, although it is making determined efforts to attract more skilled projects (e.g. electronics).

Singapore and Ireland are probably the best examples of evolution from low to higher skilled activity. In both countries the two key factors were: (i) a heavy emphasis on education and training; (ii) the targeting and aggressive promotion of more advanced industrial sectors, e.g. desktop computers, pharmaceutical manufacture, and healthcare products; and (iii) institutional links between the investors, the investment promotion agency and the education and training institutions.

At Shannon, for example, the Chief Executive of the Zone Development Organization was Chairman of the Board of Ireland's first technological university established near the zone and also first chairman of the National Training Authority. The President of the Technological University was a member of the Board of the Free Zone Corporation. Close links were established from an early stage between investors, the University and the Zone Development Organization. Investors are on the Board of both the University and the Zone Development Corporation. Investors employ University students during their training period and commission research from the University and also fund part of the University's development.

1.3 Basic conditions for development of free zones

The designation of an area as a Free Zone does not automatically make an area attractive as a location for foreign industry investment. The basic conditions for attracting export-oriented investors must exist, otherwise the investment will be of a lower quality than expected or worse, the investment will not materialize. In this aspect the key considerations are:

- (i) **Political and economic stability:** for most investors this is the most important consideration. Essentially what most investors look for is (a) a consistent economic policy favouring private enterprise, foreign investment and export development and (b) a politically stable environment.

- (ii) **Good transportation and communication facilities:** For most free zone industries (e.g. electronics, light engineering and clothing) good air connections are important. This means adequate air cargo capacity and services to all major destinations. For international service activities, good telecommunications facilities are very important.
- (iii) **Good Physical Environment:** Most free zone investors are international companies with a good reputation. As such they will look for a pollution free environment with high standards of physical planning.
- (iv) **Reliable infrastructure:** A reliable water and electricity supply are important. Some free zones have preferential arrangements with electricity companies to avoid supply interruptions except in extreme emergencies.
- (v) **Market Access:** Preferential access to a major market is a very big advantage, e.g. Caribbean countries vis-à-vis US and Canada, ACP countries vis-à-vis EC.
- (vi) **Support Services:** Basic support services such as banking and freight forwarding are essential in all zones. If a zone is seeking higher skilled engineering or electronics activities, the existence of good quality sub-contractors and spare parts suppliers is an advantage.
- (vii) **Labour:** The cost and productivity of labour and the range of skills will, more than anything else, determine the type of industry which will be attracted to the zone.
- (viii) **Good Organization:** An organization which can (a) deal efficiently and quickly with investors applications; and (b) assist investors once approved in the establishment phase is important. Very often the difference between two locations is marginal and the location decision will hinge on minor considerations. The overall impression made by the Zone Organization on the investor, can be decisive in such circumstances.

- (ix) **Urban Environment:** If a free zone hopes to attract good quality light industry and expatriate personnel, a well developed urban environment is important.
- (x) **Existing industry:** It is an advantage to the firms setting up in the zone and the host country that a certain amount of industrial development should have already taken place in or near the proposed zone.

1.4 Physical Planning and Layout

It is perhaps stressing the obvious to state that the design, planning and layout of a zone must be based on a realistic appraisal of the demand for space in the zone. Nevertheless, many of the less successful zones and industrial parks throughout the world have not been based on such an appraisal. The key issue in determining the demand for space is the type of investor likely to locate in the zone. This will, in large part, determine the infrastructure requirements as well as the standard of building design and layout. If most of the investors are likely to be garment and leather product manufacturers, the water demand will be low (under 150,000 litres per hectare per day). No process water will be required and sewerage treatment will not be a major problem. Damage to the environment will be negligible. Garment producers will generally seek low cost buildings and high density layouts to minimize site costs. (Covered buildings could occupy 40% or more of the total zone area).

If fabric manufacturers (spinning, weaving) and particularly diehouse operators are to be accommodated in the zone, very significant quantities of water will be required (up to 1 million litres per hectare per day). Without a large, fast flowing river or a good sea outlet, serious problems may arise in disposing of diehouse effluent. Mauritius is at present facing serious problems in disposing of such effluent and "an environmentally satisfactory" solution will cost millions of dollars.

If the zone is to accommodate electronics and pharmaceutical manufacturers, high quality building design and low building density may be required (25% to 30% of the zone area devoted to covered buildings). For these industries a good appearance, clean environment and pleasant living conditions are important.

Many food processors will require large quantities of water and special purpose buildings, unlike what might be termed standard factory buildings used by garment producers, warehouse operators, or electronic assembly companies.

There are many examples around the world of infrastructure being designed to cater for a demand which never materialized, e.g. a sewerage pumphouse installed in the Bataan zone in 1983 at a cost of hundreds of thousands of dollars was never used because the volume of sewerage was too small. A transformer in the Karachi EPZ was unusable because the demand was insufficient.

As a general rule free zone sites like standard industrial parks should be developed on a phased basis, so that each phase can be fully completed in about 3 years. A first phase of 10 hectares should be sufficient in most situations. If the demand is higher than anticipated, the second phase can be accelerated. It should be possible within each development phase to offer investors a choice of sites and sizes (e.g. 2,500 sq. m., 5,000 sq. m. and 10,000 sq. m.). One or two advance factory buildings of about 1,000 sq. m. capable of sub-division or expansion could also prove attractive.

Large unoccupied areas within an industrial park or free zone are difficult to control and police. Infrastructure investment, especially electric cables and water mains are often vandalized and illegally tapped. There are many examples around the world of unused industrial sites being vandalized. The proposed free zone at Trujillo is part of a larger industrial park which is largely unoccupied. Much of the electric cable has been removed and squatters have moved in on part of the area.

The zone should be planned as a commercial development and designed to extract the maximum income per hectare of ground. As a general rule, one third of the site should be devoted to roads, infrastructure and common areas. The remainder (two thirds) should be available as sites. In a non-commercial zone revenues will not cover operating costs, including maintenance costs. The result is a lack of maintenance and a gradual deterioration of facilities.

1.5 The Free Zone and Regional Development

The free zone in isolation is not an effective instrument of regional development. Many attempts to use free zones to stimulate or facilitate development in less developed regions have failed because the necessary location conditions for successful free zone development did not exist. Zolic in Guatemala is one example. The Lamphun zone in the north of Thailand is another. Thailand is a country with a very successful record in attracting export-oriented manufacturing industry. Nevertheless, investors could not be persuaded to go to Lamphun because the necessary infrastructure was not in place.

The Shannon zone in Ireland is often cited as an example of a free zone being used to stimulate economic activity in a less developed region. Shannon is in the West of Ireland, which is the least developed part of the country and the zone has over the last 33 years had a very important regional development impact. However, Shannon was an established international airport with daily services to the United States and Europe before the free zone was established in 1959. In addition, there were (and still are) a number of sea ports with daily container services to Europe within a hundred miles of Shannon.

A free zone can only succeed in a less developed region if telecommunications and regular international transport services (and not just ports and airports) to key destinations exist prior to the establishment of the zone, or are developed simultaneously with the zone. In most cases the volume of business from a zone will not be sufficient to support an adequate range of international transport services.

1.6 Free Zone Investors

In many free zones around the world about one third of investment projects are 100% domestically owned. Another one third are domestic/ foreign joint ventures and the remaining one third are foreign owned projects. Most free zone investors come from neighbouring countries, or countries with which the zone has traditional links. Japanese investors dominate in Korea, U.S. investors are important in Mexico. Taiwanese and Hong Kong investors are important in China. Shannon has many traditional, cultural, transport and ethnic links with the United States, thus U.S. investors predominate in Shannon. European investors are important in North Africa, e.g. Morocco and Tunisia.

1.7 Privatization and Free Zone Development

Some international agencies have been advocating that free zones should be developed by the private sector for years. They believe that private developers are more efficient. In addition, private developers will choose sites based strictly on economic criteria, whereas government organizations may be swayed by political considerations to select uneconomic sites. There are many examples of such inappropriate choices around the world.

1.8 Costs and Benefits

The costs and benefits associated with free zone development are relatively straightforward. The direct benefits are the foreign exchange earnings, employment and income generated. For a country where foreign exchange and employment opportunities are in short supply, these benefits however small are highly valued. The secondary or indirect benefits include training and on the job experience, learning through imitation or association by local firms and business people.

The costs include public expenditure and zone development and subsidies or artificially low charges for services (e.g. electricity). In the studies that have been undertaken for Penang in Malaysia, Tanjung Priok in Indonesia, Masan in Korea and Bataan in the Philippines, high rates of return were found in the first three studies. The Bataan study resulted in a negative rate of return.

The reason for the positive returns in Malaysia, Indonesia and Korea were a combination of modest development costs and a rapid build up of employment and exports to yield significant benefits within a few years. Bataan on the other hand was a very expensive project to develop - about US\$ 200 M. Employment peaked at around 20,000 people in 1980.

As a general rule, zones which have achieved a low occupancy rate after ten or fifteen years can be classed as failures. If development costs are exceptionally high the zone may be considered a failure even if employment is high. Development costs can be kept within reasonable limits if the site chosen is close to existing infrastructure, housing and commercial services. A recent World Bank study on free zones examined 60 zones in 27 countries which are in operation for 5 years or more. The study concluded that 25 of the zones are "predominantly successful", 10 are close to this category, 7 are "no more than partly successful" and 18 are "clearly unsuccessful". Almost all of the successful zones are in Asia, the Dominican Republic or Jamaica.

Employment:

In most free zones around the world about 80% of the jobs created are for low skilled women workers in the 18 to 25 age group. This is because garment production and electronic assembly are the dominant activities in these zones. Where the emphasis is on processing domestic raw materials (e.g. agricultural or forest products) the employment structure favours men. Many of the zones established in recent years in Latin America and Africa are emphasizing the processing of local or regional raw materials. In most zones for which information is available, the employment conditions within the zones are generally much better than employment conditions in comparable jobs outside the zone. Wage levels are on average about

20% higher in the zone. In addition, zone factories are usually cleaner and facilities (canteen, medical, recreational) are better.

Value Added:

The value added in a zone usually ranges from 30% to 40% in the garment sector, or around US\$ 3,000 per worker per annum, and 10% to 15% of gross output in the electronic sector, or US\$ 5,000 to US\$ 6,000 per worker per annum.

Exports:

As most or all of the output is exported in most zones, the net foreign exchange earnings is close to the value added. In most traditional zones, net exports per worker range from US\$ 3,000 to 6,000 per annum. In places like Singapore and Shannon where the value added per worker is US\$ 30,000 to 50,000 per annum and substantial local linkages exist, net exports per worker can be in the order of US\$ 60,000 annually. Where zones process domestic raw materials the net export earnings can reach US\$ 30,000 to 50,000 annually, depending on the value of the materials.

