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STRATEGIC ASSESSMENT OF THE SAN BARTOLO FREE ZONE

Final Report

Bureau for Private Enterprise
U.S. Agency for International Development

Prepared for: *USAID/El Salvador and the San Bartolo Free Zone*

Prepared by: *The Services Group*

Sponsored by: *Private Enterprise Development Support Project II*
Project Number 940-2028.03
Prime Contractor: Arthur Young

June 1989

Arthur Young

A MEMBER OF ARTHUR YOUNG INTERNATIONAL

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TABLE OF CONTENTS

TABLE OF CONTENTS (continued)

LIST OF TABLES AND FIGURES

ACRONYMS AND ABBREVIATIONS

CABEI	Central American Bank for Economic Integration
CODEXI	Committee for the Development of Exports and Investment
EPZ	Export Processing Zone
FUSADES	Foundation for Social and Economic Development
GOES	Government of El Salvador
ISCE	Salvadoran Institute of Foreign Trade
km.	kilometer
MICE	Ministry of Foreign Trade
OIP/FZ	Office of Investment Promotion and Free Zones
OPD	Office of Physical Development
PEDS	Private Enterprise Development Support Program
PRIDEX	Export and Investment Promotion Program
SBFZ	San Bartolo Free Zone
SFB	Standard Factory Building
sq.ft.	square feet
sq.m.	square meter
TSG	The Services Group, Inc.
USAID	U.S. Agency for International Development

FOREIGN EXCHANGE RATE

Prior to 1986: US$1 = C2.50

1986-Present: US$1=C5.00

EXECUTIVE SUMMARY

Purpose. The purpose of this report is to assess the current organizational, managerial, and operational structure of the San Bartolo Free Zone (SBFZ) to arrive at short-term recommendations to improve its economic and financial performance and propose strategic alternatives for its future development. The investigations summarized in this document were conducted through extensive field work and direct interviews as well as office research and analysis.

Background. The San Bartolo Free Zone is a public sector project established by the Government of El Salvador in 1974 and now operated by the Salvadoran Ministry of Foreign Trade. One of the first free zones in the Central American and Caribbean region, the SBFZ flourished in the early years of its operation and by 1979 had attracted 14 tenants and generated employment for over 4,000 persons. However, the rising domestic conflict in the late 1970s and early 1980s resulted in a dramatic drop in occupancy levels and the zone languished until 1983.

Since that time, the combination of an improving investment climate, the demand for industrial space in El Salvador overall, and an infusion of U.S. Agency for International Development financing for new building construction and infrastructure improvements have brought about a revitalization of the project which is once again approaching full occupancy. Nevertheless, long-standing problems in management and operations continue to stifle the growth potential of the SBFZ and are in need of immediate attention.

Assessment of SBFZ Financial Position. While the zone's occupancy levels have varied over time, the financial performance of the SBFZ has consistently fallen short of profitability. This is due to several factors, the uneconomic rental rates charged for zone space, inordinately high operating costs, shortcomings in rental collection procedures, among others. Moreover, the exact financial position of the SBFZ is largely disguised by the fact that the funds it uses are not drawn from the revenues that it generates, but rather from the annual Government budget for the project and USAID financing. Finally, the accounting practices employed by the Ministry are inadequate to track the true performance of the SBFZ, no regular audit procedures are employed and funds are commingled with those of internal operations of MICE.

Assessment of SBFZ Managerial and Organizational Structure. As presently structured, the management of the SBFZ is undertaken at two distinct levels: the Office of Investment Promotion and Free Zones within the Ministry and the on-site staff of the SBFZ. A third office, also within MICE, the Office of Physical Development, is overseeing the new USAID-financed construction program. Each of these offices relies on the approval of the Minister or Vice-Minister for even the must rudimentary decision. The diffusion of responsibility for the project among these different offices and individuals has resulted in delays in decisionmaking, gaps in coverage in key areas such as data collection and investor assistance, and general frustration on the part of all concerned. Moreover, payroll costs for the total on-site and Ministry-based personnel are an estimated 30 to 40 percent higher than in other free zones in the region.

Assessment of SBFZ Physical Development. The existing stock of industrial factory space totals approximately 43,000 sq.m. When coupled with the ongoing USAID-financed construction program, expected to be completed in 1989, the total under-roof space in the SBFZ will reach over 67,000 sq.m. At that time, roughly 35 percent of the total 80-hectare site will be urbanized. The "all-in" construction cost of the new buildings is US$387/sq.m. This figure includes the cost of land preparation, architectural/engineering services, construction and materials, and construction supervision; it does not include raw land value. While expensive when compared to the regional average of US$215/sq.m., the cost is defensible based on the design standards used and land development considerations. The uneven topography results in higher than average land preparation costs and the building design is heavier and more costly than normal due to the risk of earthquakes. Moreover, lengthy lag times between submission of bids and actual construction, and the escalation of factor costs during the interim have inflated the all-in figure. It should also be noted that the US$387/sq.m. includes the cost of land preparation for a parcel of land to be used for future construction. The advance preparation of this site will result in lower construction costs in the next stage of SBFZ development. Finally, the impact of government procurement procedures on program costs must also be taken into consideration. For example, the policy of subdividing the aggregate of civil works into smaller packages has reduced the economy of scale and resulted in non-standard building design which has also contributed to higher costs.

In general, the facilities offered by the SBFZ are in good condition, although problems in basic service delivery have beset the project for some time. However, the measures outlined in the current construction programs to improve on-site infrastructure, coupled with the augmentation in the capacity of key external services delivered to the zone, as currently envisioned, will be largely sufficient to support the new facilities and the project as a whole. Further development of the site is likely to require additional improvements, especially in telecommunications and electricity.

Assessment of the SBFZ Promotion Program. In reality, there is no promotional program for the SBFZ and has not been for almost 10 years. The zone has gone through periods of high vacancy, as in the early 1980s, as well as high demand, as is presently the case, in the absence of any pro-active measures to attract clients. Given the capabilities and resources of the SBFZ and MICE staff, a formal promotional program is not a practical avenue to pursue. Instead, a small-scale initiative should include: (i) training of key MICE personnel in the fundamentals of the free zone program in El Salvador; (ii) improvements to data collection and dissemination procedures; and (iii) enhancement of staff capabilities to offer investor assistance. This will complement the efforts of more appropriate and experienced private sector organizations to promote the project.

Recommendations for Short-Term Corrective Measures. The analysis conducted indicates a clear need to consolidate the activities of the SBFZ-related offices into a single unit. This unit, headed by the General Manager of the SBFZ, would take on the entirety of the activities now distributed within the Ministry and at the zone itself. The office would be based on-site, but would have a significant status within the Ministry, no less than that presently held by the Office of Investment Promotion and Free Zones. As with a private business enterprise, SBFZ management personnel would establish performance objectives for the project and regular reporting procedures to measure effectiveness. In the reorganization process, cutbacks should be made in support staff and salaries raised for key personnel to better approximate market levels for their positions.

Alternative Strategic Configurations for the Project. In addition to the remedial measures to be undertaken on a managerial and operational level, the Government should seriously consider the possibility of the structural reconfiguration of the project as a whole. Options that have been examined include establishing the zone as an financially autonomous unit, contracting out the management of the project to the private sector; establishment of an autonomous parastatal to take control of the project; and total divestiture of the zone. Apart from financial autonomy, which, as configured, does not appear to warrant consideration in and of itself, each of these options can be pursued in a complementary manner, and to a great extent, concurrently, with the ultimate goal of divesting the SBFZ to the private sector. It is recommended that a public-private sector committee be established to head the effort to implement privatization.

I. INTRODUCTION

1.01 This report has been prepared by The Services Group, Inc. (TSG) for the Ministry of Foreign Trade (MICE) of the Government of El Salvador (GOES). It presents the findings of a study funded by the United States Agency for International Development through the Private Enterprise Development Support (PEDS) program. The purpose of the study is to conduct a comprehensive assessment of the San Bartolo Free Zone (SBFZ), its structure, operations and management, and to arrive at a strategic configuration and implementation framework to improve its financial and economic performance.

1.02 As set forth in the scope of work, the study is composed of two parts which have been combined in this report. The first component of the work program, encompasses an assessment of the administrative, financial and managerial structure and functions of the SBFZ. The second component focuses upon an analysis of the physical development and marketing programs of the SBFZ, in light of the findings of the initial investigations and analysis. The discussion presented in this report is based upon data collected through TSG field work in El Salvador, encompassing the aggregation and review of SBFZ and MICE historic records and planning documentation as well as extensive discussions with MICE and USAID personnel and contractors.

1.03 The TSG project team extends its appreciation to Amado Sanchez, Luis Felipe Alam y Alam, Justo Pineda, and Rigoberto Payes of MICE/SBFZ who have each been especially helpful in our work thus far. In addition, Roberto Duran and Eliu Brizuela of MICE provided guidance in gathering the financial information needed for the preparation of this report. Finally, TSG would like to especially thank Beatriz Peralta, USAID/PRE, for her support in the execution of the work program, along with the other members of the PRE staff of USAID/El Salvador.

II. BACKGROUND ON THE SAN BARTOLO FREE ZONE

A. LEGISLATIVE AND REGULATORY CONTEXT

1. Legal Origin

2.01 With the passage of the Export Promotion Law in September 1974, the Government of El Salvador created the legal framework for the initiation of the national free zone program. In this legislation, the right to develop and manage free zones was reserved exclusively for the Government, with private ownership and administration of free zones expressly prohibited.

2.02 The Ministry of Economy was charged with the responsibility for all aspects of free zone development in the 1974 law -- from site selection to administration to regulation -- with the exception of the normal prerogatives of other GOES entities such as the Ministry of Finance (Hacienda), Social Security, and others to exercise their duties. The option was also provided for the Ministry to delegate its responsibilities to other "decentralized public entities."

2.03 The first and, thus far, only free zone project to be established in El Salvador is the San Bartolo Free Zone. A public sector project located just outside San Salvador in the Ilopango district, the SBFZ was designated by national decree in 1974, and became fully operational in 1976. Funds for the initial development phase were provided by a loan from CABEI, the Central American Bank for Economic Integration, with counterpart funds supplied by the GOES. In 1978, the free zone implementing regulation, or "reglamento," was enacted which expanded on the free zone law, setting forth general operating rules for both the SBFZ and its users, and specifying the types of activities that could be lawfully undertaken and the responsibilities of zone management and occupants.

2.04 Since its designation, responsibility for the development and administration of the SBFZ has been transferred between several different GOES entities. In each instance, the combination of the institutional capabilities of the administrative body, the socio-political climate of the period, and the priority ascribed by GOES to the project, has had a profound impact on the zone's performance.

2.05 During the earliest stages of the SBFZ development, the project was administered by the Ministry of Economy. By 1976, however, responsibility for the zone was transferred to ISCE, the Instituto Salvadoreno de Comercio Exterior (Salvadoran Institute of Foreign Trade), a public sector entity created by the 1974 Export Promotion Law to support and catalyze the expansion and diversification of foreign trade activities in El Salvador. As set forth in the Law, ISCE enjoyed considerable autonomy in carrying out its mandate within the framework established by an inter-Ministerial policymaking Council including the Ministers of Economy (Economia), Finance, and Foreign Relations (Relaciones Exteriores). The Executive Committee of ISCE, composed of both public and private sector leaders, was charged with establishing program activities, and technical and budgetary direction of the Institute, subject to the approval of the Council.

2.06 From 1975 through 1980, the SBFZ functioned essentially autonomously, with authority and decisionmaking responsibility vested entirely within ISCE. During this period, the zone was a regional leader in terms of its growth and performance. On January 8, 1980, a GOES decree was enacted constituting a governmental reorganization. The ISCE was dissolved and replaced by the Ministry of Foreign Trade (MICE, "Ministerio de Comercio Exterior"), an entity which also took on related functions previously discharged by the Ministry of Economy. Responsibility for control and administration of the SBFZ was formally transferred to MICE by a 1983 legislative decree.

2. Present Regulatory Framework

2.07 The principal GOES objective in the creation of MICE was to centralize all the regulatory and promotional support functions related to foreign trade and economic diversification in one government body. The SBFZ, therefore, as a mechanism to promote foreign investment and economic expansion, fit neatly into the institutional portfolio of the ministry. However, by 1982, widespread civil unrest had taken its toll on foreign investment and zone occupancy had dwindled to five firms from a peak of 14 in 1979. The uncertain Salvadoran business climate and its impact on interest in the SBFZ, made further development or even active management of the zone a low priority for the GOES in the early 1980s.

2.08 As the national political climate stabilized somewhat and the global economy experienced a rebound, the GOES became aware of the need to simplify the regulatory framework and strengthen its export and investment promotion program to more effectively compete with its regional neighbors. In 1986, a new Export Promotion Law was enacted, superceding the 1974 law, that included new elements and incentives to promote economic growth. The most important change enacted in the law in terms of the future development of the Salvadoran free zone program was that it authorized the establishment of privately owned and/or operated free zones in El Salvador (Chapter 10, Article 26).

2.09 Apart from laying the legal foundation for future private sector involvement, the 1986 law had little direct impact on the SBFZ. Only one Article specifically addresses GOES free zones, Article 28, which permits the MICE executive body to delegate the administration of state-owned free zones to "decentralized [government] bodies" or to "national or foreign private individuals or legal entities" through a contract signed with the Ministry. In terms of the zone's ownership and administrative structure, the scope of the clause is important in that it authorizes the transfer of zone management, but not ownership, though divestiture of the property is not expressly prohibited.

2.10 In 1988, a new free zone implementing reglamento was passed setting forth the regulatory framework for private free zone development in El Salvador, and streamlining the operational aspects of the Salvadoran free zone program as a whole. The passage of the reglamento, coupled with the initiation by USAID of a US$26 million project directed primarily to the support of private free zones, have created a new context for Salvadoran free zone development. Should the private sector undertake zone development in El Salvador, foreign and domestic investors will for the first time be able to choose among alternative zone projects and the SBFZ will be faced with domestic, as well as regional competition.

B. ZONE GROWTH AND DEVELOPMENT

1. Historic Performance

2.11 As mentioned above, after its establishment in 1975, the San Bartolo Free Zone experienced rapid growth over the following four years to 1979 when 14 zone enterprises employed a total of 4,078 workers in the production of apparel and textiles (7 enterprises), high-technology metal products (5), electronic assembly (1) and shoes (1). This initial period of rapid growth, it should be noted, occurred despite the difficult recession years of the mid-1970s when competitive zones in the region were either losing factories or barely holding their own.

2.12 The worsening socio-political climate of 1979-81 in El Salvador had its inevitable effect and by 1982, nine of the fourteen companies had ceased operations, dropping the work force to 1,192. A turnaround in demand for free zone facilities, however, began to develop in 1983 and by 1986 there were nine companies operating in the zone employing 2,368 and today (May 1989) MICE lists nine manufacturing firms with a total work force of 3,867.

2.13 The foregoing summary of the fluctuating occupancy level from the zone's inception in 1975 to early 1989 illuminates an important, albeit not-too-obvious, fact relevant to the project's inherent feasibility. Despite the generally inauspicious economic and political environment within which San Bartolo has had to operate -- from the depression years of the mid-1970s to the widespread civil unrest and military confrontations of the 1980s -- it has successfully attracted occupant industries, created significant numbers of jobs, survived, and rebounded from the low point of 1982. The record is a testimonial to the project's basic appeal and potential attractiveness vis-a-vis other free zones of the region. Translating this potential into effective demand would require a substantially improved investment climate as the first, most-important step and that, in turn, will depend to a large extent on the reestablishment of domestic tranquility.

2.14 The area under the jurisdiction of the SBFZ is 80 hectares/1 (198 acres), located 10 kms. east of San Salvador on the Pan American Highway and adjacent to the Ilopango Airport. The original Master Plan showed a layout of 126 building plots of 4,200 sq.m. each (slightly over 1 acre or 45,000 sq.ft.) earmarked for industrial shells (Standard Factory Buildings or SFBs), 29 plots of 3,000 sq.m. each for commercial buildings and an internal road network totalling six kms. in length. In the early planning period, it was envisaged that 63 SFBs of 1,334 sq.m. (about 14,500 sq.ft.) would be erected on half the available industrial plots while all commercial plots would be utilized, each

/1 Often reported as 85 hectares, but specified as 80 hectares in the MICE Action Plan 1988; we have assumed 80 hectares. At this stage of development, the difference is not material.

accommodating a 600 sq.m. structure. This plan implied that 63 industrial plots would be available for other uses such as owner-built factories and common services (social, recreational, etc.).

2.15 Actual construction implemented between 1974-78 resulted in the urbanization -- that is, development of land and provision of infrastructure (power, water, telecommunications, sewage, roads, and so forth) to accommodate the erection of industrial/commercial buildings and the services needs of future occupants -- of about 20 hectares. Primary areas of development included Poligonos A, B and C, plus connecting roads and common service areas (see Annex 1, MICE Plot Plan "Proyecto de Urbanizacion"). Also, 4 kms of hard-top road and 13 SFBs with a total under-roof area of approximately 40,000 sq.m. (430,000 sq.ft.) were completed. Subsequently, no further construction was undertaken until 1987/88 when USAID funds were made available.

2. Current Demand for SBFZ Space

2.16 Since 1978, several of the SBFZ buildings have been internally subdivided and one has undergone a major expansion (Building 5-A, leased by AVX Ceramics). Of the 13 original structures, three (totalling 11,106 sq.m.) are occupied by the army and ten are occupied by industrial firms (although one firm is not in production currently). In addition, a new SFB, Building No. 18, totalling 2,163 sq.m. was recently completed and is now occupied. Theoretically, at full occupancy the eleven SFBs could accommodate about 3,000 workers per shift. (Several firms are now operating on a two- or three-shift basis.) If the space occupied by the army could be converted to rentable industrial space, the job creation potential of the project's existing facilities would rise to about 4,000 workers per shift. Full development of the 80-hectare site would provide facilities for up to 16,000-20,000 workers on a single-shift basis, assuming an average of 11 sq.m. per worker.