Linkages:

Linkages with the rest of the economy are limited in most zones. The principal reason is that local suppliers cannot deliver the inputs of the required standard and reliability. Zone companies cannot risk dealing with unreliable suppliers for packaging or other inputs. The willingness of zone investors to source materials locally depends among other things on whether or not the zone company is responsible for its own purchasing. Sometimes the parent company purchases on behalf of the zone company. Maquiladora companies in Mexico who are responsible for their own purchasing, source much more materials locally than companies which depend on the parent company in the United States for supplies. There are many examples of companies in zones around the world working with local suppliers to produce over time inputs of an acceptable quality and reliability. Only in cases where zone companies use agricultural raw materials or cotton fabrics are substantial quantities of local inputs normally used.

Knowledge Transfer:

In most zones, knowledge transferred is related mainly to production management and organization, accounting skills and possibly some marketing. Very little "high tech" knowledge or expertise is being transferred except in places like Shannon and Singapore. In both Shannon and Singapore many workers have acquired technical skills and business knowledge, which they have used to establish projects supplying sub-assemblies or services to zone companies or producing directly for export.

Indirect Impact:

The scale of the indirect impact or multiplier effect of a zone on the local/regional economy depends on the nature of the zone. It depends if zone investors use local inputs; if strong linkages exist between the zone company and local education training institutions and/or sub-contractors. As a minimum, each job created in the zone can result in two additional jobs in the local economy, assuming a multiplier effect of 2.0. Where, however, strong connections exist between the zone and the rest of the economy, the indirect impact of the zone on the local and regional economy can be much more significant.

CHAPTER 2

THE ECONOMIC ENVIRONMENT

2.1 The Latin American Economy

While in the 1960's and 1970's, the Latin American economy experienced a strong growth rate (averaging 5% to 6% annually), the decade of the 1980's, particularly 1988 to 1990, were depression years for the continent generally. Growth averaged about 1% for the decade with a minus growth rate being recorded (-0.1%) in 1990. However, in 1991 there were clear signs of economic recovery throughout the continent. Practically all countries experienced strong growth in 1991 and regional GNP increased by 3.2%. This growth has continued through the last 2 years. The major stimulus for this recovery came in most cases from the expansion of internal demand and private investment growth in particular, as well as growth in international trade. Growth in trade between neighbouring countries in recent years has been an important feature of the Latin American economy. For example, trade between Columbia and Venezuela has expanded by about 40% in recent years. The four countries of the MERCOSUR (Brazil, Argentina, Uruguay and Paraguay) experienced a 55% growth in trade in the 3 years since 1990.

The balance of payment structure for the Latin American region reflects many of the fundamental changes taking place in the continent. These changes are related to the liberalization of import regimes and the improvement in the investment climate. The trade balance in most countries has deteriorated with strong growth in imports. On the capital account there has been a substantial increase in capital inflows. The largest component of the capital inflow has been foreign direct investment which reached 11 billion dollars in 1991 - an increase of nearly 5 billion dollars over the 1990 figure¹¹. These flows have continued in 1992 and 1993. This situation is in contrast to the worldwide trends where foreign direct investment has been declining.

¹¹ See Annex 5: Foreign Direct Investment - Global and Latin American trends.

Most of the investment to date has been concentrated in Argentina, Chile, Colombia, Mexico and Venezuela. A substantial portion of foreign direct investment was used to purchase state investments as part of the privatization process. Another important component of capital inflows was the portfolio investment in stocks and bonds.

It is believed that continued progress in Latin America will be determined by the success of the domestic reform programmes and the growth of intra-regional trade. The growth of trade will be facilitated by the development of MERCOSUR, the Andean common market and other sub-regional trade groupings. A successful conclusion of the current GATT trade talks will improve access to world markets. Under these conditions, the outlook for foreign investment is good despite suggestions of a world capital shortage and a slowdown in foreign direct investment generally. One of the major obstacles to increased foreign investment inflows in Latin America is institutional. There is a lack of good information channels for investors. Bureaucratic delays, legal difficulties in starting new ventures, customs problems and some uncertainty about the permanence of the new situation are factors which investors must contend with.

Table 2.1 in Annex 5 outlines the change in both Japanese and U.S. investment on a worldwide basis over the second half of the 1980's. Latin America ranks second after Europe as a destination for United States investment and has increased in importance in recent years. It is probable that Latin America will become an even more important destination for United States investment in the coming years. Much of the United States investment in Europe was caused by the creation of the single European market. Now that a single market is a reality, U.S. investment flows into Europe have declined. On the other hand, there are growing opportunities for investment in Latin America arising from the privatization process and the reduction of trade barriers. Apart from the United States, Western Europe and the Asian countries, an investment source of growing importance is the countries of Latin America themselves, investing in neighbouring states. Exact data and information on these internal Latin American investment flows to date are limited. For example, Chilean outward investment has increased from US\$ 10 M in 1988 to over US\$ 400 M in 1992, according to Central Bank data.

When undeclared investments are included, some estimates place Chilean outward investment in 1992 at about US\$ 800 M. This investment has been spread throughout much of Latin America.

2.2 The Peruvian Economy

Economic Policies:

The Peruvian new economic policy is characterized by liberalization measures. Since the election of President Fujimori in 1990, those policies rely on the dynamics of the markets, doing away progressively but decisively with the protection policies that constrained investment and economic growth. International trade barriers have been lifted (Law on International Trade, decree 668); the rate of protection for national industries has been considerably lowered. Tariffs being consolidated at two rates: 15% (applicable to 80% of the total value of imported goods) and 25%. The global average stands at 17%. Peru plans to introduce a unified 15% rate before the end of 1994. Costs of storage and unloading at ports have fallen by around half. A privatization programme of 230 state companies is being implemented.

This transition towards a freer market economy has been financially and technically supported by the IMF and the international financial community. The negotiation of the foreign debt and payment of arrears since 1990 has allowed a re-insertion of Peru in the international community. More than US\$ 1.2 billions have been disbursed since. As a consequence, Peru has checked inflation, the budget deficit, the imbalance of payments and resumed growth. Foreign exchange regulations have been removed and the currency is freely convertible. Peru has come out of the hyperinflation cycle (over 700% in 1990). The annual rate of inflation has been reduced to 1.6% in October 1993. Inflation over the year 1993 should be around 40%. The target for 1995 is a one digit figure.

The budget deficit was reduced from 6.5% of GDP in 1990 to 3% in 1991 and 2.5% in 1992. International reserves in October 1993 were US\$ 2,552 millions. The rapid return of capital and the new flow of the foreign investments (more than US\$ 800 millions for 1993, primarily under the form of privatization and new investments in the mining sector) are very significant.

In 1993, the GDP growth is likely to stand above 7%, which is most likely to be a Latin American record figure for 1993. Manufacturing grew 9.5% during the first 9 months of 1993 against the same period of 1992. Capacity use in manufacturing rose from 42.2 to 53.9%. The Lima stock exchange boom (second best in the Western hemisphere after Panama in 1992) is further proof of the renewed confidence in the Peruvian economy.

Services:

The ongoing privatization of practically all services run in the past by state organizations (energy, transport, financial institutions, telecommunications) has already significantly improved most services.

Once hyperinflation was mastered and the 1991 liberalization of the financial markets was launched, capital flight was stopped and a remonetization boosted the deposits from US\$ 500 millions to today's 4 billions. Yet, credit remains expensive. As in many other Latin American countries, there are no longer limitations for opening a bank or financial institution, national or foreign.

Legal Framework and Administration:

The structural adjustment reforms implemented by the present government are considered the most audacious carried out in Latin America.

The Framework Law for the Promotion of Private Investment (decree 757) reduces government interference, eliminates certain bureaucratic procedures and protects investors against changes of rules.

The Foreign Investment Promotion Law (decree 662) guarantees non-discriminating rights to foreign investors, freedom of remittance of profit and of repatriation of capital. Agreements signed by state authority CONITE also guarantee the rights acquired under this law and the present tax incentive system. Foreign investments are guaranteed by the MIGA and the ICSID (Investment Council for the Solution of Investment-related Differences). Bilateral agreements protecting investments have been signed with Thailand and Sweden. Negotiations with Germany, the Netherlands and South Korea are at an advanced stage. Negotiations have been initiated with Italy, France, the United Kingdom, the United States and Switzerland.

The Free Zone Law (decree 704) provides special incentives to export-oriented businesses (see Chapter 4).

The Law for the Promotion of Private Investments in Public Utility Facilities (decree 758) introduces a system of 60 years concessions.

A new law cancels the agricultural reform laws and promotes agro-industrial development.

The role of government and state bureaucracy has been considerably reduced by (i) the adoption of a new legal framework; (ii) by a reduction in state intervention and (iii) by the downsizing of the public sector (under Law for the Protection of Private Investment in State Owned Companies, decree 674).

The government has launched anti-corruption initiatives and reforms of the customs administration.

Access to Foreign Markets:

Peru is not part of any regional integration project, but has expressed its interest for a return into the Andean Pact, as soon as foreign trade policy differences can be resolved, that is most likely not before 1995. On January 1, 1994, the Andean Pact will implement a Common External Tariff. Its duty structure will be 5-10-15-20% while Peru is planning for 1994 a 15% or even 10% flat rate.

However, Peru signed a free trade agreement with Bolivia, as well as an agreement that will facilitate Bolivian trade access to the Pacific through the harbour of Ilo and provide for a Bolivian free zone there (in Ilo).

Peru signed bilateral trade agreements with neighbouring countries. The agreement with Ecuador already lifts import duties on a list of around 500 products; the agreements with Colombia and Venezuela lift duty on 400 products. Peru also signed, within the frame of ALADI, trade agreements with Chile, Mexico, Argentina, Brazil, Paraguay and Uruguay. Trade with Chile, in spite of proximity and the size of the Chilean trade, is still only US\$ 240 millions (1992 figure). Further negotiations are under way to enlarge the list of duty reductions or exonerations with most of those countries.

The ATI (Andean Trade Initiative) passed by the US Congress in November 1991 gave duty free benefits similar to those of the CBI (that is 2,200 products above the GSP) to the exports of Bolivia and Colombia (July 1992), of Ecuador (April 1993) and of Peru, recently designed as beneficiary (September 1993).

Present liberal trade policies are a preparation for taking part in the Enterprise for the Americas Initiative (EAI, also known as "Bush Initiative") that is supposed to grow out of NAFTA. This western hemisphere-wide free trade area would create the world's largest free trade area of an economy of almost US\$ 7 trillions with over 720 million people.

Customs Procedures for Exporters:

Peru operates three standard formulae for making available imported materials free of duty for exporters. These are: (i) the duty drawback system; (ii) the temporary importation of goods free of duty under license or via bond cover; and (iii) free zones. The consultants discussed the three formulae briefly with some investors. It seems that both the drawback and temporary import systems have problems associated with them. The government is slow to refund import and other duties paid under the drawback system. The cost of providing bond cover or bank guarantees to cover the duty liability as required under the temporary import scheme, can be expensive. It can cost up to 6% of the duty liability. Some small- and medium-sized firms cannot get the necessary bank guarantees or bond cover and therefore cannot avail of the temporary import system.

2.3 Foreign Investment in Peru

Peru was an important destination within Latin America for foreign investment in the 1960's and '70's. By 1980 Peru ranked fourth after Brazil, Panama and Mexico as a destination for Japanese investment in Latin America. In recent years, however, there has been no new investment in Peru. Accumulated U.S. investment (according to the United States Department of Commerce statistics) exceeded US\$ 1 billion in 1986. In the following 5 years total U.S. investment declined to about US\$ 400,000 in 1991. Peruvian investment statistics show a static situation with regard to foreign investment over the decade of the 1980's. Investment in manufacturing activity increased by about US\$ 20 M a year in the 5 years to 1991.

In recent years however, there has been a substantial growth in investment in the mining sector. Over US\$ 1 billion of mining investment projects are planned at present. There has also been substantial investment in the Stock Exchange this year (about US\$ 700 M). The outlook for the coming years is encouraging. Further investment in mining and other natural resource projects, as well as the Stock Exchange, can be expected. In addition, the Peruvian Privatization Programme is likely to attract considerable foreign investment.

2.4 Foreign Investor Attitudes

Generally, investors manufacturing for export have a choice of location. The extent of the choice depends on the source of the inputs and the markets for the product. In terms of location choice, an extreme example would be a garment or leather producer using material which can be sourced without difficulty in many parts of the world to produce products for sale in North America and Western Europe. He can establish an efficient low cost production operation in 30 or 40 countries in Asia, North Africa, the Caribbean or parts of Latin America. A producer supplying a regional (e.g. Latin American) market, or making a product from a raw material produced locally (e.g. fruit) has a more restricted location choice. He does, however, have some choice of location. Fruit, for example, can be sourced in a number of countries and the South American market can be supplied from any one of 5 or 6 different countries within the continent. Such investors (export-oriented investors) are influenced by political and economic stability, as well as good international transport and communications services. They are also strongly influenced by promotion efforts and the incentives available in a particular country or region. Export investors unlike many domestic market suppliers who can be large multinationals, are often relatively new small- and medium-scale producers.

During the course of the project, interviews were conducted with a number of investment advisors (Trade/Commercial Attachés) and private sector personnel in Peru concerning the issue of attracting export-oriented manufacturing investment. Peru is generally not considered a good place to establish an export manufacturing project. The country is considered "a high political risk" location, however the situation has improved significantly in the last year or so.

Another issue highlighted during the interviews was the lack of clear government support for export industries and free zones. The lack of an effective promotion agency was also seen as a problem. This last point (lack of promotion effort) was especially highlighted. What is necessary, the advisors believe, is a powerful promotion agency which can communicate effectively with investors and provide them with the necessary detailed information on such issues as the availability of raw materials (quantity, quality, price, type and future projections), and assist investors overcome various bureaucratic obstacles. The need for a pro-active promotion effort was often emphasized. Overall however, even with an improving investment climate, Oriental investors are unlikely to attach a high priority to Peru as an investment location.

CHAPTER 3

THE PERUVIAN FREE ZONE PROGRAMME

3.1 Background

Interest in the development of a Peruvian free zone programme accelerated during the second half of the 1980's. In 1988 USAID commissioned a study on the development of free zones in Peru⁽²⁾. This study concluded that free zones could make a contribution to the development of the country and identify two potential sites suitable for free zone development. The two sites recommended were at Piura and Tacna.

Law No. 25100 on the development of free zones was passed on 28 September 1989. In the following nine months, six industrial free zone sites along the Pacific coast were identified and designated by the Government for development. There has been very little progress to date on the development of those sites except for Ilo, due to lack of government finance and an apparent lack of interest by the private sector.

The Ilo free zone administration has been able to secure development finance from ZOTAC. An area of 15 hectares at Ilo has been developed. The development includes all the necessary infrastructure, including a road network and fence, administration building and four factory buildings.

Pisco, because of its location close to Lima may be able to attract private sector funding. The zone administration is optimistic that within a year or so the zone will be operational.

⁽²⁾ USAID Study n° 52-0298.

In addition to the establishment of six industrial free zones, the Government has provided for the creation of two special trade treatment zones, one at Tumbes - a coastal location in the extreme north of the country close to the Ecuadorian border and a second at Tacna in the south of the country close to the Chilean border. Only the Tacna free zone is operational. The Tacna zone covers the city of Tacna and a small hinterland area. Goods can be imported into the Tacna zone on payment of a 10% duty and sold to retailers or the general public. (Goods imported into the rest of the country are subject to an import tax of 15% to 25% plus an indirect tax of around 18%). In 1992 recorded sales in the Tacna zone amounted to US\$ 240 M. The 10% duty (US\$ 24 M) went to ZOTAC, the zone management administration. This year zone sales are expected to reach US\$ 150 M providing a tax revenue of US\$ 15 M for ZOTAC. This tax revenue is spent within the region where Tacna is located (Jose Carlos Mariategui region), except for 2% which goes to CONAFRAN (the national free zones administration). The Ilo free zone administration (ZOFRI/ILO) receives about one third of the tax revenue, which is used to fund the development at Ilo. The balance of the tax revenue goes to ZOTAC and the regional and local governments.

The ZOTAC administration has completed a special trade zone of about 30 hectares with a very advanced communication system on the outskirts of Tacna to accommodate traders, wholesalers and warehouse operators.

3.2 The Free Zone Law

The development and operation of free zones in Peru is governed by the legislative decree number 704 of 13 November 1991, which replaced free zone law number 25100 of September 1989. The objectives of the decree are set out in Article 2 and include technological development, job creation, foreign exchange earnings, and decentralization of investment. The law provides for the establishment of free zones, special trade treatment zones and special development zones. Free zones are defined as limited areas where goods and services can be produced for export. Special trade treatment zones are limited areas exclusively for commercial activity.

Article 9 provides that future legislation shall not apply in free zones except where the proposed changes provide for a more favourable legal regime.

Article 10 provides that goods imported into the free zone are free of all duties and taxes. Up to 20% of zone output can be sold domestically after all duties and taxes are paid.

Article 11 denies free zone companies access to national quotas.

Article 13 exempts zone users from all national, regional and municipal taxes for 15 years.

Articles 14 to 16 exempts free zone companies from what might be termed "the more onerous aspects" of labour legislation.

Article 17 deals with zones of special trade treatment and provides that imports into such zones are exempt from all present and future tax "and must pay a special custom's tariff" (this tariff is 10% in Tacna). 98% of the revenue received from this special customs tax goes to regional and local government funds in the region where the zone is established. The remaining 2% goes to CONAFRAN. Special trade treatment zone users are subject to the "formal and substantial taxes" as applied in the rest of the country.

Zone users can be Peruvian or foreign individuals or juridical persons whose operations are authorized by the administration of the zone in question. Zone users do not need the approval of the national free zones administration. This is unusual. Most free zone laws provide that free zone users must get a license or permit from the national government or free zone authority or administration.

Articles 30 to 32 deal with the establishment and operation of CONAFRAN, the national commission for free zones. Its main functions include the supervision of zone operations, the approval of feasibility studies and the evaluation of proposals for free zone development.

Each zone is governed by a management board established for this purpose. Where the zones are created by private initiative (80% private investment), the Board will include 4 private sector representatives, including the chairman, 3 public sector representatives and a representative of zone users.

The fourth supplementary provision of the decree allows CONAFRAN on behalf of the state to conclude stability agreements with zone users guaranteeing the benefits of the free zone decree.

3.3 Legal/Administrative Anomalies

The 1991 law contains what might be termed some legal or administrative anomalies. The right to establish a business in a free zone is a privilege in a Peruvian context. The investor can avail of a 15 year tax holiday, exemption from labour legislation and the right to import equipment and materials free of duty. In most countries the right to grant such privileges (establish businesses in free zones) is retained by the government, or government sponsored free zone authority. An investor must get a license or permit from the government, or the national free zone authority, before he can establish any business in a zone. In Peru it seems that investors only need authority from the management board supervisor, or management committee of the particular zone (Article 27). The management board can be controlled by the private sector group (Article 36) if 80% of the investment is funded from private sources. Thus it would seem that the private sector can grant permission to investors to establish businesses in a free zone and avail of all the related privileges.

Free zone investors can only sell 20% of their output on the Peruvian market under the regime applying to third country imports. It is possible that an investor would use a Peruvian free zone as a base for supplying neighbouring markets (Bolivia and Chile) as well as Peru. In these circumstances, the Peruvian market accounts for about 40% of the total on an income basis. For particular products, e.g. mining, or fishing equipment, the Peruvian market might represent in excess of 50% of the total market. If the 20% rule were rigidly applied, a Peruvian free zone

might not be an attractive location for an investor supplying the three neighbouring countries. A Peruvian free zone producer would be at a disadvantage vis-à-vis a Chilean or Bolivian producer. Bolivian or Chilean producers are subject to the third country import regime when selling in Peru, but no sales restrictions. The Peruvian free zone producer is subject to both the third country import regime and sales restrictions.

Free zone producers cannot use Peruvian textile or other quotas. The consultants understand that most Peruvian quotas are not being used and that there are limited prospects of such quotas being used in the next few years. A major attraction or selling point for the Dominican free zones, and indeed many other zones around the world is the availability of garment and textile quotas. It has been suggested that half of the 150,000 or so people employed in the Dominican Republic zones would lose their jobs if the companies could not avail of the quotas.