2.17 Current demand for free zone space in El Salvador has proven to be substantial, although primarily domestic in origin. Of the nine firms presently operating in the SBFZ, only three are foreign owned. While AVX Ceramics (U.S.) has been a tenant of the SBFZ since 1976, Jeesan Enterprises (Korea) and County Line Sportswear (U.S.) have both begun operations within the last two years, indicating that demand from abroad may once again be a factor. However, apart from current occupants seeking expansion space, virtually all of the firms requesting space in the free zone are Salvadoran.

2.18 The predominance of domestic demand was supported by the results of a 1988 market demand study conducted for USAID. Over 85 percent of the sizeable demand for free zone space revealed (52,900 sq.m.) came from local businesses. The firms surveyed made clear that one of the primary stimulants of the demand is simply the lack of suitable industrial space in El Salvador, whether inside or outside zone boundaries. As one of the country's few established industrial complexes, the SBFZ is enjoying a strong resurgence of demand for its facilities.

2.19 As shown in Table 2-1, there is little space available for lease at San Bartolo. Moreover, MICE has reportedly received letters of intent from ten firms that would absorb all the SFB construction planned for 1989. This demand for zone space has arisen in the absence of any promotional effort on the part of MICE or the on-site SBFZ administration, and includes both foreign and domestic firms.

TABLE 2-1

TENANTS OF THE SAN BARTOLO FREE ZONE, MAY 1989

Company Name	Building Leased	Area (sq.m.)
Specialty Products	8, 13	5,630
Manufacturas de Papel	2	3,353
Jeesan Enterprises	11, 7-B	3,065
Procesadora de Cafe	7-A	963/1
INTECU	4-B, 18	4,626/2
Form-O-Uth	4-A	1,759
AVX Ceramics	3, 5, 5-A	8,363
County Line Sportswear	1-C	1,338
Celoprint	10	1,767
Expon, S.A.	1-B	680/3
Total leased area		**31,544 sq.m.**
Space occupied by army battalion		11,100 sq.m.
Total occupied area		**42,644 sq.m.**
Total under-roof area		43,664 sq.m.
Total available space		**1,020 sq.m.**

/1 Procesadora de Cafe is leasing space but not operating.
/2 Includes 300 sq.m. INTECU uses as a private cafeteria.
/3 Remodeling of a portion of this building is underway and will soon be opened as a cafeteria, owned and managed by a private Salvadoran concessionaire, bringing the total number of users to ten.

Source: SBFZ Administration records.

2.20 Given the demonstrated demand for the new SBFZ facilities, the need for a rational, businesslike approach to the letting of the new buildings is apparent. The marketing of the facilities, pricing of the factory shells, and determination of services provided, will all have an effect on whether the SBFZ becomes a profitable operation or fails to capitalize on its present competitive edge.

III. INSTITUTIONAL FRAMEWORK

3.01 Principal among the attributes required for the profitable operation of a free zone project is effective business management, from strategic planning through to physical maintenance. Unlike private zones where the organizational structure generally reflects the essential business functions to be performed, management responsibilities in public free zones are frequently ascribed to institutions or agencies where the previous spectrum of responsibilities bore little relation to property development and industrial management. The experiences of national governments worldwide in initiating and operating free zone projects and programs have demonstrated that this is often a difficult task for a public entity to execute.

3.02 The following discussion focuses on the role of the GOES in developing and administering the San Bartolo Free Zone, rather than its broader obligation to create and maintain the regulatory framework necessary for running a free zone program. It examines the structure and effectiveness of the institutional framework that has been established for the management of San Bartolo and its impact on the zone's performance.

A. INSTITUTIONAL OBJECTIVES

3.03 The San Bartolo Free Zone was established by the GOES as a mechanism to promote export-oriented economic development in El Salvador. Specifically, the purpose of the zone as described in the most recent MICE Action Plan is as follows:

> The San Bartolo Free Zone is an instrument for the economic and social development of the country through the promotion of investment for exports operating under a fiscal regime, regulated by a free zone 'reglamento,' and within the framework of an economic design that contains the maximum permissible value added, and which is oriented to the processing of Salvadoran raw material, which could represent the platform for the development of a Salvadoran industrial process directed toward exportation.

Based on this objective, the responsibility of the GOES in free zone development is two-fold: to create and administer the appropriate regulatory environment for the attraction of zone users and to develop and successfully manage the zone. The structure and staffing of MICE vis a vis SBFZ management are examined below.

B. INSTITUTIONAL DEVELOPMENT

3.04 Prior to the GOES reorganization creating MICE in 1980, the SBFZ was part of ISCE's portfolio. According to several individuals interviewed, the shift of responsibility from ISCE to MICE resulted in a significant change in zone management and decisionmaking practices. ISCE had operated much like an independent agency and, as a functional unit within ISCE, the SBFZ management enjoyed much of the same autonomy in their day-to-day decisionmaking. For example, under ISCE, SBFZ management was accorded control over zone revenues, which in turn were channeled to cover the project's expenses. Decisions were also made on-site regarding staffing, purchasing, physical improvements and other key managerial functions. With the establishment of MICE, managerial responsibilities for the SBFZ were centralized within the Ministry itself, in a "Free Zone Division" created to oversee the operations of the SBFZ.

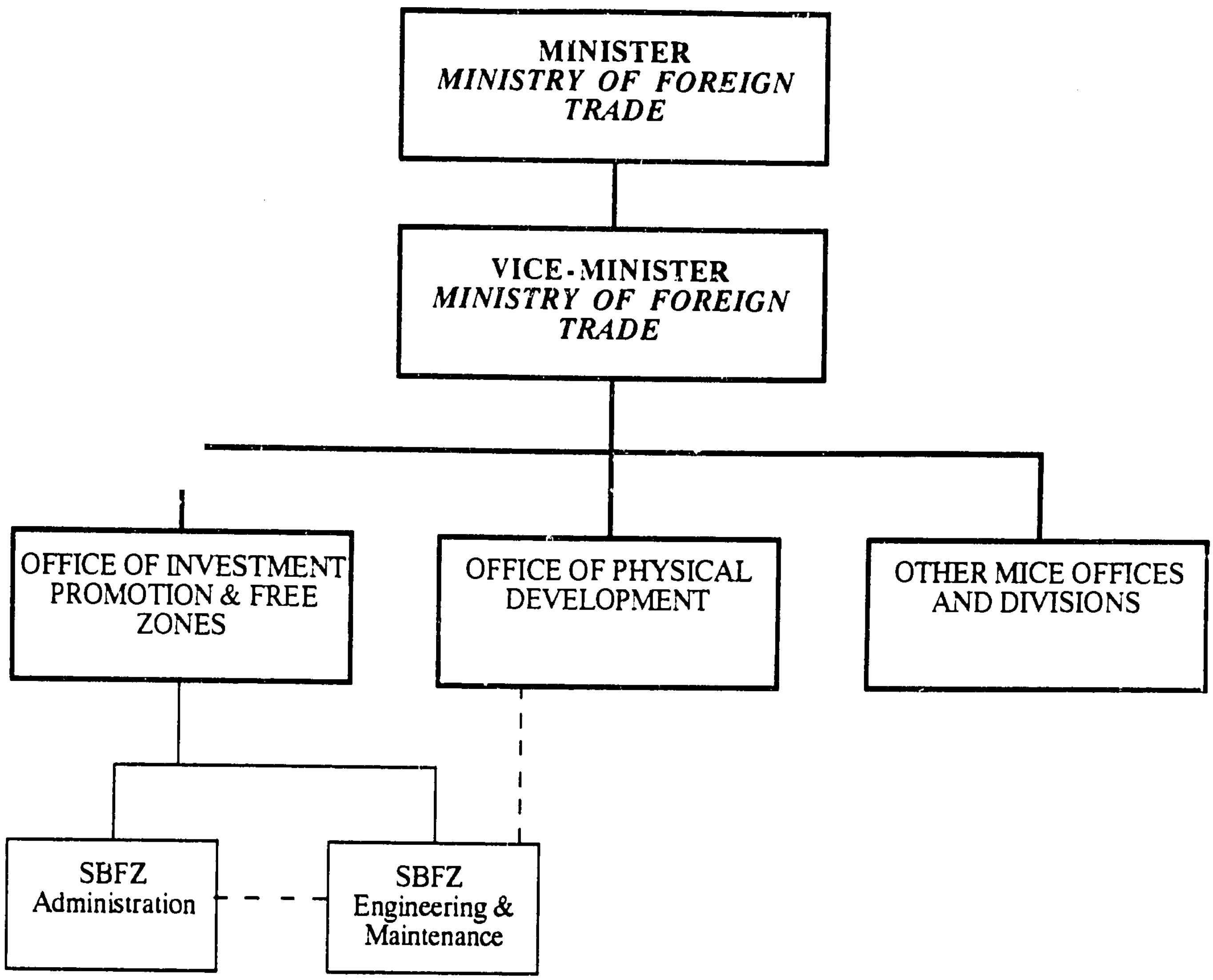
3.05 At the time of the reorganization in 1980-81, foreign tenants were already beginning to leave due to the perceived risk to both employees and property posed by the political situation. Perhaps because of the rising vacancies after several years of strong performance and great expectations for the project, during the early 1980s little effort was directed by MICE toward maintaining the client base and there was no active promotion of the zone. The Free Zone Division basically served as a processing office for the documentation required to keep the zone operational. From 1980 to 1986, MICE's role in the administration of the SBFZ focused on the preparation of the annual budget for submission to Congress, disbursement of the funds as required to cover operating costs, and collection of rental revenues from the tenants that had remained.

3.06 However, MICE's involvement in the drafting and passage of the new export promotion law, and evidence of renewed local and foreign business interest in investing in El Salvador, rekindled institutional support for the SBFZ in 1986. Local currency funds were made available by USAID for new construction and steps were taken by MICE to establish the technical capability required to support further development of the zone. The present organizational structure of the SBFZ was established at this time.

C. STRUCTURE AND STAFFING

3.07 In an effort to rationalize the management of the project within MICE's institutional framework, the SBFZ was combined with the Ministry's Investment Promotion Office as can be seen in Figure 3-1 on the following page.

FIGURE 3-1
SBFZ/MICE ORGANIZATIONAL FRAMEWORK



3.08 From a management perspective, the SBFZ suffers from multi-layered administration, with responsibilities divided among various offices and individuals. In practice, this often entails the involvement of MICE personnel in SBFZ affairs whose primary duties and responsibilities lie elsewhere. For example, the Minister of MICE is the final authority for many minor decisions made regarding zone management and operations. The functions of the key positions within the MICE/SBFZ framework are summarized below.

1. Ministry-Based Offices

3.09 **Direccion Promocion de Inversiones y Zonas Francas** (Office of Investment Promotion and Free Zones, OIP/FZ) is the office charged with both the investment promotion activities of the Ministry and the supervision and management of zone operations. Consequently, the Director and his staff must divide their time between their investment promotion responsibilities and SBFZ-related work. The Director is appointed by the Minister of MICE and reports directly to the Minister or his designate. The Director of the OIP/FZ "doubles" as the General Manager of the SBFZ and the office serves as a clearinghouse for zone affairs, from rental collection and accounting through hiring practices to tenant relations. However, it maintains no on-site presence at the SBFZ, and its actual decisionmaking authority is limited.

Current OIP/FZ Staff: Director (1), administrative coordinator (1), technical specialists (2), accountant (1), secretary (2).

3.10 **Direccion de Desarrollo Fisico** (Office of Physical Development, OPD), also housed within the Ministry, oversees the USAID-financed SBFZ construction and US PL/480 funds contribute to its operating budget. Salaries for three professional positions, including the Office Director, are provided through USAID project funding. The OPD is involved in ongoing zone operations only to the extent that coordination is required for the installation of infrastructure, on-site supervision of civil works, and monitoring of the progress on the construction under way. Like the OIP/FZ, there is no on-site presence and the Office reports directly to the Minister or his designate.

Current OPD Staff: Director/Engineer (1), architects (3), engineers (3), support staff (1).

3.11 In addition to these two offices, several other units and individuals within MICE are involved in the SBFZ to a more limited extent, they include:

> **Special Assistant to the Minister** of MICE who supervises the SBFZ activity related to the USAID Projects #0287 and #0323 and coordinates USAID-funded technical assistance under the projects./1

/1 USAID Project #0287, Industrial Stabilization and Recovery was begun in 1984 and provides funding to MICE to support its export and investment promotion efforts. USAID Project #0323 (1988) is the Free Zone Development Project which includes technical assistance to the SBFZ.

MICE Office of Finance, while not directly involved in zone operations, receives and reviews the accounting records prepared by the OIP/FZ, and supervises all financial matters related to funding of the project through USAID PL/480 funds and other external financing.

MICE Office of Legal Counsel which handles the legal aspects of SBFZ administration, including drafting of the lease agreements signed with SBFZ tenants and GOES decrees related to changes in zone rental rates.

2. On-Site Administration

3.12 The on-site administrative staff of the SBFZ is comprised of two professionals with limited office support staff (two office assistants and one secretary) and a sizeable cadre of maintenance personnel, gardeners, and security guards. The total on-site staff of the SBFZ totals 49 people. As noted above, there is no General Manager on site, therefore each of the professional positions described below operate essentially autonomously and report to the Director of the OIP/FZ within MICE.

SBFZ Administrator manages the day-to-day operations of the zone, including client relations and interaction with Customs and other GOES entities. The Administrator supervises the following individuals:

1 supervisor of watchmen and gardeners
1 office assistant
1 secretary
1 administrative assistant
16 watchmen (on three, 8-hour shifts)

SBFZ Engineer supervises and directs all zone maintenance and repair activities. The SBFZ Engineer has the following support staff:

1 assistant
1 foreman
8 gardeners
17 maintenance men (incl. masons, carpenters, laborers, etc.)

3.13 All decisions made by the SBFZ Administrator or Engineer with regard to staffing, hiring, firing, or promotion of personnel must be authorized by the OIP/FZ in MICE. That office in turn requires the approval of the Minister or his designate. As is true for all non-autonomous Government entities, none of the positions listed above can receive raises based on tenure or performance. The salaries are set for such positions in the public sector by Presidential decree. The present compensation levels for MICE-based and on-site staff are presented in Table 3-2 on the following page. Total SBFZ-related payroll is shown in Table 3-3.

TABLE 3-2
1989 SBFZ WAGES/1

POSITION	COLONES/ MONTH	US$/ MONTH
MICE OFFICE OF INVESTMENT PROMOTION/FREE ZONES		
Director	4.500.00	900.00
Administrative Coordinator	2,405.00	481.00
Technical Specialists	2,142.50	428.50
Accountant	1,300.00	260.00
Secretaries	1,215.00	243.00
MICE OFFICE OF PHYSICAL DEVELOPMENT		
Director/2	4,500.00	900.00
Architect & Engineer/2	4,500.00	900.00
Architect/Engineer	1,325.00	265.00
Secretary	800.00	160.00
SBFZ ON-SITE PERSONNEL		
Administrator	1,600.00	320.00
Engineer	1,600.00	320.00
Maintenance Foreman	1,188.00	237.60
Engineering Assistant	912.00	182.40
Maintenance Men	801.60	160.32
Supervisor of Watchmen	801.60	160.32
Watchmen	801.60	160.32
Gardeners	816.00	163.20
Office & Support Staff	801.60	160.32

/1 Median wage levels for each position.

/2 Temporary positions funded by USAID.

TABLE 3-3
1989 MICE/SBFZ PAYROLL

OFFICE OF INVESTMENT PROMOTION/FREE ZONES		
Director (1)	4,500.00	
Administrative Coordinator (1)	2,405.00	
Technical Specialists (2)	4,285.00	
Accountant (1)	1,300.00	
Secretaries (2)	2,430.00	
SUBTOTAL		14,920.00
OFFICE OF PHYSICAL DEVELOPMENT		
Director/USAID funded (1)	4,500.00	
Architect/USAID funded (1)	4,500.00	
Engineer/USAID funded (1)	4,500.00	
Architects/Engineers (4)	5,300.00	
Support Staff (1)	800.00	
SUBTOTAL		19,600.00
SBFZ ON-SITE PERSONNEL		
Administrator (1)	1,600.00	
Engineer (1)	1,600.00	
Maintenance Foreman (1)	1,188.00	
Engineering Assistant (1)	912.00	
Maintenance Men (17)	13,670.40	
Supervisor of Watchmen (1)	801.60	
Watchmen (16)	13,039.20	
Gardeners (8)	6,456.00	
Office Support Staff (3)	2,404.80	
SUBTOTAL		41,672.00
TOTAL PAYROLL/MONTH (C)		76,192.00
TOTAL PAYROLL/YEAR (C)		914,304.00
TOTAL PAYROLL/MONTH (US$)		15,382.40
TOTAL PAYROLL/YEAR (US$)		184,588.80

Source: Interviews with MICE and SBFZ personnel.

3.14 In viewing Table 3-2, there is a sizeable differential between the pay levels of Ministry-based staff and the salaries paid to the SBFZ on-site personnel, which are well below market levels in the private sector for comparable positions. (Likewise, there is a significant difference between USAID- and GOES-funded positions.) The SBFZ engineer, for example, estimated that a private engineer would earn C3,800/month (US$760), more than double the SBFZ salary. The wages for the SBFZ staff are based on a 44-hour work week, assuming a half-day worked on Saturday. Fringe benefits include 10 days of holidays, 15 days vacation, retirement benefits, but not health benefits.