If the Peruvian authorities want to encourage traditional free zone activity (garments and leather manufacture) in the free zones, then investors must have access to quotas. A key point in reviewing the quota issue is the role of free zones in Peru. The Peruvian free zone programme can be viewed as a first step in providing Peruvian business with the necessary facilities, which include a modern reliable infrastructure and administrative system to compete on export markets. These facilities can gradually be extended through the country as administrative reforms are put in place and resources for infrastructure development on a countrywide basis become available. Alternatively, the free zone can be viewed as a tax free enclave for foreign and Peruvian investors, which makes a very limited contribution to the economy. If the former view prevails, there is a strong argument for making quotas available to zone investors, provided non free zone producers are not adversely affected.

Zones of special trade treatment (the ZOTAC zone in Tacna) are exclusively dedicated to commercial activity. Manufacturing activity, it seems is excluded. A logical economic objective of any development in Peru (including the zone at Tacna) would be to maximize added value or the economic contribution of the project to the economy. Under existing regulations,

it seems that ZOTAC zone investors must manufacture their products elsewhere, e.g. just outside the zone or in the Ilo zone, or in Chile or some other location. This type of restriction places added costs on potential investors who want to manufacture and discourages ZOTAC investors from evolving from distribution operations to projects which involve manufacturing and distribution.

It has been suggested that the regulations to be issued relating to free zones would prohibit investors from manufacturing any product whose exports from Peru exceed US\$ 1 M. The logic of such a restriction is difficult to understand. Free zone investors could not manufacture products in which Peru has an obvious competitive or comparative advantage. If domestic producers cannot compete with Peruvian free zone producers on the export market, they are unlikely to be able to compete effectively with Chilean or other free zone producers either.

3.4 Government attitudes to Free Zone Development

It is difficult to understand the government's attitude to free zone development in Peru. The government passed two free zone decrees in 3 years (1989 to 1991). The new decree of 1991 has many positive features from an investor viewpoint. These include (i) a generous tax holiday (15 years); (ii) exemption from onerous labour legislation; and (iii) a promise not to scale down the advantages on offer to free zone investors in future years. The negative aspects of the law include a limitation of 20% on sales in the domestic market (which is a feature of many other free zone laws) and non-accessibility to quotas.

The government since 1990 has followed an economic programme which potential free zone investors would consider positive. Legislative decree number 662 of September 1991 on guarantees for foreign investment provide that "the state promotes and guarantees foreign investments in every sector of economic activity".

The government, however, has done little to promote free zone development since 1991. The only developments which have taken place are in Tacna and Ilo. These developments were funded by special duties collected by ZOTAC.

There is no documentation as far as the consultants are aware, setting out the role and function of free zones in Peru as part of the government's economic development programme, apart from the objectives set out in the legislative decree.

Recent statements by government officials on free zone development have caused some confusion. It has been suggested that free zones will not generate resources for those who most need them. The same statement also refers to the need for foreign investors to pay taxes like everyone else, and of excessive exemptions which free zone regulations provide.

3.5 The Role of Free Zones in Peru

There are three possible types of activity which might be developed in Peruvian free zones. These activities include:

- (i) the processing of imported raw materials for export or sale in the markets of the Northern hemisphere, e.g. the manufacture of garments or electronic assembly, which is a traditional free zone activity;
- (ii) the handling, packaging, wholesale and manufacture of imported materials for distribution in regional (Andean or Latin American) markets; and
- (iii) the processing of local raw materials for sale in regional markets (Latin America) and the international markets such as Asia, North America and Europe).

The potential for developing traditional free zone activity (processing imported materials for sale in Europe and North America) in Peru is limited. Peru has no obvious advantage through which it can encourage this type of activity. It does not have a reputation like Asian countries for low cost and high productivity, e.g. China and Vietnam. It has no obvious cost advantage over Central American and Caribbean locations as a manufacturing base for supplying

the North American market. Peru would have extreme difficulty in competing with Eastern European countries (e.g. Albania 80 kilometres from Italy with wage rates of US\$ 70 per month), or North African countries as a base for supplying the European market.

Peru like other countries in Latin America, has the potential to develop as a manufacturing and distribution base for supplying the Latin American market itself. To develop successfully, Peru needs to develop trade and transportation links with neighbouring countries. In addition, the cost of operating in Peru must be in line with costs in competing locations, e.g. Chile. It was not possible to make a detailed cost comparison of this nature during this study because of time constraints. However, some details on free zones in the Americas is included in Table 4.1. The investment advisors interviewed, however, expressed a definite preference for Chile over Peru as an investment location. There was also some anecdotal evidence that Peruvian exporters were opting to establish production bases in Chile. However, Peru is still developing its new economic policy. The main focus to date has been on creating financial stability. In the coming years the emphasis is likely to shift towards creating a competitive operating environment for investors.

The processing of local materials for export can be undertaken in free zones. Peru has large quantities of high quality agricultural and marine based raw materials and supplies can be increased if necessary. These materials have existed in Peru for 30 years. Very little processing has taken place to date. The mere fact of establishing a free zone in or near such raw material supplies will not in itself result in the establishment of processing projects.

Proper studies are necessary to determine whether and under what conditions free zones in Peru will lead to (i) the use of Peru as a base for supplying (manufacturing and distributing) a range of products throughout the continent and (ii) increased processing of local raw materials for sale in regional (Latin American) and international markets (Asia, North America and Europe).

TABLE 3.1

Duty free processing in the Americas (November 1993)

Country	Management	Technology	Regime (*)	Employment	Labour cost/bil.	Balance
Mexico	publ./priv.	average	IE, TFF	530,000	US\$ 2	positive
Domin. Rep.	publ./priv.	low	EPZ, TFF	150,000	US\$ 1	positive
Guatemala	public	low	TFF	70,000	US\$ 1	positive
Brazil	public	average	DOM	50,000	US\$ 1	mixed
Costa Rica	publ./priv.	average	EPZ	23,000	US\$ 2	positive
Haiti	publ./priv.	low	TFF, IE	18,000	US\$ 1	positive
Jamaica	publ./priv.	low	EPZ	14,000	US\$ 1	positive
Columbia	public	low	EPZ	12,500	US\$ 1	negative
Honduras	public	low	EPZ	11,000	US\$ 1	mixed
El Salvador	public	low	EPZ	7,000	US\$ 1	mixed
Barbados	public	average	IF	6,000	US\$ 2	positive
Puerto Rico	public	high	IE	1,500	US\$ 7	negative
Bahamas	private	high	IF	5,000	US\$ 5	positive
Chile	public	average	DOM	4,500	US\$ 1	mixed
Panama	public	low	TS	4,000	US\$ 1	mixed
Dominica	public	low	IE	1,500	US\$ 1	mixed
Sta. Lucia	public	low	EPZ	1,000	US\$ 1	mixed
Uruguay	private	average	TS	1,000	US\$ 2	mixed
Curaçao	public	average	TS	500	US\$ 3	mixed
Grenada	public	low	IE	500	US\$ 1	mixed
St. Vincent	public	low	IE	450	US\$ 1	mixed
St. Kitts	public	low	TFF	450	US\$ 1	mixed
Trin. & Tob.	public	average	IF	450	US\$ 2	negative
Antigua	public	low	TFF	350	US\$ 2	negative
Venezuela	public	low	EPZ	300	US\$ 2	negative
Peru	public	ns	EPZ	0	US\$ 1	negative
Total	-	-	-	913,000	-	-

Projects of creation or reshaping of EPZ or TFF programmes:
Bolivia, Nicaragua, Peru, Uruguay, Venezuela

- (*) EPZ: Export Processing Zone
TFF: Tax Free Factories
IF: Industrial Estates with TFF
DOM: Zones selling primarily to the domestic market
TS: Primarily Trade and/or Service

3.6 Site Selection

The basis which the government used to select the six designated industrial free zone sites is not clear (the basic data in relation to each site is set out in Annex 1). It was not possible to review in detail the various sites and their suitability during the limited time of this study. It is clear, however, that a number of the sites lack many of the conditions necessary for successful free zone development. In particular, all of the sites lack good international transportation facilities. There are port facilities at or near all of the sites. However, there are few regular services operating from these ports. There are also airports in or near most of the sites but with very few international services operating from these airports. Pisco, because of its proximity to Lima, is the best place from a transportation viewpoint. Commercial and urban support services are lacking in a number of the sites. With the exception of Pisco, the consultants found no evidence during the site visits that private developers were willing to invest money in developing any of the sites.

It is worth noting that the USAID study identified only two sites (Piura and Tacna) which are not included in the six government selected industrial free zone locations.

The sites at Tacna and Ilo are already developed. The consultants are not aware of any marketing strategy or plan to promote either of these sites. Some co-ordination between the two developments would seem desirable. In order to make the best use of the investment already in place, it would be useful to analyze (i) how best the two zones could be marketed (in the light of infrastructure deficiencies) as a base for supplying the Latin American market, especially Bolivia and the Southern cone and (ii) the infrastructure (including transport infrastructure) which is required to facilitate such development.

3.7 Administrative Decentralization

Peruvian exporters and business people with whom the issue of free zone site selection was discussed, emphasized the need for administrative decentralization and infrastructure development. The bureaucracy in Peru they stated, is highly centralized. Business people operating in the regions must maintain a liaison office in Lima. Free zones can only be developed successfully in the regions if there is effective administrative decentralization and infrastructure development.

As a first step in the process of administrative decentralization, a special regime could be established on an experimental basis in the free zone. This regime could provide investors with all the permits, authorization and certificates which are necessary without travelling to Lima. If successful the regime could be applied on a wider basis.

Many policy and administrative initiatives have been tried at the Shannon free zone over the years. Those which have proved successful have been extended on a national basis.

CHAPTER 4
CONCLUSIONS AND RECOMMENDATIONS

4.1 Conclusions

- 4.1.1** The Latin American economy is undergoing a major economic transformation with a strong emphasis on the privatization of many government activities and the reduction of trade barriers. Investment flows are increasing. Trade and investment flows within Latin America itself are growing in importance.
- 4.1.2** The Peruvian economy is undergoing a transformation similar to that of the rest of Latin America. Peru up to 1990 suffered a more serious economic decline than most of the other countries on the continent, due in part to very violent insurgent activity.
- 4.1.3** Throughout the 1980's there was very little investment in Peru. In the last 12 months or so investment flows have resumed and the outlook over the next year or two is encouraging, particularly in the case of investors interested in mining, the Stock Exchange, and government projects being privatized.
- 4.1.4** Foreign investor attitudes towards Peru are improving. Export-oriented manufacturing investors, however, still view Peru as an unattractive location because of its high costs, poor infrastructure and uncertainty about the permanence of the current economic policy.
- 4.1.5** The export processing zone is a policy instrument used by countries to promote export manufacturing development when a country's infrastructure is underdeveloped and the administrative (including customs) procedures are complex and difficult. As the infrastructure develops countrywide and procedures are streamlined, the need for special arrangements in the form of an export processing zone diminishes.

- 4.1.6 The location requirements for a successful free zone development include: good infrastructure, reliable international transport and communications services and facilities and basic support services, a good urban environment, in addition to efficient zone management/organization.
- 4.1.7 Good physical planning and design of free zones are important. There are many examples of badly planned free zones around the world where infrastructure (e.g. water and electricity) are insufficient and not related to the demand for space. Over optimistic demand projections leading to large amounts of unused developed land and lack of design flexibility are problems that often arise in the less successful free zones.
- 4.1.8 Free zones used as instruments to stimulate investment in underdeveloped regions have usually failed. The essential requirements for free zone development must exist prior to the development of the zone. Lack of international transportation services and urban support facilities are often major problems in underdeveloped regions.
- 4.1.9 Free zones to be successful in cost/benefit terms should achieve rapid growth and the development costs should be modest, i.e. development should take place in or near existing facilities.
- 4.1.10 The attitude of the Peruvian government to free zone development at present is unclear. This conclusion is based on (i) the relative inactivity over the last few years in relation to free zone development; and (ii) negative government statements on the subject in recent weeks.

- 4.1.11 The Peruvian free zone law has many positive features from investors' point of view - exemption from labour laws, generous tax incentives and guarantees that new legislation and administrative measures will not adversely affect a zone. However, the law unlike most other free zone laws, allows (in theory at least) private free zone developers to issue authorizations to investors to establish in free zones. The quota restrictions in the legislation make Peruvian free zones unattractive for many traditional type free zone investors (i.e. those planning to make garments or leather products for sale in North American or European markets). The restriction (20%) on domestic sales may make Peruvian free zones unattractive for investors intending to supply regional markets (Bolivia, Peru and Chile).
- 4.1.12 There is no evidence (that the consultants are aware of) that any or all of the six industrial free zone sites selected in 1989/90 were chosen on the basis of strict location criteria, e.g. good international transportation services, urban environment and good support services. Their viability as free zone sites is open to question.
- 4.1.13 A good way of testing the economic viability of various sites is to rely on the private sector to develop them.
- 4.1.14 Many free zone investors come from the domestic sector or neighbouring countries. Peru's zone promotion agencies should take account of this fact and gear their promotion efforts accordingly.

4.2 Recommendations

- 4.2.1 The Peruvian government, if it wants to proceed with an industrial free zone programme, must set out its expectations for the programme based on a realistic assessment of the potential of and limitations of free zone as a development policy instrument in Peru. The government should view the free zone as a formula for providing foreign and domestic export producers and manufacturers with reliable infrastructure and an efficient administrative framework on a selective basis, until such time as these conditions can be provided on a countrywide basis.
- 4.2.2 The existing legislation should be modified either directly or via regulations so that CONAFRAN evaluates and approves (or rejects) all proposals to establish businesses in free zones.
- 4.2.3 The question of making quotas available to free zone investors should be reviewed in the light of demand from the non free zone sector, and the potential to attract garment and leather producers into Peruvian free zones.
- 4.2.4 The limitation of 20% on domestic market sales should be reconsidered for producers using the free zones in Peru as bases to develop regional markets, particularly in Bolivia and Chile.
- 4.2.5 Proposals to introduce legal restrictions on the type of product which can be made in a free zone, e.g. products whose exports from Peru exceed US\$ 1 M should be dropped. Instead, a flexible approach to what can and cannot be produced in a free zone should be adopted. This can be done via a licensing system. CONAFRAN can issue licenses or permits to each zone producer, setting out the products which he can or cannot make in the zone.

- 4.2.6 The development of free zone sites should be left to the private sector. This will ensure that sites to be developed and the scale of development would be based on commercial and economic criteria. The private sector may not select the sites already designated as they may not be considered commercially viable. It follows, therefore, that if the government is to depend on the private sector to develop the zones, it must allow private developers to select sites which they consider to be commercially viable. In this context consideration may be given to the Chinese and Korean proposals to develop industrial free zones at selected locations.
- 4.2.7 The free zone at Ilo should be commercialized in so far as this is possible.
- 4.2.8 The government should consider removing the restrictions on manufacturing activity in the ZOTAC zone at Tacna to encourage greater value added in that zone.
- 4.2.9 If the government plans to proceed with an industrial free zone programme, it should undertake studies to (i) identify the type of investor likely to be interested in establishing businesses in the free zones at ZOTAC and Ilo; the conditions under which investors would be interested; and the facilities and infrastructure services which must be put in place (especially transport infrastructure and services) to attract investors; (ii) identify the potential for processing raw materials in the vicinity of the designated free zone sites, with particular emphasis on the conditions necessary to attract investors. In undertaking these studies there should be no implicit assumption that the selected sites are viable free zone locations.
- 4.2.10 In addition to undertaking feasibility studies, the government should seek technical assistance on how to successfully implement a free zone programme. This advice should focus on (i) the development of a suitable organization at national level to promote and oversee the programme; (ii) the drafting of a suitable set of regulations to complement the existing legislation; (iii) the building of a successful working arrangement between CONAFRAN and the customs authority so that goods move freely

and quickly between the zone and their origin/destination; (iv) plan an effective investment promotion campaign geared initially at domestic producers and potential investors from neighbouring countries in Latin America; (v) installing systems for the monitoring of investor queries, the evaluation of investment proposals, the supervision of zone operations (in so far as such supervision is necessary); and (vi) establishing an information network to monitor developments in competitor locations. The technical assistance would take the form of an experienced free zone expert working with CONAFRAN for about 6 months. He would be assisted by 2 specialists (one a customs official and the other an industrial promotion expert) for about 2 months each.

- 4.2.11 The government should establish a special administrative regime, on a pilot experimental basis, in the free zones so that investors can transact all business without coming to Lima.

ANNEX 1

Site descriptions

1. PAITA

1.1 Brief description

1.1.1 Local inputs:

In spite of a decline in fishing due to (i) the influence of the El Nino warm current pressing south; (ii) to an obsolete fleet and (iii) to market factors (above all the counter publicity of the cholera epidemic, now under control), fishing activity is still important (596,000 MT) and above all promising.

Highest quality cotton (Pimax extra long fiber) is the traditional export of the region of Grau. Industrial Textil, Piura, exports most of its production of thread (5,700 MT in 1991). Cotton production of the region (350,000 MT) is still less than half the production registered before the agrarian reform launched by the military regime in the 1970's.

Total exports of the region only reached US\$ 89 M in 1992. The region has a vast potential for agricultural diversification, provided the waters of the Andes can be combined with the dry tropical coastal land. The hydroelectric and irrigation project of Alto Piura would add 42,000 hectares to today's 186,000 hectares of irrigated land.

The high quality mango exports reached US\$ 8 M in 1992 to which US\$ 2 M of pulp and concentrate can be added, as well as some exports of lime and asparagus of the best quality. The other department of the same region (Tumbes) is also an incipient exporter of bananas. Non traditional agricultural exports of the Grau region grew from US\$ 8.5 M to 23.8 M between 1988 and 1992.

1.1.2 Human resources:

- **Managers:** Availability is very limited in Paita but available and trainable in Piura (linked by a good road of 57 km), due to its technological and higher education facilities that serve a 16,500 strong student population.
- **Clerks:** Clerks are also limited in Paita but available in Piura.
- **Skilled workers:** Not available except in fish processing activities, but available in Sullana and above all in Piura, centres of a relative industrial development in the Grau region.
- **Unskilled workers:** Unemployment in Paita is high due to irregular fishing and fish processing. The unemployment figures, more relevant in the assessment of resources available for the IFZ, are very low. Total unemployment in Paita is estimated at only 1,035, but unemployed manpower is available in Sullana and above all in Piura which is suffering from industrial recession. According to the preliminary figures of the last census (July 1993), the total population of the Grau region is 1,544,000, with a concentration in the Piura and Sullana districts (respectively 546,000 and 224,000). The population in Paita, according to the same source is only 77,000.

1.1.3 Industrial Environment:

Apart from fishmeal and a depressed fish canning activity plus a cardboard factory, Paita has no significant industrial tradition. Industries concentrate on a Piura-Sullana axis.

1.1.4 Transport:

- **Airfreight:** The airport at Piura (60 km away from Paita) can receive medium haul planes (Boeing 737). Flights Lima-Piura-Quito. Talara airport is 80 km.
- **Seafreight:** Ships up to 20,000 MT can call in the very secure harbour of Paita, 3 km from the IFZ. This 35 feet draught harbour receives an average of 15 ships per week and a weekly container RO-RO service of CCT calling on the Atlantic coast of the United States. Harbour authorities expect a significant development of exports of fruit and phosphate.
- **Land Transport:** Road communications to Piura, Sullana or Talara are good. The zone is located 56 km from the Pan American highway.

1.1.5 Services:

- **Electricity:** Paita, Piura and Sullans are interconnected in the same system of thermoelectric generation, with an installed capacity of 57.1 MW. Unless the IFZ hosts highly energy consuming activities, power generation is not a constraint. The long term hydroelectric and irrigation project of Alto Piura would add 134 MW (estimated cost US\$ 363 M).
- **Telecommunications:** Availability and quality is guaranteed. 100 lines (automatic switchboard) reserved for the IFZ.
- **Professional services:** Piura is well serviced, including offices of the major banks of Peru and one bank with its main office in Piura itself, the Banco Regional del Norte.

1.1.6 Industrial Zone:

A total of 940 hectares within 3 mn distance of the harbour have been transferred by the Paita district to ZOFRI-Paita, a public autonomous body, like the five other IFZ authorities. The infrastructural works have been initiated on 20 hectares, including water pipes. Spending on infrastructure for this first phase is estimated at US\$ 7 M.

Renting costs: infrastructured ground: US\$ 0.34m²/month
 non infrastructured ground: US\$ 0.24m²/month

1.1.7 Quality of life for expatriates:

The region, which is dry tropical and has beaches, is averagely attractive. However, Paita is a poor urban environment (limited school, health, cultural and entertainment facilities). Piura, on the other hand, although not on the coast, would offer an acceptable quality of life. Tourism facilities are under developed throughout the region.

1.2 Perspectives:

Paita is handicapped by limited transport facilities and a limited urban and employment environment. Its proximity to Piura, its access to Ecuador and farther north to Colombia and the possible long term development of the internodal (road and Marañon and Amazonas rivers) bi-oceanic route to Brazil (Manaus - Belen) could attract a private developer. The prerequisite of course is a clearly set out government policy on industrial development, industrial exports and IFZ development.