3.15 As shown in Table 3-3, total payroll for SBFZ personnel, within the Ministry and on-site, is C 76,192/month (US$ 15,382). This figure includes the salaries for the staff of the Office of Physical Development, which has been expanded considerably to accommodate the personnel requirements of the SBFZ's current construction program. Specifically, three high-paying (C4,500/Month) technical positions were established as one-year posts, running through June 1989. As was discussed in the preceding Chapter and is evidenced in the table below, the total payroll ascribed to the SBFZ is extremely large for a project of this size. With some exceptions, this is due to the number of individuals on the payroll, rather than the salaries that they receive.

3.16 The SBFZ/MICE managerial framework, as outlined, is generally acknowledged to be difficult to administer and plagued by delays in the decisionmaking process. The problems arising from overlaps (or gaps) in authority and the number of different office and individuals involved have resulted in considerable frustration among the employees and dissatisfaction on the part of zone tenants. The strengths and weaknesses of the present framework, relative to the key functional areas of zone management are discussed later in this report.

IV. FINANCIAL ASSESSMENT

4.01 This chapter reviews the financial performance of the SBFZ from 1978, when it began operations, to 1988. It also provides a general assessment of the zone's systems of financial management and accounting and concludes with recommendations for remedial action.

4.02 Evaluation of the financial history of the project has been handicapped by data gaps and certain anomalies in the budgeting, bookkeeping, and financial control procedures as applied by MICE which depart from standard accounting practices of typical commercial enterprises. These are discussed later in this chapter in some detail. In the following paragraphs, a four-step format is used: (i) all financial data available within MICE, covering the period 1978-1988, is summarized and reviewed; (ii) USAID-funded activities are similarly summarized and discussed; (iii) capital investment data is consolidated and the financial outlook projected based on estimated future revenues, costs and net profit; and (iv) the SBFZ rental policy is examined in light of project costs and comparative data.

A. FINANCIAL PERFORMANCE, 1978-1988

1. Capital Investment

4.03 On the following page, Table 4-1 summarizes the growth in nominal value of assets and liabilities for the years 1978 and 1984-86:

TABLE 4-1

SBFZ SUMMARIZED BALANCE SHEETS, 1978 AND 1984-86
(Colones, '000s)

	1978	1984	1985	1986/1
ASSETS				
Current				
Cash and Cash Equivalent	1,623	1,267	1,277	--
Materials and Supplies	108	136	122	141
	-----	-----	-----	-----
Total Current Assets	1,731	1,403	1,399	141
Fixed				
Equipment	119	300	297	297
Land	3,903	3,778	3,778	3,778
Infrastructure	4,828	5,835	6,844	6,844
Buildings	7,069	9,102	11,002	11,002
Works in Progress	592	1,153	1,157	3,046
Miscellaneous/2	222	4,477	1,960	3,662
	------	-----	-----	-----
Total Fixed Assets	16,733	24,644	25,028	28,629
Total Assets	**18,464**	**26,047**	**26,427**	**28,770**
LIABILITIES				
Deferred Obligations	134	293	294	347
Capital and Reserves	18,330	25,754	26,133	28,423
	------	------	------	------
Total Liabilities	**18,464**	**26,047**	**26,427**	**28,770**

/1 Latest yearly statement available.
/2 Includes advances to contractors and other payments awaiting allocation; and in 1985 and 1986, "maintenance expenses."

4.04 Over the ten-year period, 1978-1986, fixed assets have grown nominally from C17 million (rounded) to over C28 million, mainly in terms of buildings, but also to some extent through infrastructure expansion (roads, utilities, etc.). Among the striking features of the Balance Sheets as presented by MICE (and consolidated in Table 4-1) are (i) the absence of long-term debt; all funds used are booked as equity; and (ii) absence of depreciation charges against buildings and other depreciable assets./1 Scrutiny of the year-by-year numbers turns up other curious items. In 1985, a new line item appears (at the bottom of the fixed asset list), i.e. maintenance costs of C209,000, rising in 1986 to over C2 million. Maintenance costs are normally booked under current expenses in the income statement and should not appear in the Balance Sheet. The MICE accounting department was unable to clarify this question, although one possible explanation is that heavy costs were incurred to preserve or salvage some fixed asset or assets and it was decided to capitalize and amortize the investment over time instead of expensing it in the year incurred.

4.05 Under "cuentas de memorandum," or contra accounts, available but unused funds and contingency liabilities are listed on both sides of the ledger./2 The total of these items has fluctuated from C35 million in 1978 to a peak of C46 million in 1982 and declining to C7 million in 1986, reflecting the final disposition of various items listed over the years. Although of interest in evaluating the SBFZ's total financial history, the "contra" accounts do not affect the nominal value of assets, liabilities and capital. The reallocation of the balance of the CABEI credit on the MICE balance sheets is one noteworthy entry. A loan of US$11.5 million was made to the GOES by CABEI for development of San Bartolo in 1978. The loan was carried on the MICE books until 1982 when US$10 million was reassigned by the GOES for agricultural uses, and the CABEI entry dropped from C26 million to C1 million in 1984. The net contribution to the SBFZ, therefore, was US$1.5 million, which has been fully disbursed.

4.06 Based on the 1986 Balance Sheet, the 40,000 sq.m. of under-roof factory space built at the zone is valued at C11 million or C275/sq.m., equivalent at today's exchange rate to US$55/sq.m. or US$5.11/sq.ft. This nominal value is probably no more than a quarter of the replacement value at current construction costs. Each square meter of building area has a total book value of C720 (C28.8 million divided by 40,000 sq.m.), i.e., the total investment in land, infrastructure and buildings assignable to each square meter of under-roof

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/1 MICE stated that depreciable assets are carried at original value until discarded, replaced, or otherwise disposed of, at which time they are completely depreciated. Such a system of depreciation, while used by some public entities, would not be used by commercial enterprises because it fails to reflect the year-by-year drop in asset value which should be balanced by a growing reserve against the day that replacement investment must be made. Also, only a non-taxpayer could delay booking depreciation as MICE is doing; for tax-paying firms, depreciation is a legitimate business cost, resulting in lower taxes, inter alia.

/2 Contra accounts appear on MICE's yearly Balance Sheets, but are not shown in Table 4-1 since they do not affect the bottom line.

factory space, or US$144/sq.m., or US$13.38/sq.ft. In contrast, current construction at the zone will cost, when completed, in the range of US$350-380 for each square meter of under-roof (rentable) factory space.

4.07 While inflation, currency devaluation and rising prices since 1978 can explain a large part of the discrepancy between nominal value of assets and current market or replacement value, another factor must be taken into account. Raw land value was booked at a total of C3.9 million in 1978 and is shown as C3.8 million in 1986 (probably reflecting a sell-off or give-away of a small parcel of the site). This nominal value of the zone's 80 hectares is totally unrealistic today; the real market value could be three or four times as high or higher. The wide gap between MICE's Balance Sheet figures and current market values must be clearly understood since any future negotiations with private investors, whether as zone users or as candidates for takeover or joint venture partners, will revolve about that issue in large measure. Specifically, MICE and private negotiators will have to agree on the basis for assessing the value of zone assets. This can be by any one or a combination of three distinct approaches:

(a) Book value drawn from the Balance Sheets, grossly underestimates the value of the project;

(b) Fair market value which takes into account wear and tear, aging, depreciation and condition of the assets;

(c) Replacement value, that is, today's cost to replace zone assets.

4.08 The major conclusion to be drawn from the preceding analysis of capital investment and asset value at the zone is that booked values as presented in the Balance Sheets are unrealistic and substantially understate the real values represented by land, buildings, and services installed. In addition, the accounting and financial reporting system needs an overhaul -- preferably by a competent, outside firm of auditors -- in order to provide project management with the valid financial data tools needed to run an enterprise of this types effectively. Although managed by a Government entity, the essential nature of a free zone is that of a commercial enterprise and it must be managed as such.

2. Zone Revenues

4.09 Zone gross revenues, essentially rental income on leased factory space, are shown in Table 4-2 on the following page:

TABLE 4-2
SBFZ STATEMENT OF REVENUES/1
(Colones)

Year	Number of Companies	Occupied Space (m2)	Expected Revenues/2	Actual Revenues	Actual Revenues as a Percentage of Expected
1979	14	33,824	1.217,664	1,014,592	83.3%
1982	5	13,020	468,720	314,754	67.1%
1983	5	14,362	517,032	557,088	107.7%
1984	6	16,824	706,608	651,760	92.2%
1985	8	21,800	915,600	678,159	74.0%
1986	9	28,249	1,186,458	811,500	68.3%
1987	9	28,249	2,372,916	747,265	31.4%
1988	9	31,545	2,839,050	2,463,271	86.7%

/1 Data is presented only for those years between 1979-1988 for which accurate occupancy information was available from the SBFZ.

/2 Expected revenues are rough estimates calculated by multiplying the stock of occupied space estimated to have been available in a given year by the average rental rate prevailing.

Source: SBFZ Administration and MICE Accounting Department records.

In the initial boom years of 1978-79, revenue peaked at over C1 million in 1979, declining drastically by nearly 65 percent in 1982 when occupancy dropped from 14 to five companies. After the low point in 1982, annual gross revenues showed a slow but steady resurgence to 1986/87, reflecting both new users and expansion of one or two established users. The sharp increase in 1988 -- from C747,265 in 1987 to almost C2.5 million -- is the result of rental arrears collection as well as a substantial increase in annual rental rates, from US$1.40/sq.m./month to US$2.00/sq.m./month, equivalent to about US$2.23/sq.ft./year.

4.10 The decision to raise rental rates to US$2.00/sq.m./month in 1988 is a move in the right direction, although it falls short of achieving a reasonable market return on the real value of SBFZ assets. At this level of income, the project shows a nominal annual profit, but this is largely illusory. As already noted, there is neither debt service nor depreciation charged against income. While there is no long-term debt (only equity) carried by the project, it would be fair to insist that: (i) the investment return at least the opportunity cost of capital, or say 10-12 percent interest in dollar terms over and above administration costs; and (ii) a depreciation reserve be set up and deducted from annual gross revenues as a legitimate cost of operation. These two factors, if applied, would demonstrate that the project has and will continue to incur losses rather than profits.

3. Operating Expenditures

4.11 Table 4-3 tabulates the annual budgetary forecasts of funding requirements and expenditures from 1978-88. Budgeted funding allocations are shown as originally forecast and then adjusted, if necessary; in fact, there were no adjustments indicated in seven of the 11 years and in only one year, 1986, was there a substantial (upward) modification, undoubtedly induced by the demands of a major construction program earlier than anticipated at the time the budget was first prepared. Under the expenditure category, all line items requiring cash outflow are listed including both current expenses (mainly personnel) and capital investment.

TABLE 4-3
SBFZ OPERATING BUDGET, 1978-88
(Current Colones)

	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
GOVERNMENT BUDGET											
Original Budget	2,459,890	10,850,880	5,807,980	5,224,200	590,000	326,800	2,834,490	1,435,200	565,090	699,130	738,490
Budget After Adjustments	2,459,890	10,850,880	5,807,980	5,224,200	590,000	847,800	2,834,490	1,435,200	2,939,140	729,150	702,130
BUDGETED EXPENDITURES											
Personal Services /1	616,890	520,610	616,560	729,200	335,820	300,800	331,080	385,200	453,823	478,200	492,595
Non-Personal Services /2	146,000	308,000	253,320							36,250	1,605
Materials & Supplies /3	580,000	245,170	236,000	70,800	52,180	324,000			36,250	214,700	207,930
Machinery & Equipment /4	62,000	17,100	2,100						214,067		
Property & Installed Equip. /5		800,000	200,000								
Constructions, Additions, & Contract Improvements /6	156,800	8,960,000	4,500,000	4,204,200		221,000	2,503,410	1 050,000	2,235,000		
Current Transfers /7				2,000	2,000						
Financial Investments /8					200,000	200,000					
TOTAL	1,561,690	10,850,880	5,807,980	5,006,200	590,000	1,045,800	2,834,490	1,435,200	2,939,140	729,150	702,130

Notes:
1. Includes salary payments of all SBFZ personnel.
2. Includes payments for maintenance of equipment and property, rent of machinery and equipment, publicity, etc.
3. Materials and supplies includes expendable items with an economic life of one year or less.
4. Includes office equipment, machinery, electrical apparatus, engineering and drawing materials, etc.
5. Includes acquisition of land, buildings, demolition equipment and machinery.
6. Includes expenditures for new construction, buildings, roads, recreational areas, sanitary works, installation and supervision of construction.
7. Payments to individuals, private institutions and parastatals, such as social security, grants, compensation, sick pay, etc.
8. Includes contributions made for the amortization of public debt, acquisition of securities, and financing of loans.

72

4.12 The data presented in Table 4-3 are, of course, budget forecasts rather than actual expenditures. However, they are useful to the extent that they reveals an interesting trend in the personal services line item (or wage bill) which averaged C620,000 per annum between 1978-81, declining to an average of about half that figure in the depressed years 1982-84, and rising steadily thereafter to C493,000 in 1988 (but still well below the early years). The fact that the recent budgeted wage bills are still lower than in the early years of the project, despite substantial inflation in the intervening period, implies that SBFZ management has streamlined, at least to some extent, what must have been a greatly overstaffed operation in the 1970s.

4.13 Table 4-4, presents actual SBFZ expenditures for the years 1986-88 and indicates that the project has operated with a budgetary surplus over the past three years. The table indicates that the most recent expenditures for construction by GOES-sourced funds took place in 1986. Apparently, a budget surplus of C569,345 in that year (likely due to slow or delayed implementation of planned installations) was not used in either 1987 or 1988 and reverted back to the national treasury. Evidently, all construction in 1987 and 1988 was funded solely by USAID.

TABLE 4-4

SBFZ -- ACTUAL EXPENDITURES VS. BUDGET FORECASTS
(Current Colones)

	1986	1987	1988
GOVERNMENT BUDGET			
Original Budget	565,090	699,130	738,490
Budget After Adjustments	2,939,140	729,150	702,[illegible]30
EXPENDITURES			
Personal Services/1	442,506	451,097	464,605
Materials & Supplies/2	84,164	122,012	126,050
Constructions, Additions, & Improvements by Contract/3	1,843,125	--	--
TOTAL EXPENDITURES	2,369,795	573,109	590,655
BALANCE (DEFICIT)	**569,345**	**156,041**	**111,475**

Notes: 1. Salary payments of all SBFZ personnel.
2. Expendable items with an economic life of one year or less.
3. Includes expenditures for new construction, buildings, roads, recreational areas, sanitary works, installation and supervision of construction, etc.

<u>Source:</u> MICE Accounting Records.

4.14 In Table 4-5 below, gross revenues and operating costs for the years 1986-1988 are indicated. These are, in effect, abridged income statements which are of some, albeit limited, value in analyzing the financial performance of the SBFZ.

TABLE 4-5

SBFZ PROFIT/LOSS STATEMENT/1
(Not Including USAID Contributions)
(Current Colones)

	1986	1987	1988
SBFZ REVENUES	811,500	747,655	2,463,271
PRIMARY OPERATING COSTS			
Personal Services/2	442,506	451,097	464,605
Materials & Supplies/3	84,164	122,012	126,050
TOTAL OPERATING COSTS	526,670	573,109	590,655
IMPUTED NET INCOME	284,830	174,546	1,872,616

Notes: 1. Table constructed from raw data provided by MICE.
2. Includes salary payments of all SBFZ personnel.
3. Includes expendable items with an economic life of one year or less.

Source: MICE Accounting Records

4.15 As shown, net income has been significantly positive over the last three years, jumping dramatically to over C1.8 million in 1988 (reflecting, as noted earlier, an increase in rental rates plus a one-time revenue surge attributed to a determined collection effort in 1988 to eliminate rental payment arrears). However, the indicated profits, as already noted, are an illusion. Obviously, if charges for depreciation, maintenance (which appears to be booked under fixed assets in the more recent Balance Sheets), and other normal charges were booked, the apparent net positive results would be much smaller, or even negative. And if foregone income on the invested capital was taken into account -- reasonably imputable in an amount at least equal to the opportunity cost of capital in El Salvador -- the so-called "profits" would certainly be recognized as masks concealing far greater real losses. Alternatively -- disregarding the esoteric concept of "foregone income equal to the opportunity cost of capital . . ." -- if the debt service on the original CABEI loan of US$1.5 million were charged to the zone, as it should be, rather than to the national treasury, profits would likewise disappear. Assuming a concessional rate of only 8 percent, the annual interest charge would amount to over US$100,000 in the early years of principal repayment, or C500,000. This one change would virtually double the operating costs shown in Table 4-5.

4. Expenditures Financed by USAID PL480 and ESF Funds

4.16 Table 4-6 summarizes the funding provided to the SBFZ by USAID since 1986:

TABLE 4-6

USAID FUNDING FOR THE SBFZ, 1986-89
(Colones, millions)

Source	Amount	Project Title and Execution Data
PL 480/86	3.623	Support to the SBFZ Executed May 1986-April 1987
PL 480/87	5.428	Support to the SBFZ Executed May 1986-April 1987

Funds Disbursed	9.051	
ESF/88	32.000	Support to the SBFZ May 1988-April 1989 (scheduled)
ESF/88	3.800	Supplement - May 1988-April 1989
ESF/88	3.600	GOES counterpart contributions to Project 519-0287, SBFZ, May 1988-April 1989 (scheduled)

In Process	39.400	

4.17 For purposes of this report, it is assumed that the PL 480/86 and PL 480/87 funds provided in 1986/87 are fully disbursed and any incremental assets in the form of developed land and buildings will be incorporated in the 1988 Balance Sheets, when available.

4.18 Starting in 1988, the total funding of C39.4 million from ESF/88 sources is being disbursed against the civil works and related costs proposed in the Action Plan "Physical Development of the San Bartolo Free Zone" (May 1988) discussed in detail in Chapter 5. Despite the fact that the original appropriation of C35.6 million has been augmented by one supplemental appropriation of C3.8 million and C3.6 million for a total of 39.4 million, current estimates indicate that completion of the construction program in late 1989 will require an additional C4,859,000 or a grand total of about C45 million. (In Chapter 5, reasons for the increased cost estimate, almost 50 percent above the original figure, will be analyzed.) This final supplement of C4.86 million was requested by the Ministry of Planning in a letter dated January 25, 1989.

with an attached summary breakdown of sources and uses of funds. At the time of the mission, USAID action was pending on the most recent request.

4.19 The current expansion program when completed in late-1989 will provide eight new SFBS, an expanded Administration building, additional road construction developed land for future construction, a new main access gate and fencing, and an air cargo ramp. Total rentable factory space will be increased by over 23,000 sq.m. from the (estimated) 43,600 sq.m. in 1988 to a 1989/90 total of about 67,000 sq.m. The indicated "all-in" capital cost is C1,928 per square meter of rentable new factory space, equivalent to US$36/sq.ft. The all-in cost includes the cost of land preparation, architectural/engineering services, construction and materials, and construction supervision; it does not include raw land value. Based on average construction costs in the Caribbean/Central American region of US$18-22/sq.ft., this is an extraordinarily high figure.

4.20 Overall, the book value or all-in capital investment for the 67,000 sq m. of factory space will be C74 million (rounded), or C1,104/sq.m., equivalent to US$20.52/sq.ft., when presented in the 1989 Balance Sheet. The real value of the assets is much higher, of course, but until revaluation of assets might be permissible (indexation) the historic figures in colones will be carried forward. If there is a devaluation of local currency, the equivalent US dollar value will decline to an even lower and more unrealistic figure. The implications of the new construction on the economic rental rate for the SBFZ are discussed below.

B. ASSESSMENT OF SBFZ RENTAL POLICY

4.21 Although a high operating cost structure and difficulties in rent collection have constrained the profitability of the SBFZ, the principal reason for lackluster financial performance is its uneconomic price structure. Since inception in 1976 until 1988, the base monthly rental rate for SFB space in the SBFZ was C3.50/sq.m. (US$0.70/sq.m. at the current official exchange rate of C5=US$1). In 1988, the monthly unit rental rate was renegotiated to US$2.00/sq.m. or C10/sq.m. While this increase is encouraging, it still fell below economic levels, as discussed below.

4.22 As with all real estate ventures, the determination of rental rate for under-roof space in free zones reflects two primary considerations:

- the rent charged must be high enough to ensure capital cost recovery, meet all operating costs and generate a reasonable profit; and

- the rent must be competitive with competing free zone locations.

4.23 Although the objective of full cost recovery for SFB rentals may not be initially realized, economic rental rates must prevail over time. Historically, the SBFZ has charged uneconomic rents, thereby failing to generate sufficient revenue to ensure capital cost recovery, let alone a profit. The degree to which the SBFZ has under-priced its assets is indicated by comparing its current rental rate with that of leading free zones in the region.

TABLE 4-7

COMPARATIVE SFB RENTAL RATES IN THE CARIBBEAN BASIN REGION, 1989
(US$, sq.m./month)

COSTA RICA	
Alajuela	$2.15
Cartago	$2.69
Moin *	$0.90
DOMINICAN REPUBLIC	
Bani	$2.69
Chemtec	$2.37
La Romana	$1.12
La Romana II	$2.36
La Vega *	$1.94
Puerto Plata **	$2.69
San Cristobal	$3.59
San Isidro	$4.49
San Pedro de Macoris *	$1.62
Santiago ***	$1.18
Villa Altagracia ***	$1.61
Villa Mella	$3.59
EL SALVADOR	
San Bartolo *	$2.00
GUATEMALA	
ZOLIC *	$1.20
Grupo Zeta ***	$2.00
HONDURAS	
Puerto Cortes *	$2.69
JAMAICA	
Kingston *	$3.92
Montego Bay *	$2.80
PANAMA	
Colon *	$2.40

(*) Public sector free zones, (**) Public/private zones; (***) Private, non-profit zones. TSG data compiled in 1989.

4.24 As shown by Table 4-7, the SBFZ rental rate of US$2.00/sq.m./month is among the lower rates in the region./1 In this light, the derivation of a minimum "economic" rental rate is the first step in attempting to redress the legacy of uneconomic pricing in the SBFZ. Furthermore, the issue of efficient rental pricing will require increasing attention and corrective action as the current expansion program is implemented, not only with respect to the newly constructed facilities but also as it applies to existing space.

4.25 As stated above, the all-in cost for SFBs under the ongoing SBFZ construction program is C1928/sq.m. (US$385/sq.m.) of under-roof space. This includes land development, the structure, engineering/architectural design, and construction supervision services. It does not include raw land value. If the SBFZ were operated as a commercial enterprise (and so had to live within its means and generate a reasonable surplus), the SFB would have to generate an annual cash flow of at least 15 percent of capital cost or US$4.84/sq.m./month (US$5.40/sq.ft./year) of the new rentable under-roof space to cover operating costs, including debt service (interest and principal), and yield a minimally acceptable positive return on investment. If factors such as interest and other financial charges are especially onerous, and/or if administrative costs are inflated, the economic rent could even go higher.

4.26 The suggestion that the economic rental rate of the new SBFZ buildings is about US$4.84/sq.m./month, reflects a number of important factors. The first is that the building construction and land urbanization cost bids accepted by the SBFZ are high compared to national and regional standards. The second is the straightforward result of an over-valued exchange rate, which artificially inflates local costs in dollar terms. In order to be truly competitive, a currency adjustment is needed. Although, when considered together with the extremely low costs ascribed to the first construction phase (40,000 sq.m.), the average "all-in" capital investment for the 67,000 sq.m. of factory space will be about C1,104/sq.m. (US$20.52/sq.ft.), close to regional standards.

4.27 From a financial perspective, if we accept the "all-in" value of C1,104/sq.m. of rentable factory space, the current standard rent of US$2.00/sq.m./month might already be marginally profitable on a cash-flow basis assuming 75 percent occupancy of 67,000 sq.m.. or 50,000 sq.m. by paying customers (if the army continues to occupy 12,000 sq.m. and another 5,000 sq.m. on average is not generating income for one reason or another). However, such an approach is difficult to justify in light of several significant

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/1 Comparisons made among zones on the basis of base rental rates alone are misleading. Most private, for-profit zones charge additional fees for special services, and many sell SFBs as well as rent under different terms and conditions. Many more zones are currently able to charge users a premium above base rental rates for zone space. In the Dominican Republic, leading private zones are still asking (and receiving) up to 6 years rent in advance. The public sector Kingston Free Zone in Jamaica is charging new companies rental premiums averaging 10-20 percent. The Cartago Free Zone in Costa Rica is demanding an up-front rental deposit of 25 percent on the rental contract to new users.

considerations. Although funded with external financing and representing no "cost" to the GOES, the construction of the new buildings for rental at the US$2.00/sq.m./month rate makes little sense from an economic perspective, and would in fact result in a loss of upwards of US$800,000 annually in income foregone, when compared to economic rental rates. Moreover, at the highly subsidized rate, the new buildings represent unfair competition to comparable private facilities with normal debt servicing and other financial obligations. In keeping with its overall effort to generate national economic growth -- a program which includes strengthening the contribution of the private sector to economic development -- the GOES should not undermine private free zone projects that are likely to arise in the months ahead. At a minimum, the effective subsidy provided to firms locating in the new facilities should be minimized, and the rates charged reflect those prevailing in similar private sector projects.

4.28 Fortunately, by specifying rents in US dollars or dollar equivalent in colones, the SBFZ has in its hands a powerful tool for ultimately achieving profitable operations without the subsidies represented by 100 percent grant funding of investment capital or accounting quirks such as disregarding depreciation, maintenance and other legitimate operating costs. For the new facilities, the SBFZ should raise it rents to at least US$3.00/sq.m./month, which is more or less the economic level that would be charged, as a minimum, by a for-profit ownership group for buildings that cost about US$220/sq.m. While this is still far short of the US$4.84/sq.m./month that would be required to cover costs, it is a marked improvement over the grossly inadequate US$2.00/sq./month rate planned for the facilities. In addition, the rental rate for the initial SBFZ facilities (14 SFBs) should also be raised, over the medium term, to approximate market levels.

4.29 In conclusion, based upon the foregoing analysis, after completion of the USAID financed construction in late 1989 and leasing of premises by early 1990, financial performance should be positive event if more stringent accounting practices are adopted. This is true only because what is normally a major operating cost in projects of this types -- interest on long-term debt -- does not exist for the SBFZ. With adequate financial planning and controls, adequate maintenance, active promotion and enhanced utility and other services, annual rental rates of US$3.00/sq.m./month should be attainable. On this basis, the operation should be profitable on a strictly free market approach, i.e., imputing typical interest charges on say 60-75 percent of the invested capital.

V. ASSESSMENT OF SBFZ FACILITIES AND INFRASTRUCTURE

A. ZONE LAYOUT AND DESIGN CONSIDERATIONS

5.01 The SBFZ complex -- located in Ilopango, close to the capital, bounded on the south by both a railroad and the Pan-american Highway and adjacent to an airport -- has been excellently sited to serve the needs of export-oriented industries. As noted in Chapter 2, prior to the implementation of MICE's current Action Plan, some 20 hectares of the total 80-hectare area had been urbanized and 14 buildings erected providing 43,664 sq.m. of under-roof factory space. Annex 1 (Proyecto de Urbanizacion -- Alternativa de Desarrollo "A") shows the overall plot plan to scale, with the existing structures (cross-hatched) and new buildings now being erected (in outline).

5.02 Because of the undulating topography, land preparation is expensive and thus contributes disproportionately to the "all-in" cost of rentable space. In addition to the extensive cut-and-fill work required to achieve the terraced building plots required and heavy well-anchored retaining walls to prevent ground movement (and possible mud slides in wet weather) some structures located close to an elevated section of land must be suitably reinforced. Thus, for example, the rear wall of Building No. 20 is within 6 or 7 feet of a sheer vertical bluff rising some 18-20 feet to the original level of land./1 It has been decided to fill the space between the building and the "mini-cliff" face behind it with compacted earth to a height of 4 or 5 feet as a means of resisting earth movement that could eventually push in the rear wall. Concomitantly, the rear wall will be reinforced so that it will also function as a retaining wall. Such measures, of course, significantly increase the cost of construction which is already above normal because El Salvador is an earthquake zone. The threat of earthquakes dictates heavier and stronger structural elements, more steel reinforcing and special design features (e.g. columns connected by grade-beams below grade level).

5.03 As a general comment, the overall Master Plan laid down in 1974/75 was well-conceived, although development ceased after completion of the first phase of construction in 1978, as already discussed. The current status of construction shown in Annex 1 reflects some modifications and departures from the original plan but still well within the original parameters. Operating experience has dictated, for example, an SFB design standard with an increased floor area -- from 1,300 sq.m. to 2,000 and up to 3,800 sq.m. -- which in turn necessitated larger building plots and a certain amount of redrawing of building plot boundaries. Major features, however, have not changed. Over the long-term, the full 80-hectare plot will be developed as originally planned.

/1 The Salvadoran building code mandates an easement of only 6 feet from the property boundary, which is where this wall is located.

B. INSTALLED FACILITIES AND SERVICES

5.04 Up to now, only the northwest segment of the property, including Polygons A, B, and C, were developed to accommodate the 14 SFBs already installed and the zone Administration building. This area is readily accessed and served by the main entrance on Calle Lempa, at the western edge of the site, and the four kms. of internal road installed in the 1970s. Green areas shown in the Plot Plan (Annex 1) have been well-maintained on the whole. But the earlier ambitious plan for a sports complex and recreational area including swimming pool and cafeteria, and a planned reservoir in the low-lying catchment basin between Polygon J and H and water treatment plant have not been installed.

5.05 The SFBs are suitable for light industry and generally resemble the factory shells offered at competing regional locations. Some have been increased in size (larger floor plans) in response to tenant requests. Each building is equipped with a cistern or storage tank to hold a reserve water supply which is drawn down when the normal supply system is unable to meet high demand periods.

5.06 Electricity, telephones and water supply, i.e., the three basic services provided by external utility sources (liquid effluent is piped to a sewage main running along the internal road network), have been admittedly inadequate. The unreliable electric power supply, for example, has led occupants to install stand-by generators for emergency use. In cooperation with the responsible utility companies (ANDA, ANTEL, CAESS, etc.) remedial measures are intended to be implemented under the Action Plan as will be discussed below.

5.07 In summation, the SBFZ Phase I development of 20 hectares and 14 SFBs created a small industrial park as a first step in a long-range plan to develop the 80-hectare site. Services have been minimal to date, and in some respects inadequate. Looking to the future, the Action Plan launched in 1988, which is now in an advanced stage of completion, should be considered a new point of departure. Coupled with the managerial, accounting, and procedural reforms this report recommends, the SBFZ's aggregate fixed assets in the form of land, buildings and services should soon become a viable and profitable operation.

C. CURRENT CONSTRUCTION PROGRAM

5.08 MICE's 1988 Action Plan defined the overall parameters and specific components of the USAID-financed program for expansion of the SBFZ to be executed in four stages, as summarized below:

> <u>Stage 1</u> covers all past construction -- essentially, 20 hectares of urbanized land and 13 SFBs -- and new construction initiated in 1987/88 funded from USAID administered resources, including: four additional SFBs (Buildings 14, 15, 16, and 17) and an administrative building expansion to accommodate the needs of the security staff.
>
> <u>Stage 2</u> includes the installation of the new main access gate and Avenida San Salvador connecting the gate with the main North/South artery, Avenida Chaparrastique; and erection of

four more SFBs (Buildings 19, 20, 21, and 22). In this second phase of construction, it was also planned that Avenida Chaparrastique would be extended west from the intersection with Avenida San Salvador forming Calle Nonualco which would terminate at the Air Cargo Terminal and Ramp.

Stage 3 encompassing completion of Calle Izalco east from the intersection of Avenida Chaparrastique to the intersection with Avenida Ahuachapan (about one-half kilometer) paralleling the open drainage canal This would open up Polygon F to erection of SFBs on the nine lots bordered by the road after the area had been prepared for construction by terracing, complete with retaining walls and adequate provision for surface drainage.

Stage 4 providing for the installation of street lighting along the three roads to be completed, i.e., Avenida San Salvador, Calle Nonualco, and Calle Izalco.

5.09 By far the largest component of the four-stage program of development comprises the eight SFBs (Nos. 14, 15, 16, 17 and 19, 20, 21, 22, see Annex 1) and will absorb about 75 percent of the funding provided under ESF/88, as shown below:

TABLE 5-1
SFB CONSTRUCTION -- AREA AND COSTS

Unit Number/1	Area (m2)	Estimated Cost (colones)
14	1,871.3	
15	3,748.3	

	5,619.6	6,010,854
16	3,748.3	
17	3,369.1	

	7,117.4	7,320,210
19	2,402.4	
20	2,402.4	

	4,804.8	6,177,139
21	3,397.1	
22	2,402.3	

	5,799.4	7,668,911

Total Area: 23,341.2 sq.m.

Total Cost: C27,177,114

/1 SFB No. 18, financed with PL480/86 allocations, has been completed.

5.10 Architectural and engineering design and supervision services add a further C2,625,000 to the building costs presented above, for a grand total of C29.8 million. In considering these costs, it should be noted that the SFB construction program is being undertaken by no less than nine separate contractors, four architectural/engineering design firms and five construction companies. The reasoning presented in support of this approach is understandable, that is, it is more acceptable politically and, ideally, would allow the total program to be completed more rapidly. Nevertheless, certain economies of scale that might otherwise have been realized had only one A/E firm and perhaps two construction firms been contracted, have been foregone, with an accompanying increase in total project costs.

5.11 In general, the current building construction program is in keeping with international design standards for projects of this type. On average, the land use ratios in the new facilities are comparable with other EPZs, 40-50 percent of each lot is covered by under-roof space. However, the orientation of the building to the plot boundaries, is in some cases less than optimal and has been corrected in the actual construction. The size of the buildings is larger than standard, although they are constructed as "mirror images," thereby allowing for easy subdivision. Likewise, the floor to eave height of 18 feet, is sufficient for the construction of a mezzanine level which could be used as office space, health clinic, cafeteria, etc., by firms in need of expansion space.

5.12 The overall budget, including roads, terracing of Polygon F, expansion of the Administration building, new main gate, etc., is tabulated below.

TABLE 5-2

ACTION PLAN BUDGET -- FEBRUARY 1989 ESTIMATE

Item	Cost (colones, millions)
1. SFBs (8 units) including Architectural/ Engineering Services	29.8 (contracted)
2. Construction of Calle Izalco, Terracing of Polygon F, Adm. Bldg. expansion, new main gate, Customs office and street lighting	7.7 (contracted)
3. Construction of Calle Nonualco and air cargo ramp	6.8 (est.)
Total	**C44.3 million**
Rounded	**C45 million**

Since Item 3 above has still not been tendered and a certain amount of overrun may reasonably be expected on all civil works contracted, total expenditures could go higher.

5.13 Regarding the improvement of services, programs were initiated in 1987/88 as tabulated below:

TABLE 5-3

INFRASTRUCTURE IMPROVEMENTS

Item	Funding Source	Amount (C)
1. Additional 20,000 KV line, Aguacaliente-SBFZ to supply an additional 500 KVA	ESF/88 *	3,622,988
2. Sewage Collection Main	PL480/87	708,883
3. Water Supply (deep well, 52.5 m3 storage tank, plus connections)	PL480/87	2,497,604

* Installation is being carried out by CEL/CAESS, financed under a USAID/IRD local currency program, apart from MICE program funds.