Paita and the region have easy access to Ecuador and to southern Columbia through the Pan American road. Peruvian exports to these neighbouring countries are limited by its temporary withdrawal from the Andean Pact. Peruvian exports to Ecuador reached US\$ 18 M during the first 6 months of 1993, against US\$ 25 M over the same period in 1992, while Ecuadorian exports have increased during the same period from US\$ 46 M to 63 M. Of course these figures do not include active smuggling activity, although not of the magnitude of the smuggling in the Southern Peruvian region. Ecuadorian companies seem mostly attracted by powdered milk, glass containers, instant coffee, steel office furniture, plastic moulds, dies and chemical products.

Paita could also become the Pacific door of the Amazonas, a very promising perspective that would require appropriate studies. The project of an internodal bi-oceanic route (road from Paita harbour to the Marañon river, a tributary of the Amazona river that itself can be navigated until the harbour of Belen on the Atlantic) would at the minimum allow the soya production of the Brazilian Amazonas to be exported to the Pacific rim countries and phosphates of the Grau region to be exported to Brazil.

2. TRUJILLO

2.1 Brief description

2.1.1 Local inputs:

The region of La Libertad is the main producer of asparagus in Peru. Most of the asparagus canning activity also takes place in that region. The department of San Martin houses the two largest irrigation projects of Peru. Trujillo is the closest harbour to connect the Selva to the Atlantic.

2.1.2 Human resources:

- **Managers:** Available. University population of La Libertad province: 22,500.
- **Clerks:** Available.
- **Skilled workers:** Available.
- **Unskilled workers:** Available. Trujillo has 650,000 inhabitants. Region San Martin-Libertad has 1,185,000 inhabitants.

2.1.3 Industrial environment:

Textiles and food processing industries suffer from a severe crisis; the industrial park (the size of the proposed free zone) has only 12 factories in operation out of 28 installed.

2.1.4 Transport:

- **Airfreight:** 13 km from the Trujillo airport, limited to national medium haul flights.
- **Seafreight:** 22 km from the Salaverry harbour (30 feet of draught).
- **Land transport:** 14 km from the Pan American highway.

2.1.5 Industrial zone:

Under study stage on 115 ha, within the already existing but sleeping industrial park.

2.1.6 Quality of life for expatriates:

Moderate.

2.2 Perspectives

The Trujillo IFZ has no particular advantage over other zones outside of a national industrial policy and of a strategy of IFZ specialization.

3. CHIMBOTE

3.1 Brief description

3.1.1 Local inputs:

On top of a cotton and corn production, Chimbote is a major fishing port.

3.1.2 Human resources:

- **Managers:** University population in the Chavin region: 16,000.
- **Clerks:** idem.
- **Skilled workers:** limited.
- **Unskilled workers:** labour force in Santa Province: 1,000,000. In Chavin region: 300,000.

3.1.3 Industrial environment:

Steelmill and metallurgy, small boats, fishmeal, fish processing and fish oil, sugar industry and asparagus processing.

3.1.4 Transport:

- **Airfreight:** Airport 1.5 km, used by B-737, project of new airport.
- **Seafreight:** Artificial deep water harbour at 15 km of the IFZ, ships up to 29 draft feet.
- **Land Transport:** 4 km from the Pan American highway.

3.1.5 Industrial zone:

Total area: 252 ha. Main studies have been completed.

Renting cost: structured land: US\$ 0.50m²/month.

3.1.6 Quality of life for expatriates:

Poor.

3.2 Perspectives

The Chimbote IFZ has no particular advantage over other zones outside of a national industrial policy and of a strategy of IFZ specialization.

4. PISCO

4.1 Brief description

4.1.1 Local inputs:

The city of Pisco has a population of about 50,000 people. The region of Los Libertadores - Wari has a population (1993) of 1,545,000. Pisco is 262 km from Lima and connected to the capital by a highway. Driving time to Lima is 2-3 hours. The region produces a wide range of agricultural products.

4.1.2 Human Resources:

- **Managers:** A university is being planned in the city. This combined with its proximity to Lima and Ilo should mean that managers and qualified technical personnel will be available.
- **Clerks:** available.
- **Skilled workers:** available.
- **Unskilled workers:** available.

4.1.3 Industrial Environment:

There is a good industrial structure in the city with food processing, textiles and engineering industries. A new industrial park is being constructed by the private sector - reflecting confidence in the city and its future.

4.1.4 Transport:

- **Airfreight:** There is an airport very close to the zone. This is an alternative airport for Lima with a runway of 3,020 m capable of accommodating the largest aeroplanes in operation.
- **Seafreight:** There is a modern port (possibly the best of the free zone ports) based 23 km from the zone. The water depth is 10 metres. At present the port handles only bulk cargo.
- **Land transport:** Pisco is 15 km from the Pan American highway.

4.1.5 Industrial Zone:

The zone is located about 4 km from the city in an area where there is already some industrial development. Electricity supply lines run close to the site. In addition, large quantities of water will be available.

4.1.6 Quality of life for expatriates:

Generally good.

4.2 Perspectives

From a brief review of the six sites Pisco seems to be the most promising. Its proximity (less than 3 hours by road) to Lima and all the services there is a major advantage. There is a growing industrial sector in the city. The zone administration is installing basic services on the site and fencing it with a view to attracting private developers.

5. MATARANI

5.1 Brief Description

5.1.1 Local inputs:

Diversified agro products of the Arequipa region and biological agriculture of the Andes. Copper, lead, zinc, silver and gold resources in the Arequipa region.

5.1.2 Human resources:

- **Managers:** Scarce in the Islay province but available in Arequipa (31,740 university students in 1989).
- **Clerks:** Scarce in the Islay province but available in Arequipa (31,740 university students in 1989).
- **Skilled workers:** Scarce in the Islay province but available in Arequipa.
- **Unskilled workers:** Islay province had only a 22,400 labour force in 1989. Total labour force of the Arequipa region was 338,000 in 1990.

5.1.3 Industrial environment:

Mostly fish processing and agro-industries in Matarani, textile, apparel, alpaca processing, agro-industries, leather goods, shoes, jewellery and handicrafts in Arequipa, second city of Peru.

5.1.4 Transport:

- **Airfreight:** 111 km from the Arequipa international mid-range airport.
- **Seafreight:** 2 km from Matarani port, artificial deep water (33 feet of draught, 20,000 MT ship capacity).
- **Land transport:** Road system link to Bolivia to be improved. Railway to Puno and railway/ferry into Bolivia leading to La Paz and Argentina.

5.1.5 Services:

- **Electricity:** Study to be concluded; theoretically 5 MW available.
- **Telecommunications:** Study to be concluded.
- **Professional services:** Limited.

5.1.6 Industrial zone:

354 hectares at researching stage (infrastructural studies under way). Rent not yet defined.

5.1.7 Quality of life for expatriates:

Limited.

5.2 Perspectives

The Matarani IFZ has no particular advantage over other zones outside of a national industrial policy and of a strategy of IFZ specialization.

6. ILO

6.1 Brief description

6.1.1 Local inputs:

The main resources of the region for export processing are fish, agro products (tomato, ají, asparagus, olives ...) and the alpaca fiber from the Puno region. Another potential is the processing of minerals (copper resources exploited by the Southern Peru Copper Corporation), silver resources of the Tacna and Moquegua departments, lead resources of the Puno department).

6.1.2 Human resources:

- **Managers:** Scarce in Ilo as well as in the Moquegua department.
- **Clerks:** idem.
- **Skilled workers:** idem.
- **Unskilled workers:** High rates of unemployment and underemployment in the department and the region. Ilo itself has only around 60,000 inhabitants.

6.1.3 Industrial environment:

Industrial activity is limited to copper treatment, fishmeal and fishprocessing.

6.1.4 Transport:

- **Airfreight:** The ongoing repair works will allow the airport (2 km from the IFZ) to receive mid-range planes. The Tacna airport is at 147 km, fit for B-727.
- **Seafreight:** The port of Ilo, at 8 km from the IFZ, is an artificial deep water port with a capacity for ships of 20,000 MT.
- **Land transport:** Ilo is connected to the Pan American highway by a good road link of 47 km.

6.1.5 Services:

- **Electricity:** Due to irregular and insufficient service to the zone from ElectroSur (2 MW), the Ilo IFZ has installed a 2 MW generation extra capacity in the zone itself. The zone is not suitable for industries with large power requirements.
- **Water:** The town of Ilo also suffers from scarce water resources. The total available water in the IFZ is limited to 6 litres. The fishprocessing industry already planned to start operations will have to build its own link to the city reservoir.
- **Telecommunications:** Micro-wave service.
- **Professional services:** Scarce.

6.1.6 Industrial zone:

Of a total area of 327 ha, half is reserved for the development of a Bolivian free zone under the Peru-Bolivia agreement.

Stage 1 of 15 hectares is finished, with an 8 km road link to the port terminal. Four of the 20 lots are adjudicated, although no company pays yet any rent (6 months grace period). Total investment for phase one was around US\$ 5 M.

ZOFRI-Ilo has a marketing office in Lima, which will be merged in a PromPeru - CONAFRAN - ZOFRI - Ilo unique structure.

Three Peruvian companies:

- a jeans manufacturer presently training workers, already manufacturing in Tacna.
- a garlic dehydrating plant, likely to extend dehydrating to other products as the garlic production is seasonal; the main equipment is already in the building.
- a fishcanning operation - one Chinese company, related to the Shougan company.
- a propylene bag manufacturer for the fishmeal industry (indirect exports).

Renting costs: Structured lot from US\$ 0.33/m² on year one to 1.10/m² on year four.
Industrial building from US\$ 0.49/m² on year one to 1.62/m² on year four.

6.1.7 Quality of life for expatriates:

Limited attraction.

6.2 Perspectives

The perspectives are constrained by poor utilities and services (electricity, water, port and airport) and a limited urban environment. Four companies have signed contracts, but under a 6 month grace for rent payment, and with limited perspectives of success for some of them. The fish processing activity for example need 4.5 litres per second of water when the IFZ disposes of 6 litres per second. The Chacalluta is already competing successfully with Ilo in attracting Peruvian investors (see Chapter 2).

However, a significant investment has been spent on the IFZ itself, and above all the site offers the geo-political advantage of a maritime door for landlocked Bolivia, provided the Ilo-La Paz road is completed and the harbour is upgraded, as is already contemplated under privatization plans. Under a bilateral agreement, Bolivia could make use of an IFZ next to the already established IFZ and was granted the usufruct of a coastal strip of 5 km for a 50 year period.