5.14 When completed, the added power availability will help alleviate the power shortages and stoppages of recent years, and sewage collection and disposal should not be a problem in the foreseeable future./1 As for the water supply, the 250 ft.-deep well has been tested at 5 liters/second or about 5,000 gallons per hour equivalent to 40,000 gallons per 8-hour shift. At full occupancy, the expanded SBFZ, assuming it is populated mainly by light mechanical industries or service activities (few or no high-water consumers, such as chemical plants), could require about 200,000 gallons/shift (mainly sanitary consumption). The well, therefore, will be capable of providing only about 20 percent of the potential demand with the balance being drawn from the municipal water supply. While the 52.5-cubic meter main storage tank and the supplementary cisterns in each SFB will help to avoid critical shortages, the water situation will bear monitoring.

5.15 The telephone system, is in dire need of upgrading. Discussions held with ANTEL indicated a willingness on its part to undertake whatever measures are required to ensure that the long-promised 100 lines are installed and operational by the time the new buildings are completed. Additional financing from the SBFZ is not required, but simply follow through on the part of ANTEL.

D. COST CONSIDERATIONS

5.16 By any standards, the cost of construction -- C1,928/sq.m. or US$36/sq.ft. -- is high compared to private sector experience in El Salvador and general experience (both public and private sector) in most regional locations.

/1 Total elimination of electric power deficiencies will likely require major investment in central power generation capacity and high-tension distribution lines.

The El Pedregal (private) project is projected to cost "all-in" about US$268/sq.m., or US$25/sq.ft., an estimate which could increase over time (as projects of this type have a tendency to do). All-in costs of construction regionally, based on recent data, range from a low of US$16-18/sq.ft. to a high of US$22-24, or on average about US$18-22/sq.ft. for comparable factory shells.

5.17 There are several explanations for the higher costs incurred by the SBFZ. As noted in paragraph 5.02, from the onset, uneven topography implies higher than normal land preparation expenditures. Building design is also heavier and more costly than usual, mainly because design standards must take into account the earthquake risk. Inordinate delays have occurred between the time plans and cost estimates were first prepared and civil works contracts signed. Rising prices during this interim plus approved design changes suggested by the contracted architects have both contributed to increased cost estimates. The policy of subdividing the aggregate of civil works into smaller bid packages to spread the work has undoubtedly engendered a cost penalty because of reduced economy of scale. Non-standard building design -- there are five different floor plans among the eight buildings -- which may have resulted from the various creative ideas of the four architectural groups, must also give rise to added cost.

5.18 While the explanations offered above justify, at least qualitatively (precise quantification would be a major study in itself), the higher costs compared to other regional locations (where terrain may be more favorable and not subject to earthquakes, and perhaps enjoying more streamlined project implementation procedures), other factors enter in when comparing the SBFZ with the EL Pedregal cost estimate. Government procurement procedures, in general, tend to be more lethargic, and therefore more costly, than private companies' experience. Whether or not El Pedregal's SFB structures will be as heavy as those at the SBFZ remains to be seen. (It is possible that acceptable earthquake damage resistance can be achieved at lower cost than at the SBFZ.) El Pedregal's land may also be flatter and land preparation costs lower. If we assume that El Pedregal will find its projected cost of US$25/sq.ft. rising to US$27.50/sq.ft. (10 percent increase) or US$28.75 (15 percent increase) -- not unusual for industrial construction -- the SBFZ's cost of US$36/sq.ft. is not too outlandish, given the various factor discussed above.

5.19 It should be noted that on completing the civil works at the SBFZ, there will be as much as five or more hectares of prepared land at Polygon F ready for the installation of buildings. Our cost analysis has absorbed this land preparation cost in the all-in cost calculation of the rentable factory space of 67,000 sq.m. It could be argued that this investment in a prepared land bank should not be charged to the existing rentable space. However, if we adopted that approach, we could go further and reduce the value of the all-in cost chargeable to the existing space by pro-rating the cost of common services such as roads and utilities. This would lead to a lower nominal cost per square meter of space but the derived economic rental necessary to recover investment would also be lower. The result would be that part of the investment would not be amortized. The significance of the foregoing discussion is this -- in the next phase of construction when Polygon F is utilized, cash required for construction costs will be lower by the amount of the investment already made in land preparation. Overall cost of construction for all rentable space at that point will be lower than it would have been otherwise.

5.20 Finally, there is much evidence that the exchange rate of US$1:C5 reflects an artificial strength for the colon. Knowledgeable sources estimate that the real or free market value is more in the order of C6-7:US$1. If the exchange rate were to be liberated and settled down at C6.5:US$1, the current cost of construction at the SBFZ would be US$28/sq.ft. (when converted at the higher exchange). That figure would compare favorably with other regional competitors, taking into account all the factors involved.

E. IMPLICATIONS FOR FUTURE DEVELOPMENT

5.21 By end 1989 or early 1990, the SBFZ will have completed the erection and installation of all facilities covered by its Action Plan. The total rentable space will be 67,000 sq.m. and about 30 hectares of the 80 hectare site will have been urbanized (developed) to accommodate buildings, roads, green areas and services.

5.22 Actual capital investment entered in MICE's books and projected indicates an average all-in cost of US$20.52 per square meter of rentable space, i.e., the average cost of Phase I construction of 43,600 sq.m. (of which 40,000 sq.m. was completed in 1977/78) and the 23,341 sq.m. under construction now. At the current standard rental rate of US$2.00/sq.m./month, assuming only 75 percent of the rentable space generating revenue, the project should be financially viable (although only marginally).

5.23 Future construction should continue to be implemented in phases of 10-20 hectares each, depending on the demand curve. On the one hand, it is sound business practice to "overbuild" judiciously, that is, prepare facilities that may not be fully occupied on completion but have a high probability of leasing a 10 or 15 percent surplus of available space within a 12-month period. The financial risk is demonstrably small in an economy subject to inflationary price increases. More importantly, available space to accommodate customers seeking quick start-up, is one of the strongest promotional tools. On the other hand, excessive overbuilding can rapidly develop into a financial burden and operating losses. Assessment of the fine balance between under- and over-building is a responsibility of zone management. Experience and skill in evaluating demand trends and realistic cash flow and credit management are basic to success in maintaining an optimum rate of construction of new facilities.

5.24 SBFZ management will have to monitor closely the growth of demand for electric power, water, sewage disposal, telephones and other services and the availability and reliability of these services from the responsible public entities. Since planning, finance and construction are essentially in the hands of state enterprises, the best contribution that the SBFZ management can make to timely availability of such services is to continually monitor effective demand trends and initiate action with the utility companies well in advance of need. No serious problems of this type are foreseen until the Phase 3 construction is initiated, circa 1991/92. (This timetable assumes no serious deterioration in the investment climate and continued strong demand.)

5.25 As a final comment, assuming that management capabilities and operational efficiency improve over time in accordance with the diagnosis and recommended actions embodied in this report, further construction can only enhance the profitability potential that has begun to emerge in 1989. Unit capital costs should decrease in the future while revenue increases both relatively and absolutely. Increased economies of scale as additional land is brought into productive use, without a proportional increase in operating costs, can be expected.

VI. MANAGERIAL AND OPERATIONAL ASSESSMENT

6.01 As discussed above, the SBFZ is potentially a profitable business operation, given changes and improvements to the institutional structure and management procedures. The analysis conducted by TSG revealed that many of the constraints to the performance of the project are operational considerations that can be addressed by simply instituting more businesslike practices in key areas. The following discussion identifies the core functions encompassed in effective zone management, assesses the execution of these responsibilities by the SBFZ, and indicates those areas where improvements are necessary.

A. ACCOUNTING AND FINANCIAL MANAGEMENT

1. Objectives

6.02 A well-run accounting department is an essential element of a profitable free zone. Decisions regarding rental rates, marketing and promotional efforts, new construction and improvements to existing zone facilities, staffing and salary levels, are all made based in part on the data provided by the project's accounting system. The primary objective of the accounting department is to provide accurate, timely information on the zone's finances, and to maintain well-organized records of the revenues received and disbursements made by the zone. In the case of the SBFZ, a public sector project, this task is complicated by the mingling of zone finances with those of the general treasury, and by the infusion of USAID financing and the reporting requirements which accompany these funds. Nonetheless, the execution of these responsibilities, using standard project-based accounting practices, is well within the capabilities of an efficiently run financial department.

2. Assessment of SBFZ Operations

6.03 To conduct a detailed analysis of the SBFZ accounting and financial control procedures, a formal independent audit would be required. It is highly recommended that an audit be conducted by a firm specializing in such investigations. In contrast, this assessment is based on a cursory review of financial documents and direct interviews. Its objective is to identify major areas of deficiency, and suggest remedial measures.

6.04 The accounting and financial recordkeeping system of the SBFZ is part of the larger MICE system. Organizationally, the SBFZ employs an accountant who reports to the MICE accountant. The accounting system of MICE is identical to other GOES ministries, and will not be described in great detail. It is a cash-based fund accounting system, primarily intended to ensure that annual expenditures do not exceed the budget allocations set by the central government.

6.05 Given the limitations of the SBFZ account system, it is difficult to assess the zone's overall financial position with any degree of confidence. Clearly, evaluating SBFZ financial performance on the basis of traditional commercial profitability and cost minimization considerations is misleading because the SBFZ does not operate as a commercial enterprise. As a governmental unit, the primary purpose of the SBFZ is to provide services -- not maximize profits.

6.06 Moreover, as a GOES unit, the SBFZ financial statements generally follow fund accounting (as opposed to commercial accounting) procedures. This essentially means that instead of endeavoring to measure operating profit/loss, the operating statements simply contrast SBFZ expenditures to the annual budgeted appropriation (funds which are derived from a general GOES allocation).

6.07 As a result, SBFZ financial statements are not comprehensive and do not include all SBFZ operating expenses and capital expenditures. There are a number of expenses that are not charged to the SBFZ operating account and are part of the MICE general fund. Moreover, as discussed in Chapter 4, a substantial part of SBFZ investment in fixed assets has been provided directly in the form of PL480 and ESF contributions by USAID. These funds are routed to MICE through SETEFE, the Technical Secretariat for External Financing, a department of the Salvadoran Ministry of Planning that coordinates all donor resources received by the GOES.

6.08 A review of SETEFE documentation regarding MICE and specifically, the SBFZ, indicates that the organization maintains timely records of the local currency funds allocated and disbursed under USAID project accounts. These records, however, do not constitute "financial statements" of any sort, but rather are intended as a paper trail delineating MICE/SBFZ's uses of the funds made available under the ESF and PL480 mechanisms. Likewise there are no formal financial statements prepared by MICE which incorporate such external financing.

6.09 In addition to the limitations and accounting irregularities in the financial statements roted earlier in this study, a system of regularly scheduled accounting and management audits by an independent agency has not been established. This is of concern, because it is quite difficult to tell if the SBFZ annual financial statements are fairly stated and in accordance with internationally accepted accounting principles. The TSG project team did not evaluate detailed accounting procedures and internal management information systems. However, based upon the review of documents and interviews with MICE officials conducted, it appears that there is room for improvement in this area, an objective that may be met through increased automation and consolidation of data and functions.

B. STRATEGIC PLANNING

1. Objectives

6.10 Strategic planning encompasses, essentially, the establishment of realistic long-range goals and the formulation of an implementation plan to apply available resources -- financial, physical, institutional, technical, and managerial -- toward their realization. In the case of the SBFZ, the historic objectives of job creation, export expansion, and foreign exchange earnings are well-documented. The implementation plan, however, as detailed throughout this report, has been largely unfulfilled, partly for lack of resources and desultory management, but perhaps more importantly, as the result of political and economic forces beyond the control the SBFZ. The present USAID-financed phase of zone development offers all interested parties the opportunity to establish a new point of departure based on a careful reappraisal of available resources, institutional restructuring alternatives, and realistic market projections.

6.11 The determinant of successful free zone management is the ability to attract users and keep them satisfied. This requires a knowledge of the market (demand) and the competition (supply) and a thorough grounding in the operational aspects of the zone itself. Successful zone projects are developed based upon detailed pre-investment analyses and in accordance with the phased development program that they set forth.

6.12 One of the primary roles of a General Manager, or management team, is to assess the market for the project and to devise a strategy that will be both profitable to the development group and attractive to the targeted industries. Once the project is operational, effective management requires monitoring the relationship of the strategy adopted to the actual performance of the project. To remain competitive, the zone management must keep abreast of trends in free zone development elsewhere and their impact on the demand for its own facilities and services.

2. Assessment of SBFZ Operations

6.13 As noted above, the structure of the SBFZ/MICE managerial framework is an impediment to the efficient operation of the zone. In terms of strategic planning, the number of offices and individuals involved makes the formulation of a comprehensive and effective approach to zone development problematic at best. There are several basic problems that have been identified.

6.14 No real effort has been directed toward reviewing and adjusting the development strategy for the SBFZ since the late 1970s. Consequently, when the zone began to rebound in terms of investor interest, there was no plan or strategy in hand; MICE and the SBFZ staff simply responded to the requests for facilities and services to the extent that their resources and capabilities allowed. Over the past two years, however, steps have been taken to rationalize the strategy for development of the zone, primarily to improve its financial performance. A review of the activity program prepared for the project reveals that MICE has emphasized three primary areas:

(i) Export investment, including a study of the maquila industry; a profile of investment conditions in El Salvador; and development of an investor data base;

(ii) Administrative improvements of the SBFZ, including collection of rent in arrears, full occupancy of existing and new facilities, and achieving revenues of C3.5 million in 1989;

(iii) Improvements to SBFZ buildings and infrastructure, including the construction of 14 new buildings in addition to the eight in progress, installation of the cargo ramp, and the construction of day care and food service facilities.

6.15 Taken as a whole, these initiatives do not constitute a strategic plan, but are simply components of the near-term operational objectives for the project. In practice, the OIP/FZ is the focal point for SBFZ planning activity, to the degree that it is undertaken. The preparation of the SBFZ 1988 and 1989 Action Plan was the work of the OIP/FZ. However, annual operating budgets for the SBFZ have been authorized by the Ministry of Finance for the past three years, without the input of <u>any</u> office within MICE. (The same funding level and distribution of funds has been maintained.)

6.16 In general, the on-site staff of the SBFZ is not involved in the strategic planning at all. This is a crucial flaw in the present information gathering system. There are no formal reporting requirements in place for the professional staff of the SBFZ with regard to their administrative/managerial needs or those of the zone users. Generally, SBFZ staff input is garnered on an "ad hoc" basis, most often when a situation has become intolerable or reached a point of crisis.

6.17 There is not an established program for setting annual objectives for the zone, which could be used as guidelines to assess management performance. There is little or no accountability within the current managerial framework, and ambiguities with regard to individual roles would make it difficult to assign responsibility, even if such an effort were undertaken. Moreover, there is no "reality check" -- measuring zone performance against the goals established in the planning documents.

6.18 On a practical level, the primary shortcoming is the absence of a single office with both an understanding of the operational aspects of the zone and the market for its facilities, and the authority (and resources) to set in motion a program to alleviate constraints on its performance and capitalize on its advantages. For a public free zone project to be successful, consolidation is essential to the process of strategy development.

6.19 Within the existing structural framework, it would appear that the position of General Manager of the SBFZ, in this case the Director of the OIP/FZ, would be the most appropriate place to centralize the strategic planning function. The present Director, Mr. Luis Felipe Alam, has substantial experience in public administration, but would need additional training in the practical aspects of free zone management in order to fully execute the duties of General Manager of the SBFZ. Such a reorientation would necessitate the transfer of the Directorship/General Manager position to the zone site, where communication with zone staff and tenants is facilitated and "hands-on" information can be easily incorporated in the planning process.

C. DAILY ADMINISTRATION

1. Objectives

6.20 After the initial planning and physical development of the zone is completed and the zone tenants begin their activity, the basic functions, as with any well-run business venture, must be administered by the zone management team. While the emphasis placed on operational areas will vary depending on the goals of the developer and the services and facilities offered to the users, there are basic administrative tasks that must be successfully executed, such as: personnel management, accounting and purchasing; as well as those specific to property management, including, rental collection, physical development and maintenance, utilities and basic service delivery, client relations, etc..

6.21 It is important to note that management's success in the crucial area of client relations will be directly related to its responsiveness and capabilities in performing its other administrative functions. In addition, efficient free zone operations rely on the ability of the zone management to expedite the entry and exit of zone goods. One of the most important services provided by management is the coordination of zone activity with other government agencies.

6.22 Free zone firms depend on regulatory and fiscal incentives such as preferential treatment of their imported materials, ready access to foreign exchange, and expedited exportation procedures. It is in the best interest of zone management to work to ensure that tenants receive the benefits accorded them by their free zone classification. The management team should be aware of any problems encountered by the users in this regard and work with them to rectify the matter with Customs, the Central Bank, or other regulatory bodies.

2. Assessment of SBFZ Operations

6.23 The problems resulting from diffusion of responsibility for the SBFZ among a number of offices and individuals within MICE is manifested on a practical level in the day-to-day management of the project. Those individuals most familiar with the zone operations are physically separated from the final authority within MICE for even the most rudimentary decisions. This results in considerable frustration for the on-site personnel and dissatisfaction on the part of the zone users.

6.24 On-site managerial responsibilities are divided between the SBFZ administrator and engineer./1 Each operates essentially independently, within their respective spheres of responsibility, although there is some overlap in areas such as personnel management and interaction with outside contractors and service providers.

6.25 In terms of general administration, the position of zone administrator is analogous in some ways to that of General Manager in other free zone projects. The primary duties are as follows:/2

/1 The present administrator is Justo Pineda, and the zone engineer, Rigoberto Payes. Both men have been associated with the project for over a decade, are well versed in its operations and shortcomings.

/2 The position of SBFZ engineer is discussed in Section 6-C, Physical Planning, Development and Maintenance.

- tenant relations
- on-site personnel management
- liaison with MICE and other GOES entities
- data compilation vis a vis zone user activity
- authorization of movement of zone goods

Few of these duties are formalized. Essentially the job requires someone to serve as a troubleshooter for problems that arise in zone operations. The administrator talks to the tenants daily and visits each factory as needed. The key elements of SBFZ administration are discussed below.

6.26 **Accounting and Recordkeeping.** With the exception of distributing payroll, on-site management is not involved in any of the zone's accounting and financial planning. From contract negotiation through to processing of invoices for basic supplies, everything is channeled through the Ministry. Nor does the zone administrator have an established role in strategy development, marketing and promotion, or even review of applications for zone space. The SBFZ administrator exercises no control over the zone's budget. Requests for uniforms for zone employees, tools for maintenance and landscaping, upgrading of on-site services and infrastructure are all routed through the OIP/FZ. As government employees, there is no flexibility in salary levels for SBFZ staff, and given the present decisionmaking framework, the SBFZ Administrator cannot exercise any authority over hiring (and firing) of SBFZ personnel.

6.27 **Lease Negotiation and Revenue Collection.** A review of the lease agreements that have been signed by SBFZ tenants since 1976 shows that the current leases have been simplified and streamlined, and represent a significant improvement over earlier versions. In 1976, the lease term was for 12 years -- an exceedingly long period, contained no provision for escalation of rent during the period of the lease, and did not specify that the rent be paid in the dollar equivalent of the colon-rate in force. Given the length of the lease term, the termination clause was particularly onerous in the case of a unilateral decision to vacate by the tenant -- payment of four years rent or the time remaining in the contract, whichever was less. Likewise, certain elements worked to the disadvantage of the lessor (at this time ISCE). For example, the value of the colon-quoted rental rate was diminished by half by the 1986 devaluation. Consequently, all the leases not containing a clause regarding the dollar equivalent had to be re-negotiated, resulting in management-tenant tensions. Although new leases had been drawn up and signed by all the users by the end of 1988, several companies still owe rent for the 1986-88 period as of May 1989.

6.28 Another provision of the earlier leases that had lingering repercussions provided that should the tenant elect to renew the lease, the prevailing rate <u>two years</u> prior to the expiration of the lease would be the basis for the new rental rate for <u>another 12 years.</u> Clearly, changes in the economy as a whole and the market for zone space occurred during these lengthy terms, again resulting in lost revenues for the SBFZ.

6.29 Many of the 1988 lease agreements reflect the concessions that were made by MICE/SBFZ to those tenants whose prior agreements were still in force. Most long-time tenants are granted grace periods and an escalation of the rental rate to US$2.00/sq.m./month is phased in over time. Payments are due monthly, and a 1 percent/month interest charge is levied against payments made in arrears. The 1988 leases are for three or four years, and contain an automatic renewal provision for an equal period under the same provisions, with the exception of rental rate. The rental rate is specified in colones, but at the dollar equivalent at the time. In addition, many of the contracts contain an escalation clause to allow the rent charged to be raised by up to US$0.60/sq.m./month by GOES decree, during the life of the lease.

6.30 While the terms and conditions of the leases have been rationalized to some extent, review of the documents by TSG revealed that several contain mathematical inconsistencies in terms of the total colon value of the lease and the sum of periodic payments as specified. Clauses regarding grace periods were also confusing. On an operational level, the collection practices of MICE need improvement. The payment of the rent directly to the Ministry is awkward for firms based in Ilopango. The SBFZ administrator in some cases will serve as a go-between with regard to disputes over rent payment, but has no authority to take any action. Maintaining current records of accounts in arrears should be easily handled on site by transferring relevant bookkeeping tasks to the staff.

6.31 **Zone Security.** In terms of zone security measures, the present staff of 15 security guards (five per shift) is sufficient to provide a 24-hour watch over their property. However, according to zone administration, this is only because the SBFZ security is augmented by the Salvadoran army's own security measures for their SBFZ-based battalion. Should the battalion be removed, Mr. Pineda estimates that the SBFZ would need an additional 15 men per shift to provide adequate security. However, clearly the cost of the additional security force would be covered many times over by the revenues earned by the SBFZ from the rental of the 11,100 sq.m. of SFB space that the army now occupies./1

6.32 **Data Collection.** Apart from maintaining records of each firm's imports and exports, data collection from zone users -- capital invested, number of employees, foreign exchange earnings, percentage of local value added, etc. -- is not conducted regularly. According to Mr. Pineda, a comprehensive survey of zone operations was last done in 1987. Visits to and from MICE are infrequent, although Mr. Pineda talks with the OIP/FZ on a weekly basis, or as the need arises with regard to purchasing, staff management, or other issues.

6.33 In this context, specific shortcomings in the management structure as it relates to the daily operations noted include:

- The absence of a General Manager located within the SBFZ discourages the coordination of the activities of the two functional management divisions. Moreover, the ability of the SBFZ management to respond to the needs of zone tenants is inhibited by the lack of this on-site decisionmaking authority.

/1 The army's presence in the zone is a complicated issue, and the tenants views on regarding the matter vary. In any case, it presents an image problem for marketing purposes.

- There are no formal reporting procedures in place to ensure that the information needed by MICE to assess zone performance is gathered by the SBFZ staff. In some cases, potential areas of service provision to users that could be developed by the SBFZ have been foregone because of lack of communication with and slow response time by the Ministry.

- There is no incentive for SBFZ staff to improve the performance of the project due to the lack of control over the composition of the budget or the use of zone revenues.

6.34 As in the area of strategic planning, it is clear that the constraints to the SBFZ administrative performance arise primarily from the structure of the decisionmaking system, rather than shortcomings in individual performances. The lack of autonomy afforded the SBFZ, coupled with the difficulties inherent in running a profitable business operation when there are no direct benefits realized by the employees present a substantial obstacle to be overcome.

D. PHYSICAL PLANNING, DEVELOPMENT AND MAINTENANCE/1

1. Objectives

6.35 A free zone is an industrial property, and as such, the quality of the facilities and basic infrastructure it provides to its tenants are fundamental to operational success. The design and construction standards employed in the buildings leased, the appearance and maintenance of the grounds, the reliability of basic service delivery, are all essential to the efficient functioning of a zone industry. In a developing country, often the primary attraction of free zone facilities for foreign investors is that they are simply the highest quality industrial space available. In such a context, physical development and maintenance is clearly a high priority.

6.36 The presence of an engineer on site is considered to be essential for a free zone project, whatever its size. This individual may or may not be involved in the initial planning and design phase, but should in any case be well acquainted with the blueprints, building specifications, and other technical documents related to zone design and construction. If the project is to be developed in phases, as most free zones are, the engineer generally will serve as a technical advisor to the design and construction teams that develop subsequent phases of the site. Often the engineer is involved in the drafting of the technical specifications included in tender documents. Finally, the engineer, like the General Manager or Administrator, plays an important role in client relations, working with the zone users to ensure that all the installed facilities and equipment are in good operating condition, basic services are in order, and that the common areas are well maintained.

/1 The physical facilities and infrastructure of the SBFZ, as well as the ongoing USAID-financed construction program, are discussed in detail in Chapter 5.

2. Assessment of SBFZ Operations

6.37 The MICE Office of Physical Development is supervising the new development at the SBFZ while maintenance and improvements to the installed facilities are the responsibility of the SBFZ engineer. The OPD, headed by a civil engineer, is overseeing all the construction and infrastructure development now being undertaken with USAID funding at San Bartolo. The OPD staff is housed within the Ministry, although Mr. Aguilar visits San Bartolo several times a week to monitor the progress of the new construction.

6.38 At present, there are at least six different design and supervision firms and general contractors involved in the zone expansion. At the SBFZ, roughly one third of the total site is presently fully developed with 40,000 sq.m. of industrial space. The new zone development will add eight new SFBs and improvements to internal infrastructure. As is often the case, the construction program is presently behind schedule. Moreover, the winning bid came in substantially higher than anticipated and budgeted.

6.39 Discussions with MICE and SBFZ personnel indicate that the construction of the new zone facilities is taking place entirely under the supervision of the MICE-based engineer. The on-site engineer, Mr. Rigoberto Payes, is involved in the execution of the SBFZ expansion only to the extent that he is posted on the zone grounds and is thus able to monitor the progress of the construction program on a daily basis. The specific duties he discharges are:

- supervision and execution of maintenance and repair of user facilities;
- maintenance of administration building and common areas;
- supervision of gardening and janitorial staff; and
- coordination of construction program with the MICE OPD.

6.40 Based upon a preliminary examination borne out by discussions with zone users, the maintenance of the zone buildings and grounds appears to be well executed by the SBFZ engineering and maintenance staff. The zone is generally clean and the landscaping is attractive and well-maintained. While Mr. Payes believes that his division is under-staffed at present, with 17 maintenance men and 8 gardeners, this does not appear to be the case. However, increased flexibility in "contracting out" and hiring short-term or temporary workers for one-time construction projects would be desirable.

6.41 As with the Administrative division, Mr. Payes is dissatisfied with response time of MICE for processing purchase orders, changes in personnel, and other basic administrative matters. There is no regular communication with the SBFZ by MICE staff or vice versa, contact is made only as problems or issues arise. Mr. Payes feels that the SBFZ is in need of additional machinery and equipment for the conduct of regular maintenance and repair activities.

6.42 There are two key areas where improvements are needed: response time to requests for new construction or leasehold improvements and basic service delivery. There are, without a doubt, problems in the provision of basic utilities to zone users. In the present organizational framework, neither MICE nor SBFZ staff have a formal role in ensuring the reliability of their provision, apart from maintaining the condition of the on-site systems. Tenants deal directly with the utility providers. Telephone service, potable water supply, electricity, garbage collection, were all cited by both the SBFZ Engineer and the zone tenants interviewed as problem areas. Several tenants, frustrated by basic service interruptions, have gone directly to the Minister of MICE to bring their case to his attention and to obtain his "good offices" in discussions of their situation before the service provider.

6.43 The zone users are generally supportive of the SBFZ management and their efforts to solve the problems in service delivery and, in some cases, have taken steps on their own to address the shortcomings. For example, several firms have opted to join together to contract out for private garbage collection which may, in fact, be more cost-effective than the provision of the service by the SBFZ. To guarantee a constant supply of electricity, the majority of the firms have back-up power generators, and all buildings have cisterns on site. Other situations are more problematic, as with County Line Sportswear which has been without a phone for nine months and uses the telephone in the SBFZ administration building for both its incoming and outgoing calls. It should be noted that these problems in service delivery are not unique to the zone, but exist throughout the Ilopango area, and to various extents throughout the entire country.

6.44 The delays that have been experienced by tenants with their requests for new space, construction of common facilities, and other physical improvements are a source of irritation to both the on-site staff and the users. One example is the length of time that was required for the construction of the AVX expansion building. An existing tenant was forced to wait for over a year to have a 2,150 sq.m. addition to their building, while other free zones in the region offer "build-to-suit" programs whereby tailored facilities are constructed for new clients within a three-month period. Had there been better coordination and communication between the various entities involved: SBFZ personnel, MICE Offices of Investment Promotion/Free Zones and Physical Development, the building would have been erected much more rapidly, the client satisfied, and revenues earned.

6.45 This problem can be partially attributed to the financial procedures used to track the various sources of SBFZ funding -- GOES general budget, USAID annual allocations, and also to the lack of final authority over those resources that plagues both MICE and SBFZ staff in their efforts to take action. Whatever the reason, the need for expedited response to users' requests is crucial, and effort should be directed toward streamlining the process -- from the initial decision to allocation of funds through to implementation.

6.46 In summary, the tasks associated with the maintenance of the SBFZ facilities and infrastructure are generally competently executed, given the resources available and the obstacles presented by the decisionmaking framework. Specific constraints to performance identified include:

- The absence of a coordinated effort by the SBFZ to assist the zone users in obtaining reliable basic service delivery. This does not (necessarily) entail the assumption of additional costs in terms of infrastructure installation on-site, but rather a canvassing of the tenants as to their needs and presenting the requirements of the

SBFZ to the various service providers (CEPA, ANTEL, ANDA, etc.) in an organized fashion.

- Problems and delays in communication, reporting and purchasing resulting from the separation of management between MICE and the SBFZ.

- The need for efficient processing of user requests for additional space, or improvements to property and the expedited implementation of the construction, once the decision is taken.

E. MARKETING AND PROMOTION

1. Objectives

6.47 The final basic function of free zone management to be discussed is the marketing and promotion of the project. While the market for free zone facilities in the region has experienced a phenomenal growth in recent years, the supply of free zone space has also been increasing rapidly. New sectors of industry are moving offshore as are smaller firms with different facilities and infrastructure requirements than their more traditional counterparts. Successful free zones in Central America and the Caribbean are targeting their projects and tailoring their services to meet the needs of these new market entrants.

6.48 In such a competitive environment, successful promotion relies upon the definition of a specific market niche, based on the inherent (and developed) comparative advantages offered by the zone project. This requires a thorough knowledge of the investment conditions, including regulatory procedures, zone incentive package, economic factor endowment, business support services, and the like. This data can be used both to evaluate the project's competitiveness in specific market sectors vis a vis other free zones and in the development of the promotional programs and materials for the zone.

2. Assessment of SBFZ Operations

6.49 The SBFZ is presently in the enviable position of having generated substantial demand for all the space constructed and under development at the site. However, the demand can be largely attributed to two factors: (i) the dearth of available industrial space in El Salvador in general; and (ii) the low rental rate presently being charged by the SBFZ. Both these elements are likely to change in the medium-term, as private developers take advantage of the USAID free zone project and MICE/GOES implements raises in rental rates to improve the financial performance of the project and cover the true cost of SBFZ development and operations. Moreover, the degree to which any new foreign investment is attracted to the SBFZ will be directly related to the promotional efforts undertaken, given the prevailing perceptions of the Salvadoran investment climate held by foreign firms.

6.50 There has been no active promotion of San Bartolo by MICE for some time. The most recent promotional literature available is from 1986 and it is simply a photocopied memorandum from MICE on the project. Essentially, since the demand has been more than sufficient to fill the available space, MICE and SBFZ personnel have simply responded to requests for information from export industries, maintained a listing of interested firms, and waited for the new construction to be completed. Such an approach is understandable, to the extent that the marketing of space that is not available is a sure way to tarnish the image of a project. However, there are both remedial and pro-active measures that can be taken by MICE to support the existing client base, ensure that the publicity generated by these firms will be positive, and to set the stage for project future growth. In interviews conducted with the OIP/FZ and on-site staff, the lack of zone-specific promotion efforts was discussed. Based upon these discussions and after investigating institutional capabilities and zone performance to date, several conclusions can be drawn regarding the promotional program.

a. Staff Capabilities in Marketing and Promotion

6.51 As a starting point, despite the OIP/FZ's broad objective of promoting investment in El Salvador, no operational strategy or even basic approach toward achieving this goal has been established. In such a vacuum, the staff functions in a re-active mode, addressing issues as they arise, dealing with investors when approached, and seeking out information as requested. This problem is perceived by MICE/SBFZ personnel to be one of resource constraints, in terms of the minimal funds available to support promotional activity. While this is true to a certain extent, promotion at the most basic level, relies upon a marketable product and effective communication. The marketability of the SBFZ to local, and even foreign, investors has already been demonstrated and effective communication does not have to be costly.

6.52 While glossy brochures and state-of-art video presentations are desirable promotional elements for their visual impact, they are not a prerequisite for a successful campaign. Trained personnel, with a knowledge of both the product and the market are the basis of any such initiative. Potential zone users, especially foreign firms, will be attracted to those projects where the key locational factors make sense for their business. SBFZ promotion officers should be able to speak effectively regarding the requirements of the traditional zone sectors, garments, electronics, light manufacturing, etc., and to field questions as to how El Salvador, and the SBFZ in particular, can meet their demands. This implies hiring (or training) personnel for the OIP/FZ that are schooled in the basics of international business and are informed and enthusiastic about the investment opportunities in the SBFZ.

b. Information Collection and Dissemination

6.53 In a competitive marketplace, information, and more precisely, current and accurate information, is fundamental. Individual investment decisions might hinge on marginal differences in wage rates, proximity of suitable labor, market access and quota availability, or shipping rates and schedules.

6.54 General information on national investment conditions has already been gathered and prepared for distribution by private promotion organizations in El Salvador. As discussed below, MICE and the SBFZ staff should draw upon these materials in their own promotional efforts. A more pressing need, however, exists for the compilation and dissemination of information regarding the SBFZ project itself. In this vein, data should be collected and organized in areas such as:

- number and types of firms installed
- employment figures and prevailing wage levels in zone firms
- capital investment and foreign exchange earnings
- volume of imports and exports
- transport times and delivery schedules to the zone from major sea and air ports
- training programs and vocational assistance available
- skills available in and size of nearby labor force
- access to business support services
- local quality of life, recreational attributes

This is the type of project-specific information that businesses require, in addition to the obvious data on contractual terms and conditions for the facilities and services available, to assess the merits of a location. Much of this data is also crucial to the zone developers in their own strategic planning. At present, this information has not been aggregated in any one office and is difficult to discern even from the internal documents that are available. The SBFZ should have a basic promotional brochure, available in both Spanish and English, summarizing its attributes that is distributed to investors by the MICE staff and other promotional agencies. (See Annex 2.)