Ilo could also become a bridgehead for Chile, Brazil and Argentina. The ZOTAC Free Trade Zone under construction is an asset for the export promotion of the region, provided it evolves away from its initial objective of import free zone (legalized smuggling at a 10% entry price) into a real export free zone.

A thorough study should therefore be undertaken in order to evaluate the export potential of the south region of Peru, its competitive advantages, the infrastructural build up and the feasibility of an export development strategy. In the meantime, investment and promotional spending ought to be stopped by ZOFRI-Ilo and its current expenditures reduced to a minimum. At the same time, CONOFRAN should look for a private developer to take over and reshape the zone as soon as such a strategy defines its role in the promotion of the exports of the South Peru region.

ANNEX 2

Itinerary

- 25 October 1993:** Meetings with UNIDO
- 26 October 1993:** Meetings with CONAFRAN and the Ministry for Industry (MITINCI).
- 27-30 October 1993:** Visit to proposed free zone sites at Paita, Trujillo and Chimbote; meetings with zone administration officials and port officials.
- 1-4 November 1993:** Visit to Tacna, Ilo and Arequipa.
- 5 November 1993:** Meetings CONAFRAN
- 8-11 November 1993:** Meetings: (i) Taiwanese Trade Counsellor
(ii) Japanese Trade Counsellor
(iii) Korean Trade Counsellor
(iv) French Trade Counsellor
(v) Peruvian/American Chamber of Commerce
(vi) ADEX (Peruvian Exporters Assoc.)
(vii) SNI (Peruvian Industry Association)
(viii) Visit to Pisco
- 11 November 1993:** Meetings with CONAFRAN, Ministry of Industry and UNIDO
- 12 November 1993:** Depart

ANNEX 3

Summary report presented by the UNIDO consultants in Lima

1. Definition:

1.1 Industrial Free Zones (IFZ's):

An industrial free zone is a limited geographic area (usually 40 to 200 hectares) fenced in and patrolled where investors can import equipment and materials free of all duties and taxes, for storage, warehousing, packaging, processing and export. Some domestic sales may be permitted at full or concessionary duty rates. A concessionary duty rate is normally where duty is paid on the imported material content of the product rather than the full value of the final product. Tax holidays (no tax on profits) may be offered in IFZ's but they are not an essential feature of IFZ's. About 80% of free zones do offer tax holidays.

1.2 Duty Free Factories:

These are simply single factory industrial free zones.

2. Function of IFZ's:

The main function of an IFZ is to provide investors who want to export a major percentage (or all) of their output with access to duty free equipment and materials. It is one of three formulae for providing duty free access - the others being (i) duty drawback and (ii) temporary import schemes. Drawback and temporary import facilities are both available in Peru. The free zone formula is the easiest to operate from a customs viewpoint in the early stages of a programme, or strategy to develop exports. It (the free zone formula) requires fewer controls and records than either the drawback or temporary import formulae. Users of the drawback scheme and the temporary import facility in Peru are both experiencing a number of problems. Slow payments, we are told, are a major problem with the drawback scheme. Under the

temporary import scheme, users are required to provide the Customs Authority with a bank guarantee, or bond to cover the duty and tax liability of the duty free imports. The cost of such guarantees can be expensive (about 6%). In the case of a number of small and medium scale enterprises, the banks we understand will not provide guarantees. Thus such enterprises are unable to use the temporary import scheme. The experience in Peru is similar to that in many other developing countries.

The IFZ is therefore in many ways the most effective duty free import scheme in the early stages of an export development strategy. Over time the relevance of the IFZ should decrease as effective temporary import regimes, duty drawback regimes and duty free factories develop. This has been the case in many countries which have successfully used the free zone formula in the early stages of an export development strategy, e.g. Korea, Ireland, Taiwan, Singapore.

3. Operating environment:

The IFZ to be successful must operate:

- (i) in a favourable investment climate;
- (ii) in a suitable policy environment;
- (iii) in a good physical setting with high standards of infrastructure;
- (iv) with reliable and acceptable international and transport and communications services; and
- (v) with good business support services.

4. Activity:

Industrial free zones usually permit warehousing, packaging, transshipment, trading, manufacturing and international service activity. They are especially suited to businesses which have regular (weekly) shipments of raw materials for processing and export. Garments, electronic assembly and international distribution activity in particular, have benefitted from free zone facilities.

5. Peru:

5.1 Investment Climate:

From the viewpoint of the export manufacturing investor, the climate in Peru is regarded as "not good". Peru is still perceived as a "high political risk" country by investment advisors, although they acknowledge that a number of improvements have taken place in recent years. It should be noted that an investment climate which may be acceptable to the mining industry or domestic market manufacturers, is not necessary acceptable to export investors.

5.2 Policy Environment:

The general direction of economic policy in Peru is acceptable to and supported by many international investors. The lack of a clear statement on the role of the export manufacturing sector and recent reported statements by leading government personnel on the role of free zones within the economy, have caused a degree of unhelpful confusion among investment advisors.

5.3 Physical Setting:

There are a number of infrastructural problems for manufacturing exporters in Peru. These include: limited availability of water in a number of areas and expensive electricity supplies. A related problem is the frequent interruptions to electricity supplies in many parts of the country. Security costs are a serious problem for many businesses.

5.4 International Transport and Communications:

Generally the facilities in Lima and the surrounding region are good. However, services in the rest of the country are either poor or non-existent.

5.5 Business Support Services:

The situation in Lima and the surrounding region is generally acceptable.

6. **Investment flows:**

Over the last decade or so there has been little or no foreign investment in Peru. In recent months however, there has been a very significant growth in mining investment and also in the stock exchange. Further significant inflows of investment are expected as part of the privatization process. Foreign investment in the manufacturing sector however, has been very insignificant - about 20 million dollars a year over the last 5 years. In so far as we could ascertain, there are no major foreign manufacturing investments planned in the foreseeable future.

7. **The industrial free zone as a development policy instrument:**

Properly planned and supported (by the government) the IFZ can improve significantly the operating environment for export manufacturing investors. Good infrastructure, including reliable water and electricity supplies, are a feature of any well planned and organized zone. Some zones have an agreement or understanding with the electricity authorities that supplies to the zone will only be interrupted in extreme emergencies. Because the free zone is a fenced in and patrolled area, the security situation in the zone is usually much better than other parts of a city or surrounding region.

8. **Viability:**

This study is not about the viability of an export processing zone programme in Peru. Rather the emphasis is on providing advice on the appropriate strategy and policy for the development and operation of zones. It is possible that with the proper government commitment and support and a clear policy/strategy for the export manufacturing sector, that a free zone

programme in Peru can make a contribution to the overall development of the country. It should be noted that many free zone programmes around the world have failed because of a poor investment climate, poor location decisions and difficult policy environment.

9. Potential activities:

9.1 Processing imported materials for Northern Hemisphere markets:

The main activities involved in these circumstances are garments, leather goods manufacture and electronic assembly. The Northern Hemisphere markets in question are North America and Europe. Costa Rica, the Dominican Republic and Mexico are very competitive locations in relation to North America and Peru would have difficulty competing with such locations. North Africa and Eastern Europe as well as Turkey are key locations in relation to Western Europe. Peru is unlikely to compete with Albania for example, as a base for supplying Europe with leather goods products. Wage levels in Albania are US\$ 60 a month and Albania is 80 kilometers across the Adriatic Sea from Italy. The potential for such activities in Peru is very limited.

9.2 Processing of imported materials for regional (Latin American) markets:

Regional markets in this case are other Latin American and Caribbean markets. There must be significant potential for developing Peru as a manufacturing base for supplying regional markets, provided suitable transportation links between Peru and the rest of the continent are developed. In particular, overland transportation links to the Amazon region and Bolivia are important. The activities involved in this category would include a wide range of consumer and capital goods.

9.3 Processing local materials for both regional and international markets:

Peru is an important source of both marine and agricultural raw materials. The possibility of developing manufacturing projects processing these materials within a free zone context must be significant. It should be noted, however, that over the last 30 years there has been very limited exploitation of Peru's natural resources and very limited processing of these resources for export markets. Any proposals to develop free zones in Peru for the processing of agricultural or marine based raw materials must be preceded by studies which would identify the precise potential and how such potential would be exploited.

10. **Potential investors:**

In most free zones around the world over one third of investors are local. Most of the foreign investors come from neighbouring countries, e.g. U.S. in Mexico, Japanese in Korea, Western Europe in North Africa, Taiwan in the Philippines, Singapore in Vietnam, etc. On this basis many of the investors in the proposed Peruvian free zones will come from Peru and neighbouring Latin American countries. The North Americans are also important investors in South America. Investment advisors from Korea, Taiwan and Japan have indicated that South America including Peru is a low priority. The main attractions for Oriental investors are the mining and fishing resources in South America. The priority areas for Oriental investors are China and the developing countries of South East Asia including Vietnam.

11. **Domestic market sales:**

At present free zone producers can only sell 20% of their total output on the domestic market, provided they pay all the relevant customs duties and indirect taxes on the full value of the finished product. This places free zone producers on the same level as importers. However, importers are not faced with any sales restrictions on the Peruvian market. It is possible that in some circumstances free zone producers may wish to sell in excess of 20% of their total output on the Peruvian market - for example, a producer using Peru as a base to supply the Peruvian,

Bolivian and Chilean markets. In such circumstances, a liberal interpretation or relaxation of the 20% export rule may well be justified.

12. Quotas:

Non access to quotas was an important factor in restricting the growth of a number of zones throughout the world. The Karachi zone in Pakistan is one example. Free zone investors were denied access to Pakistan's textile export quota. The result was that few investors were tempted to establish production bases within the zone. In the Dominican Republic between 50% and 75% of zone activity is based on quota availability. If zone producers were denied quota access, there would be a major reduction in employment in the free zones in the Dominican Republic. In the case of Peruvian free zones, it is possible that the main activity will be (a) processing imported raw materials for regional markets and (b) processing local materials for sale in regional and international markets. In such circumstances quotas will have limited relevance. Nevertheless, quotas should be available to zone producers - provided domestic manufacturers are not adversely affected.

13. Location:

All of the 6 free zone sites identified were chosen in 1989 in a different social and economic context and apparently without reference to location criteria for free zone development. Most of the sites do not have adequate international transportation or communications services. It is not clear that adequate infrastructure or business support services exist in many of the sites. Because of the foregoing considerations the viability of many of the sites selected must be open to question.