6.55 An attractive folder has already been designed and produced for MICE in which SBFZ information can be presented. The folder format is ideal, since it allows the promotional officer to tailor the contents to suit the interests of individual investors. With regard to the preparation of a new brochure for the SBFZ, new options have arisen alongside advances in computer technology. Desk-top publishing technology, which uses microcomputers to produce camera-ready text for printing, has drastically reduced the cost of producing attractive promotional literature. The OIP/FZ already has a computer with graphics capability for which software can be purchased to generate an attractive promotional pamphlet in a cost-effective manner. This approach has the additional advantage of allowing for frequent updating of changing factors, i.e. lease rates, types of buildings available, or upgrading of zone infrastructure.

c. Investor Assistance

6.56 In terms of investor assistance, the SBFZ/MICE staff falls short in its performance. As in other areas, investors are "assisted" on an ad-hoc basis, and both on-site and MICE-based personnel would benefit from training in the procedural requirements for free zone investment and GOES regulatory procedures, in general. This is perhaps the most important service that a marketing staff can provide, especially to a foreign investor -- assistance in successfully executing the bureaucratic requirements for investment initially, and support to zone users in their dealings with the public sector throughout their operations.

6.57 The purpose of a free zone is to minimize the complications for doing business. Even the most attractive free zone project in terms of its facilities and services cannot overcome the negative impact of red tape and prolonged delays in processing of equipment and merchandise, expatriate work visas, foreign exchange transactions, and the like. In this respect, as in many others, the existing client base of the free zone can be either a positive factor in investor locational analysis or a detriment to the project. The obstacles presented to County Line in their effort to set up operations in the SBFZ, for example, threatened to cause them to turn elsewhere. This is especially true for larger, more sophisticated firms with multiple factories and the resources available to invest in locational decisionmaking.

6.58 The capabilities of both the on-site staff and MICE personnel to provide guidance and assistance to potential and existing users need improvement. At present, company representatives interested in investigating the SBFZ are essentially on their own. There are no standardized procedures for dealing with investor enquiries, no system for tracking the progress of individual investment initiatives, and little ongoing exchange of information between MICE-based and SBFZ staff. Once an investment is realized and the firm begins occupancy of their facilities, there are no mechanisms in place to ensure that any bureaucratic obstacles it encounters in its operations are even made known to the staff, and active involvement by MICE representatives in troubleshooting problems that arise is infrequent.

d. Cooperation With Other Organizations

6.59 Finally, successful free zone promotion requires the effective utilization of all resources available. In El Salvador, PRIDEX, the Export and Investment Promotion program of FUSADES (Foundation for Economic and Social Development), is the leading promotional agency. PRIDEX has sector specialists on-staff and promotional materials available regarding investment opportunities in El Salvador that can be used by the SBFZ. As mentioned above, these promotional materials can be presented in the MICE folder alongside specific information on the SBFZ, for a low-cost comprehensive distribution piece. Likewise, PRIDEX needs to be kept up to date on the SBFZ development program, occupancy levels, space availability and pricing policies to inform potential investors they meet of the project's status.

6.60 If kept abreast of the SBFZ project, PRIDEX staff can spread the word in their far-reaching initiatives to promote overall investment in El Salvador. They attend international trade shows and conferences, host trade missions, and provide one-on-one assistance to both local and foreign businesses. Just as MICE/SBFZ staff can utilize promotional literature prepared by PRIDEX, PRIDEX staff can present information on the SBFZ at the functions they attend. This reciprocal approach has been effectively used by many other free zone projects in countries throughout the region to minimize their own promotional expenses by capitalizing on the efforts of a broad-based promotional organization.

6.61 It is also important to note that with funding and technical assistance provided by USAID, PRIDEX has recently established an office dedicated to promotion and support of the Salvadoran free zone program that will be invaluable to MICE in the marketing of the SBFZ. At this stage, the PRIDEX free zone office's activities are primarily directed toward formulating a promotional strategy, building internal capabilities as a technical source, and assisting in the development of private free zone projects in El Salvador. However, especially in the formative stage of the program, the OIP/FZ should take steps to exchange information with relevant personnel within PRIDEX, to ensure that zone-specific promotion efforts are complemented and enhanced by those of the PRIDEX personnel. At present, contact between the two organizations is casual and infrequent, and a more regular, formalized relationship would be a major step to heightening awareness of the SBFZ among potential investors.

VII. SHORT-TERM MEASURES TO IMPROVE SBFZ PERFORMANCE

7.01 The preceding analysis of the San Bartolo Free Zone institutional and managerial structure indicated the key areas where corrective action is required if the performance of the zone is to be improved. Some of the problems identified can be addressed and rectified through simple procedural changes and internal restructuring, others are more complex and would require, at a minimum, the adoption of a new approach to the management and operation of the zone.

7.02 The following discussion outlines preliminary recommendations for GOES consideration and evaluation. It focuses on actions that in the short-term will enhance the operational efficiency of the zone, improve its financial position, and strengthen its potential to contribute to the development of the export sector in El Salvador. Figure 7-1 summarizes the principal findings to date, delineates suggestions for policy changes, and makes recommendations for short-term actions. The discussion below identifies the major impediments to implementation and focuses on the likely impact of the recommendations.

FIGURE 7-1
SHORT-TERM ACTIONS TO ENHANCE SBFZ OPERATIONS

PRIMARY PROBLEMS IDENTIFIED	PROPOSED POLICY RESPONSE	IMPLEMENTATION ACTIONS
1. Strategic Planning	**1. Strategic Planning**	**1. Strategic Planning**
- poor strategic planning capability - lack of clear institutional purpose - lack of coordination between the Office of Investment Promotion, Office of Physical Development and on-site SBFZ management in SBFZ strategic planning and decisionmaking - poor ability to practice management-by-objectives and other modern management techniques	- reorient strategic planning to emphasize concrete achievable objectives and identification of implementation means - redefine core institutional mission to operate firm as a self-sustaining productive enterprise - introduce business-like management techniques - centralize and consolidate planning functions - divest non-free zone related MICE functions	- reconfigure "Office of Investment Promotion" as "Office of SBFZ Development" and divest non-zone related activities to other MICE offices - provide assistance to management in strategic planning methods - improve internal management information system - consolidate planning function into Office of SBFZ Development - have Office of Physical Development report to new head of SBFZ Development
2. General Management Structure/Functions	**2. General Management Structure/Functions**	**2. General Management Structure/Functions**
- redundant secondary layer in decision making hierarchy - overlapping organizational functions, coupled with complete absence of other core functions - lack of service-orientation - lack of clear channels for decisionmaking - over-staffing and redundancy of personnel - absence of match between specific management positions and functional responsibilities - lack of decentralized decisionmaking authority - poor personnel compensation system/lack of performance-based incentives - lack of control over hiring and firing	- eliminate layers of management hierarchy and consolidate decisionmaking - reorganize SBFZ/MICE organizational structure to define core management functions, and create a simple management structure to fulfill tasks - decentralize decisionmaking to on-site management - establish clear lines of decisionmaking within the organization - reduce the number of SBFZ administrative staff - introduce SBFZ staff to commercial practices and service orientation	- combine the existing positions of Administrator and General Manager of the SBFZ into one position having the management powers of both posts - locate the Office of SBFZ Development on-site - reduce the number of personnel in the Office of Physical Development by 50 percent - reduce the number of SBFZ on-site maintenance personnel by 8 workers - reduce the number of "technical specialists" in the Office of Investment Promotion - expose new head of the Office of SBFZ Development to private free zones in the region

FIGURE 7-1 (CONTINUED)
SHORT-TERM ACTIONS TO ENHANCE SBFZ OPERATIONS

PRIMARY PROBLEMS IDENTIFIED	PROPOSED POLICY RESPONSE	IMPLEMENTATION ACTIONS
3. Financial Management	**3. Financial Management**	**3. Financial Management**
- uneconomic SFB rental rate - excessive operating cost structure - lack of consolidated financial accounting system - irregular accounting procedures - inadequate independent financial audit procedures - inadequate rent collection system - lack of financial autonomy over financing of investments and operations	- raise base rental rate to economic levels on existing and new facilities over time - reduce operating costs by trimming labor costs and increasing operating efficiency - undertake comprehensive audit of SBFZ financial procedures by independent accounting firm - utilize accounting procedures that consolidate financial information and measure operational profit/loss - discontinue accounting practices that do not follow generally accepted international accounting principles - streamline rent collection process	- determine economic rental rate by undertaking a detailed review of SBFZ operating and capital cost structure - reduce SBFZ payroll - conduct audit by independent group, and implement recommendations - facilitate consolidation of financial reporting procedures including PL480 funding activities - streamline rent (arrears) collection process by granting more autonomy to on-site SBFZ management and increase range of punitive measures
4. Physical Development	**4. Physical Development**	**4. Physical Development**
- high building construction costs - inefficient civil works bidding process - inadequate basic service delivery - delays in the construction process - lack of attention and coordination with on-site SBFZ management - inadequate maintenance program	- more critical evaluation of civil works bids by qualified technical committee - review the civil works bidding process and identify areas for streamlining - identify reasons for delays in SFB construction process - improve coordination with on-site SBFZ engineer	- review traditional building design standards in effort to identify acceptable lower-cost alternatives - undertake evaluation of the civil works bidding and SFB construction program - reorganize the MICE Office of Physical Development under the new Office of SBFZ Development
5. Marketing and Promotion	**5. Marketing and Promotion**	**5. Marketing and Promotion**
- lack of basic zone information - no promotional materials - lack of knowledge or capability within MICE/SBFZ to promote the zone and assist investors - lack of coordination with other promotional bodies	- coordinate activities with private investment promotion groups - expose SBFZ management to promotional strategies/techniques - prepare information collection system - prepare basic promotional materials	- develop a comprehensive zone information collection system - develop system to maintain and update promotional material - participate in the investment promotional efforts of PRIDEX, other private groups - have SBFZ officials undergo training in promotional techniques

A. STRATEGIC PLANNING

7.03 Project investigations have clearly indicated a number of problems are associated with management of the SBFZ at the strategic planning level. Much of the mediocre performance of the zone stems from a basic contradiction. While the zone is expected to be reasonably self-sustaining, it is not operated as a businesslike, profit-oriented enterprise. Instead, the primary purpose of the SBFZ is to a provide a public service, and serve "...as an instrument for the economic and social development of the country" as articulated by MICE in its most recent action plan.

7.04 This objective is laudable. But, absent the operational efficiencies that ensure financial viability (cost recovery plus a reasonable surplus or profit) such well-intentioned projects eventually deteriorate into financial losers, draining scarce public sector resources in ever-increasing amounts to the point where financial losses equal or exceed any possible economic benefits.

7.05 One of the basic problems with the SBFZ is that it has no clearly defined priorities, and is expected to pursue both commercial and social objectives simultaneously. The SBFZ should start by articulating a coherent institutional goal, establish performance objectives, and develop a strategy to meet those objectives on a timely basis. This will necessitate the introduction of more businesslike management techniques.

7.06 A major impediment to the practical implementation of a rational strategic plan is the fact that management and decision-making responsibilities are spread widely among several entities: the Office of Investment Promotion and Free Zones and the Office of Physical Development at MICE, and on-site SBFZ management. The general lack of coordination among these three groups is exacerbated by the fact that the two MICE offices are at the same rank in the ministry's hierarchy. Moreover, as the salary of the head of the Office of Physical Development is funded directly by USAID, coordination with the Office of Investment Promotion and Free Zones is a low priority.

7.07 It is also clear that both offices do little else than deal with SBFZ issues. The MICE "Office of Physical Development" is entirely concerned with the development of the SBFZ only, financed by USAID PL480 contributions. The "Office of Investment Promotion and Free Zones" also appears to focus only on the zone. In its most recent action plan, only general studies related to overall investment in El Salvador are being envisaged. A level of effort of such a small scale hardly justifies the broader scope of the Office, and could easily be covered by a private group such as PRIDEX.

7.08 It is recommended therefore that the two offices be consolidated into one more effective entity, perhaps re-named the "Office of SBFZ Development". More precisely, the head of the Office of Physical Development should report to the head of the Office of SBFZ Development. The advantages of this move are not just restricted to a logical name-change. It will serve to bring together the two primary functions of the zone under the same management: physical development and operations, and result in an enhanced strategic management capability.

B. GENERAL MANAGEMENT STRUCTURE

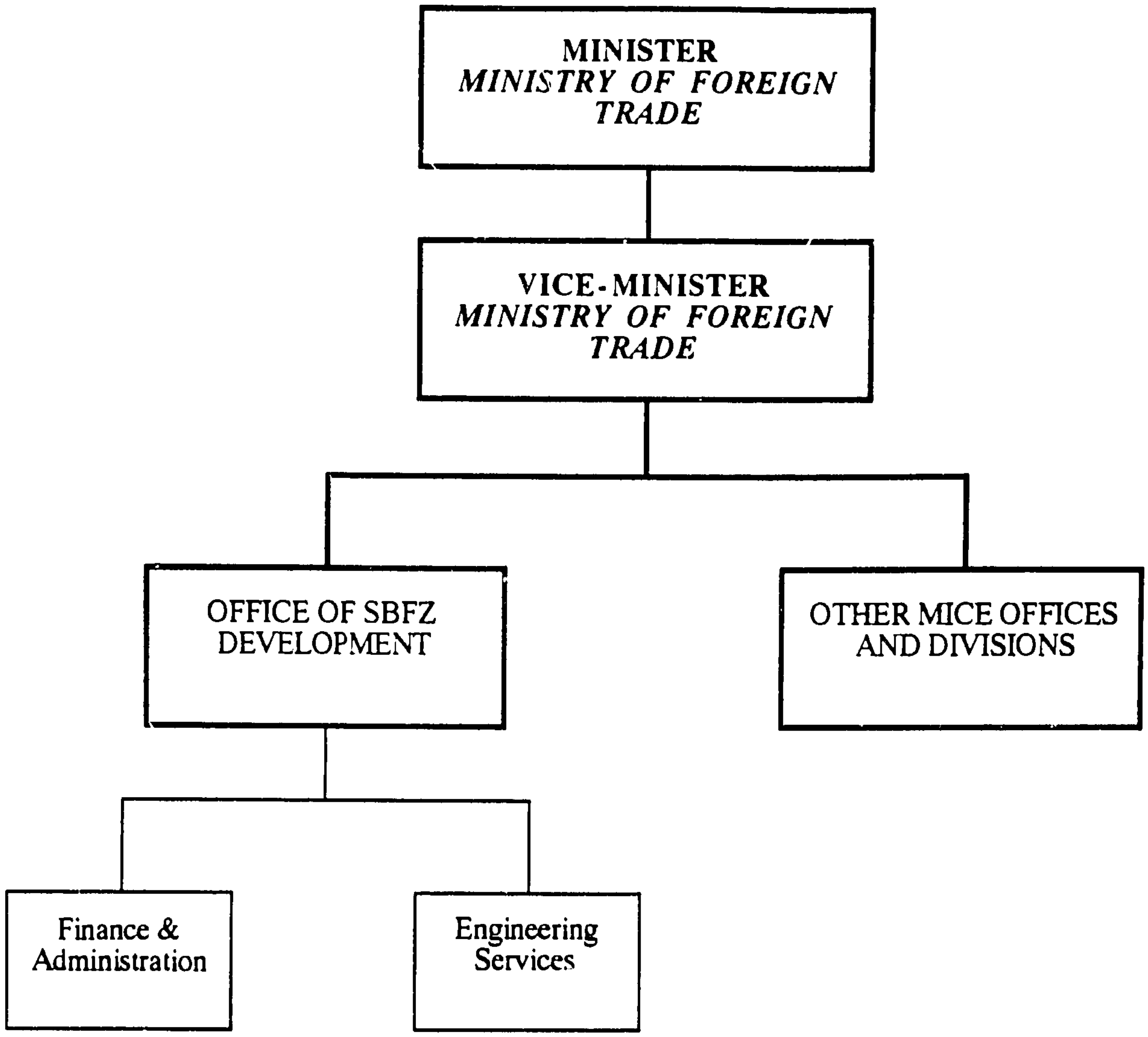
7.09 Another set of problems are due to the fact that on-site administration has no control over or connection to the strategic planning of the SBFZ. Even given the limitations inherent in a government agency, SBFZ operations are very inefficient due primarily to the fact that there are two, loosely connected layers in the zone management hierarchy: on-site and at MICE. Most of the constraints to zone management are not due to shortcomings in on-site administration, but rather because of a poor organizational framework.

7.10 Two levels of hierarchy might be justifiable if there were a substantive difference between them. In point of fact, the scope of responsibilities and management functions between the position of General Manager of the Office of Investment Promotion and Free Zones, and the on-site post of Administrator of the SBFZ are substantively identical. It is suggested therefore, that these two positions be consolidated into the new post of General Manager of the SBFZ, serving as head of the newly created Office of SBFZ Development. This individual would be in charge of zone operations and serve as the key promotional officer for the project. (See Figure 7-2 for the suggested organization structure and Annex 3 for job descriptions.)

7.11 The potential advantages of the proposed consolidation are considerable./1 Zone occupants will be able to deal effectively with one decision-maker who also exercises a fair amount of implementation power. Rent collection will be facilitated as the office will be located on-site. Development planning will be greatly enhanced, closely reflecting the input and experience gained from day-to-day administration of zone affairs. Physical development of the zone is likely to be simplified through closer coordination with the on-site engineer.

/1 It is essential that the consolidation not reduce the rank of the position in the MICE hierarchy. Rather, it should be undertaken in a way that enhances the position.

FIGURE 7-2
SUGGESTED SBFZ/MICE ORGANIZATIONAL FRAMEWORK



C. STAFFING AND COMPENSATION

7.12 The preliminary financial assessment conducted in this report resulted in two seemingly contradictory findings. On the one hand, the SBFZ has an inefficient operating cost structure, principally due to over-staffing. Comparisons with most well-run free zones indicated that the zone's payroll was as much as 30-40 percent higher than the norm. On the other hand, the analysis indicated that SBFZ personnel were under-paid, and that a significant boost in compensation levels was required to attract and maintain qualified staff.