14. ZOTAC/ILO:

As far as can be ascertained, no business or commercial studies on the viability of the ZOTAC or ILO sites have been undertaken. In order to make the best possible use of the developments at ZOTAC and ILO, commercial and marketing studies should be undertaken to determine the type of investor most likely to be interested in these sites and the conditions under which such investors can operate successfully.

15. Product limitations:

The proposal to exclude from the free zone manufactured products whose exports from Peru exceed US\$ 1 M should be re-considered. Such a proposed regulation could, according to some commentators, be difficult to administer and open to some abuse. It has also been suggested that the products whose exports exceed US\$ 1 M are those very products which are most suitable for development in the free zone, as these are the areas in which Peru has an obvious or definite competitive advantage.

16. Legislation:

At present CONAFRAN does not have direct control over the type of investor who may enter or establish a business in a free zone. The responsibility for granting permission to investors to establish operations in free zones rests with the local free zone administration. This administration could be controlled by the private sector. It follows therefore, that the private sector can in certain circumstances grant permission to investors to establish businesses in free zones. This means, in effect, that the private sector in certain circumstances can grant tax reliefs and special privileges to investors. This is a highly unusual situation. In most countries, permission to establish businesses in free zones must be sought from the National Free Zones Authority or Council. In the case of Peru, this would mean seeking permission from CONAFRAN. We recommend therefore, that an amendment be introduced in the law or regulations which provides that all investors in free zones should receive a license, approval or permit from CONAFRAN.

17. Anomalies:

At present the situation exists where manufacturing activity is excluded in the ZOTAC zone. Investors in ZOTAC if they want to engage in manufacturing activity must move outside of the zone or to ILO, or over the border to one of the zones in Chile. This may discourage zone investors from increasing value added within the zone. The implications of this restriction should be considered further.

18. Fair competition:

There has been some discussion about fair competition between zone investors and those in the rest of the economy. In a country which plans to develop a vibrant export manufacturing sector (and we must assume that this is a medium term objective of the Peruvian government), the key issue is to provide operating conditions for export investors which compare favourably with those in neighbouring countries. It may take some time to provide such conditions on a countrywide basis (good infrastructure and international transport services and efficient duty free customs procedures). These conditions can be provided in selected locations (free zones) initially. As the country develops its infrastructure, transport services and improves its customs administration procedures (duty drawback and temporary import schemes), the free zone type facilities can be spread on a countrywide basis. This is what happened in Ireland, Korea, Taiwan and other countries who have successfully exploited the EPZ concept to stimulate or initiate an export-oriented manufacturing development programme.

19. Incentives:

Incentives in the form of exemptions from profits, tax (or tax holidays) are not an essential feature of a free zone programme. The key features in a free zone are the exemption from customs duties and other forms of indirect taxation. The purpose of a tax holiday is to increase the attractiveness of one competitive location over another neighbouring location which is also competitive. (A competitive location means a place which has good infrastructure, international transport services and the other necessary facilities which allow an investor to compete effectively on international markets). In a Peruvian context, the purpose of incentives like tax holidays is to enable competitive locations in Peru to compete effectively with similar locations in Chile, Colombia, Ecuador and other parts of South America.

20. Further UNIDO assistance:

The general consensus is that further UNIDO assistance for free zone development should centre on:

- (i) An information seminar of 2-3 days duration in Lima to acquaint relevant government and private sector personnel with various aspects of free zone development.
- (ii) A marketing/commercialization study for the development of the zones at ZOTAC and ILO; and
- (iii) An evaluation of the potential for processing agricultural and marine based raw materials in other proposed free zone locations provided
 - (a) the government clearly supports a free zone programme; and
 - (b) funding is available from UNIDO.

ANNEX 4

Definitions

A recent study on the subject "The Challenge of Free Economic Zones in Central and Eastern Europe" by UNCTC listed twenty three different terms to describe free zones and related concepts. The most popular are (i) free port, (ii) free trade zone (FTZ), (iii) foreign trade zone, (iv) export processing zone (EPZ), (v) export processing regime, (vi) special economic zone (SEZ) and (vii) free zone (FZ).

(i) Free Port

This was probably the first term used. It refers to zones established by the colonial and industrial powers on the major trading routes in the 18th and 19th centuries. The first such port was Gibraltar established around 1705. Other free ports were established by the British in the 19th Century in Aden, Singapore and Hong Kong. In Africa, Djibouti was developed by the French as an important free port and trading centre. After the opening of the Suez Canal in 1864 Port Said developed as one of the world's busiest free ports. At the other side of North Africa Tangier prospered for centuries as a major centre of commerce and a free port. In Europe the best known free ports are Rotterdam and Hamburg, both of which developed in the second half of the last century. Hamburg had formal legal free port status which it still retains today. Rotterdam does not have a formal legal free port status. However, there are bonded warehouses spread throughout the port where transit goods can be stored duty free and with the minimum of Customs formalities. Rotterdam is in fact Europe's major transshipment port. All of the other major ports in the European mainland have a formal or informal free port status. Some, such as Genoa and Trieste have a history going back to the Middle Ages. Others, such as Le Havre and Marseilles are more recent developments.

(ii) Free Trade Zone (FTZ)

This term refers to free ports as well as zones set aside within port areas and at other major transport intersections (mainly road and rail). The area set aside could range from a small transit shed to hundreds of acres. Such zones are usually licensed and controlled by the Customs Authority. Within the zone duty free goods can be stored, packed, warehoused and transhipped. The emphasis in these zones is on trade and transhipment. Some of the zones are used exclusively for transhipment to a neighbouring inland country. The port of Karachi has a small transit zone to store goods destined for Afghanistan. Calcutta has a similar facility to accommodate Nepalese imports. Other zones, particularly the free ports of Singapore and Rotterdam are major inter-continental trade and distribution centres.

(iii) Export Processing Zone (EPZ)

This term describes a phenomenon which began around 1960 at Shannon airport in Ireland. The EPZ is an area of (i) usually 40 to 100 hectares developed as an industrial estate, (ii) surrounded by a fence, (iii) controlled by the Custom Authority, (iv) where investors can import equipment and materials free of duty, process the materials and export the finished product. Sometimes a small percentage (usually up to 20%) can be sold on the domestic market. This idea has spread rapidly in the last two decades throughout much of East and South Asia, Africa, the Caribbean and Central America. A number of West European countries, including France and the United Kingdom have also embraced the idea. At present most former socialist countries in Europe and Asia as well as many countries in Africa and South Africa are planning EPZ's.

(iv) Economic Processing Regime (EPR)

This term refers to an administrative rather than a physical concept. An EPR exists in Mauritius and Fiji. In both countries investors are not confined to a particular zone. An investor with EPR status can establish a facility anywhere in either country and have the same privileges and status as an EPZ investor in other countries. This means he can import materials and equipment free of duty, process the materials and export the finished product. The EPR is very similar to "automatic import licensing" and "duty/indirect tax exemption schemes". The

EPR may have a little less bureaucracy attached to it, including easier access to foreign exchange. Some people may also feel that the use of the term "export processing" has a promotional edge or appeal to it. The Maquiladora sector in Mexico and the enclave⁽³⁾ sector in Barbados could be classified also as EPR regimes.

(v) Special Economic Zones

The term "special or free" economic zone has been associated with developments in China since 1979/80. More recently the "special or free" economic zone has also been used in relation to proposals for free economic zone development in Eastern Europe. In the late 1970's the Chinese government recognized the need for special measures to attract foreign capital, technology and management. In 1979 the government announced that two provinces could experiment with the concept of "special economic zones". Zones were established in Shenzhen, Zhuhai and Shantou in Guangdong province and Xiamen in Fujian province. Local authorities in each zone were allowed to promulgate local legislation and regulations for promoting investment and improving investor applications. Favourable tax and operating procedures were also allowed in the zones, including duty free imports of materials and equipment. Most of the output was exported although some (up to 30%) local sales were permitted. The main benefits expected from these initiatives included foreign investment and controlled experiments in economic reforms.

⁽³⁾ A term used in ILO working paper n° 42 on Employment Effects of Multinational Enterprises in Export Processing Zones in the Caribbean.

ANNEX 5

Foreign Direct Investment - Global and Latin American Trends

Global direct investment fell in 1991 for the first time in 9 years by 26% from US\$ 229 billions in 1990 to 170 billions in 1991 and further to US\$ 138 billions in 1992. The major outward investors in recent years were Japan, followed by the United States, Germany, the United Kingdom and France. Other significant investors include Sweden, the Netherlands and Taiwan.

Direct investment in Latin America, which had been declining throughout much of the decade of the 1980's when global investment was growing rapidly, fell to US\$ 2.7 billions in 1986. In the following years (1987 to 1990) it averaged about US\$ 6 billions to 7 billions annually. There was a substantial increase in 1991 to US\$ 11 billions. All indications are that this level of investment has continued in 1992 and 1993.

Table 2.1 outlines the change in both Japanese and U.S. investment on a worldwide basis over the second half of the 1980's. Japanese investment in recent years was concentrated in North America and Europe. Investment in Latin America outside of Panama and the Bahamas/Caymen Islands is insignificant.

TABLE 2.1 - TOTAL INVESTMENT

	Japanese Investment in billion \$				U.S. Investment in billion \$			
	1985	% of total	1990	% of total	1986	% of total	1991	% of total
Total	83.7	100.0	310.8	100.0	259.8		450.2	
North America	27.0	32.2	136.2	43.8	i) 50.6	19.5	i) 68.5	15.2
Asia	19.5	23.3	47.5	15.3	31.7	12.2	52.8	11.7
Europe	11.0	13.2	59.3	19.1	120.7	46.5	224.6	49.9
Latin America of which:	15.6	18.7	40.5	13.0	36.9	14.2	77.3	17.2
Panama	6.4	7.7	16.2	5.2	5.5	2.1	11.0	2.4
Brazil	4.6	5.5	6.6	2.1	9.3	3.6	11.2	3.4
Mexico	1.3	1.6	1.9	0.6	4.6	1.8	11.6	2.6
Argentina	0.1	0.2	0.4	0.1	2.9	1.1	3.4	0.8
Venezuela	0.1	0.2	0.3	0.1	2.0	0.8	2.8	0.6
Chile	0.2	0.3	0.3	0.1	0.3	0.1	1.6	0.4
Peru	0.7	0.8	0.7	0.2	1.1	0.4	0.4	0.1
Caymen Island/ Bahamas	0.8	0.9	10.8	4.5	3.0	1.2	3.3	0.7
Other	10.6	12.6	27.3	8.8	19.9	7.6	27.0	6.0

i) Canada

Source: Japanese External Trade Organization
U.S. Department of Commerce