7.13 It is quite urgent that the SBFZ reduce non-essential staff, to remain competitive. Based upon the management assessment undertaken, it is clear that over-staffing is a problem with support personnel in some areas. This is especially true with on-site maintenance activities (employing 17 maintenance men, and 8 gardeners), and the Office of Physical Development (with 7 architects and engineers)./1 It is suggested, at a minimum, that a 50 percent reduction in personnel in both areas could be undertaken without adversely affecting zone operations. This would greatly reduce the wage bill, and enhance the operating cost structure in the short run. Alternatively, if layoffs are an undesirable option, a "freeze" on hiring might be imposed which, over time, will reduce costs as a percentage of revenues.

D. FINANCIAL MANAGEMENT

7.14 As shown in Figure 7-1, two primary areas for improvement in terms of overall financial management of the SBFZ were identified: those relating to zone operations and those related to reporting and accounting procedures. These findings are quite significant given the cursory nature of the analysis conducted in this report. It is suggested therefore that a comprehensive accounting and management audit of the SBFZ be undertaken. This audit should have several tangible results: objective determination of the book value of SBFZ assets, an assessment of the SBFZ accounting system and identification of revisions required, and a consolidation of financial information./2

/1 As a point of comparison, a well-run private free zone will have one engineer coordinating all maintenance activities, and utilize outside private contractors to undertake routine building and site maintenance.

/2 A potential impediment to the consolidation of financial data may be USAID regulations regarding the need for the accounting system tracking PL480-funded expenditures to be separate. This should be overcome with an adequate accounting framework, however.

7.15 On the operational side, the analysis that has been undertaken in this report indicates that an economic rental rate for the newly constructed SBFZ SFBs is US$4.84/sq.m./month./1 This rate is patently uncompetitive, given that better-run free zones charge far less in dollar terms in the region. Although when the high costs of the new construction are tallied together with extremely low costs associated with the initial construction program, the current standard rent of US$2.00/sq.m./month becomes more acceptable, it is still short of profitable.

7.16 It is strongly recommended that a higher rental rate be charged by MICE to those tenants that will occupy the newly constructed buildings and that a gradual increase in rental rates be phased in for the entire facility as well, over the medium-term. If the US$2.00/sq.m./month rate is applied to the new buildings, the loss in revenues to MICE would be over US$800,000 per annum, versus economic rental rates on the facilities. Moreover, letting of the comparatively luxurious new structures to tenants at the standard US$2.00/sq.m. lease rate, represents a formidable subsidy and will undermine the efforts of private developers to construct and market similar industrial space in any new free zone or industrial park projects coming on stream.

7.17 While it is true that given that the new construction has been financed through USAID-funded local counterpart contributions, and as such, represents no "cost" to the GOES, there is no supportable reason to undermine the income generating potential of the project to such an extent. At a minimum, the pricing of the new facilities should be comparable to the market rate for comparable private industrial space, in the range of US$3.00-3.50/sq.m. For existing facilities and tenants, escalation clauses should be incorporated in their lease agreements to raise their rent to economic levels over time as well.

7.18 Other than reducing excessive operating costs, increasing overall efficiency and charging economic rental rates, the financial position of the SBFZ would be enhanced if the lease construction, negotiation and rent collection process was streamlined. At a minimum, standardized leases should be developed clearly specifying all terms and conditions including provision for inflation and a link to a dollar rate. Rent collection procedures must be streamlined and administered on-site.

E. PHYSICAL DEVELOPMENT

7.19 Once the recommended organization changes are in place, certain actions should be undertaken to enhance the efficiency of future phases of development, including:

/1 The reasons for the extremely high construction costs have been discussed in the Chapter 5; the buildings may, to some extent, be over-designed, with specifications that provide for two stories, plumbing installations to accommodate multiple users in each building, and possibly unnecessarily high-standard safeguards against earthquake damage.

- **Preparation of a long-range plan of phased construction** -- delineation of segments of 10-20 hectares in sequential order of priority to assure optimum least-cost application of new funds and use of existing infrastructure.

- **Review of building design standards** -- investigate lower-cost alternative techniques of construction in earthquake-prone areas; increased standardization of building floor plans, elevations, facade and roof treatments; and more efficient land use planning.

- **Close study of expected demand trends in relation to basic services consumption** -- monitoring actual usage of power, water, sewage, telecommunications, and other services to help ensure timely action by the relevant state enterprises in expanding service delivery.

- **Review of civil works tendering**, including bid evaluation, contractor selection and contract negotiation procedures; institution of procedural improvements, wherever indicated, that contribute to streamlining and cost reduction.

7.20 In terms of daily operations, the lack of coordination noted between the on-site engineer and the OPD will be offset by consolidating these offices within the newly-created Office of SBFZ Development. In most free zones, the engineering department is an integral part of the zone management group, and always reports to the general manager. Clearly, one potential issue to be addressed is the extent to which USAID (which pays the salaries of key OPD personnel) will agree to this consolidation. From a managerial perspective, however, the consolidation makes good sense.

F. MARKETING AND PROMOTION

7.21 One of the constraints on the growth potential of the SBFZ is the lack of any market knowledge and promotional capability. This has not yet posed a serious impediment because the SBFZ has enjoyed monopoly status and firm demand in an extremely tight domestic market. With the advent of private free zones, however, this situation is likely to change, as local competitive facilities become established, providing alternative configurations of facilities and services, and with active promotional efforts of their own.

7.22 Nevertheless, it is not recommended that the SBFZ immediately embark on a full-scale promotional program, marshalling scarce GOES resources in high visibility efforts to attract potential users that might otherwise be drawn to other projects. Such an initiative would only be a costly addition to an already over-extended MICE budget. In fact, the optimal approach is a measured response which will lay the groundwork for a more concerted effort, once additional facilities are constructed and additional resources become available.

7.23 As outlined in Chapter 6, it is recommended that steps be taken to cultivate and enhance the skills of the OIP/FZ staff, so that they become knowledgeable of national and zone-specific investment conditions and are attuned to the workings of the local and foreign market. For the foreseeable future, active and aggressive promotional efforts can be better done by privately funded groups such as PRIDEX. Instead, SBFZ personnel should be educated in the workings of zone investment procedures, and provided training in the basic principles of promotional and marketing techniques. Such measures will strengthen the institutional capability of MICE to assist and attract potential investors, working in conjunction with PRIDEX and other organizations promoting El Salvador generally.

7.24 Finally, the preparation of an attractive, easily updated promotional brochure that can be presented as part of an information kit on the SBFZ should be undertaken in the near term. The practical utility and promotional value of such a pamphlet will be directly related to MICE's success in improving the information collection and dissemination system regarding zone activities. A system should be implemented to investigate, collect, organize and publicize information regarding the SBFZ and its activities on an ongoing basis.

7.25 The new construction program at San Bartolo provides an excellent opportunity for promoting a "new era" in the project's development. It can be used as a springboard for newspaper articles, and "photo opportunities" that are worth far more than paid advertisements in the general media. If coupled with the noteworthy implementation of the types of institutional changes recommended in this report, the SBFZ would be well-positioned to face the competition, national and regional.

VIII. STRATEGIC RECOMMENDATIONS FOR THE SBFZ

8.01 The corrective measures, changes in management approaches, and procedural reforms outlined in Chapter 7, if implemented, will improve the performance of the SBFZ and thus its contributions to the national economy. They are, however, restricted in their potential impact, to the extent that they preserve the structure of the project as a Ministerial division, with all the inherent legal and operational limitations that entails.

8.02 The following section identifies and evaluates options for more fundamentally restructuring the SBFZ. The legal actions required for any form of reorganization are first detailed. It then explores the various strategic options in terms of operations, management, and ownership, which presume a willingness on the part of the GOES to consider elemental changes in the zone's structure. These alternatives are examined in terms of the costs and benefits they would generate for the GOES and for the SBFZ, along with the practical aspects of their implementation. The various options are then evaluated and ranked, with recommendation presented as to the follow-up actions that should be taken by the GOES.

A. LEGAL ACTIONS TO FACILITATE RESTRUCTURING

8.03 The San Bartolo Free Zone is a state-owned good, classified as "national property" under Salvadoran law. It is administered by MICE, and its operation, management, and uses are the responsibility of that body. Based upon the investigations conducted, the principal legal issue that must be resolved prior to initiating any structural changes in the SBFZ is the question of centralizing the control of the entirety of the property under one GOES entity. Of the total 80-hectare area delineated as the SBFZ site (according to the original Master Plan), there are now several GOES institutions, apart from MICE, that have claim to or are occupying portions of the property, specifically, the Ministry of Labor, the Civil Aeronautics Board, and the Salvadoran Army. In order to undertake any form of reorganization, the property "rights" will have to be consolidated. That is, each of these entities (along with any other GOES bodies that might have a similar claim) will have to cede their interest in and claim to the property to MICE. Following exchange of official correspondence to this effect, MICE can act independently to pursue whatever objectives it has for the project.

8.04 In addition to the formal consolidation of the SBFZ physical property, a second legal issue must be examined when considering potential changes in the legal identity of the zone. Article 28 of the Export Promotion Law of 1986 states that the administration of state-owned zones can be delegated to other entities or individuals, domestic or foreign, through an Executive Agreement signed by MICE and the intended administrator. It does not say that the ownership of such zones may be transferred, though neither is it prohibited. Local attorneys voiced disparate views as to whether a legislative decree would be required authorizing any action beyond the simple transfer of zone management responsibilities. However, there is complete agreement among the legal experts that nothing in the Salvadoran Civil Code prohibits the sale of such public goods. Whatever the definitive opinion, as in the question of property rights, it is a matter which should be investigated by the GOES in the near term.

B. IDENTIFICATION AND EVALUATION OF STRATEGIC ALTERNATIVES

1. Separate SBFZ from MICE Financially

a. Description of Approach

8.05 Of the various options to be considered, the establishment of an institutional framework within which the SBFZ can operate with financial autonomy is the easiest to implement, both in practical and political terms. It is widely accepted as fact that the SBFZ was a more efficient and more successful venture while under ISCE, because ISCE operated as an autonomous entity. The key to autonomy in this case is financial separation. As discussed above, management responsibility and decisionmaking authority can be delegated and consolidated at the SBFZ level within the present structural framework of MICE, given an institutional will. However, as long as authority over the zone's finances is vested in the Salvadoran legislative assembly through their control of the GOES General Budget, there is little incentive for SBFZ management to maximize project revenues and profits.

8.06 At present, zone revenues are simply surrendered to the General Fund of the Treasury, where they are co-mingled with other GOES funds. This income is in no way earmarked for use by the SBFZ, or even for MICE's operations. Consequently, despite the fact that the income from the project has increased substantially over the past three years, the annual GOES budget for the SBFZ has been frozen at the same level throughout that time period.

b. Ease of Implementation

8.07 Viewpoints vary as to the options available in terms of financial autonomy. Several GOES and private sector sources interviewed stated that it simply was not possible for San Bartolo, as an operational office within MICE, to acquire control over its own finances. At a minimum, a separate GOES unit would have to be established as the SBFZ operating agency. However, according to the MICE Legal Counsel, this is not the case and a "special activities fund" could be established for San Bartolo which would provide it financial autonomy.

8.08 Exploratory steps have, in fact, already been taken in this direction. In a letter dated November 25, 1988, from the Minister of Foreign Trade to the Minister of Finance, a preliminary plan for the establishment of a special activities fund of the San Bartolo Free Zone was submitted. As outlined in the document, the fund would be made up of all the income received by the SBFZ, i.e., rental revenues from SBFZ facilities and equipment, interest payments on rental paid in arrears, fees for services provided, donations, etc. These revenues would be treated separately and used to cover the SBFZ operating expenses or re-invested in the development of the zone. Such a mechanism has reportedly already been instituted by the Ministry of Labor and in other Ministries as well. In order to establish the special activities fund, the approval of the Ministry of Finance, and Corte de Cuentas (a GOES regulatory body much like the US Office of Management and Budget) is requested in the letter. No legislative action would be needed.

c. Viability of Approach

8.09 The primary advantage of this alternative is that it is not politically controversial and, it appears, relatively easy to implement. There is no need for a legislative decree and no changes whatsoever in the zone's legal character. Moreover, special funds of the same type have already been established in other Ministries, with little fanfare and little opposition. However, as set forth in the MICE plan discussed above, there are several shortcomings as well. For example, the SBFZ management would still not have control over the rental rates charged for its facilities, which would be set by the GOES according to established procedures. In addition, while the income earned by the project would be used to cover the costs of its activities to a large extent, it appears as though the permanent staff of the project would remain on the general GOES/MICE payroll, thereby compromising the project's financial accountability. Establishment of such a fund would therefore represent only a marginal improvement over the current, confusing accounting system.

8.10 Another major drawback is that the relative ease of setting up such a fund is mirrored by the relative ease of its dissolution. There is no permanence to this measure, any GOES administration, or MICE minister can opt to reorganize the financial administration of the project, should the need arise. The absence of security inherent in this option, essentially a modification in accounting and disbursement practices makes it a weak substitute for fundamental reconfiguration of the SBFZ.

2. Contract Private Sector Management of SBFZ

a. Description of Approach

8.11 The second principal option is to utilize a private firm to undertake the management of the zone. A well-run free zone can be a very profitable business venture. The phenomenal growth of private free zones in the Caribbean and Central American region over the past decade is testament to the profitmaking potential of offshore industrial and office parks. The attractive investment incentives offered by the host government and the business acumen of private zone management has proven to be a formidable combination.

8.12 A private property management group could be compensated for its efforts in a number of ways, ranging from a straight fee-for-services-rendered contract where the management group is paid a set fee regardless of performance, to a base fee plus revenue-sharing agreement, where the management group shares in a percentage of gross revenues (or net income) above a pre-defined level.

b. Ease of Implementation

8.13 While the leading free zone projects in the region are for the most part both privately owned and operated, the alternative of assigning responsibility for management of the zone to a private firm is an acceptable first step which would be relatively simple for the GOES and MICE to undertake. Contracting private management would not necessitate changes in legislation. As outlined above, the delegation of zone administration is contemplated and authorized in the Export Promotion Law and Free Zone Reglamento. Nor would such an action require the approval of any GOES entity outside MICE. In fact, perhaps the only readily identifiable limitation on the implementation of this alternative is the degree to which qualified property management firms are available and interested in the SBFZ.

8.14 In order for a private firm to make a profit at San Bartolo, the problems noted throughout this report would either have to be resolved beforehand by MICE, or the firm would need the authority to institute its own corrective measures. This would imply that, in the area of rental rates, for example, the management company be given authority to analyze the existing cost structure and revenue stream, draw its own conclusions regarding the optimal fee structure for facilities and services and then implement them. Likewise, an agreement would have to be reached with regard to the development of the zone property, construction of additional facilities, installation and renovation of infrastructure, and other site improvements.

8.15 Whether a local or foreign property management group would find the potential earnings of the project sufficient to warrant the commitment of its own resources in managing the zone will likely rest on the attractiveness of the terms of management proposed by MICE. Often in free zone and industrial estate projects with contracted management teams, the owner of the zone charges a basic fee to the property manager, who then collects the revenues earned by the project, covers the operating costs, and retains any profit. Such a fee could be calculated on a square meter basis or as a percentage of revenues collected. Alternatively, the management team could be paid a straight percentage of the revenues.

c. Viability of Approach

8.16 Contracting private management of the SBFZ, much like establishing financial autonomy, would be relatively non-contentious. It entails no transfer of property from the State, and could in fact enhance both the financial and economic benefits realized by the GOES, if undertaken by a profit-minded, experienced management group. Should the firm's efforts to turn the SBFZ into a profitable operation be unsuccessful, the contract can be terminated and the management team replaced.

8.17 The problem with a pure contractual or even revenue-sharing arrangement with a private management group is the fact that a project usually has to have a minimum scale in order to attract the interest of serious private groups. Absent other factors, a mere fee based upon operations is not a sufficient incentive for experienced property managers. The fundamental reason for this is that the private group does not share in the ownership of the zone, nor in the potential appreciation in land value over time. Although this arrangement has been somewhat successful in free zones in other countries, it is an arrangement that is of little permanence or long-term sustainability.

8.18 Still, the merits of contracting out zone management differ depending on the perspective. For MICE, it would mean loss of day-to-day operational control of one of the Ministry's most important responsibilities, but retention of the zone within its portfolio. In addition, the presence of a private firm in a managerial role in the project could greatly enhance the zone's revenue generating potential, if effectively promoted, especially for foreign investors. From the perspective of the potential managers, the configuration of the contract and the rights and responsibilities it confers will have a determining impact on the attractiveness of and their interest in administering the operations of the SBFZ.

3. Reconfigure the SBFZ as an Autonomous Parastatal Corporation

a. Description of Approach

8.19 The establishment of a parastatal corporation to own and operate the SBFZ is a compromise between public sector and private sector ownership that merits consideration by the GOES. Autonomous parastatal entities have met with success in some locations in the Far East, though the experience in the Caribbean Basin region has been largely negative to date. In this hemisphere, free zones operated by autonomous quasi-governmental bodies can be found in the Dominican Republic, Jamaica, Costa Rica, and Guatemala, among other countries.

8.20 A parastatal corporation has the strong advantage that it is an independent legal entity, with a separate financing base, autonomous Board of Directors, and equity held at "arms-length" by other public corporations, holding companies, or public agencies. In El Salvador, independent public corporations are relatively common, as typified by most of the utilities (e.g. the phone company). The Salvadoran parastatals generally have a mixed public/private Board of Directors, appointed by the Ministers of key related Ministries. These individuals, in turn, select a general manager who exercises managerial and operational control over the new entity. Fees for facilities used, services provided, and the like, are set by the Board of Directors, with the approval of the Executive Branch of the GOES. In most parastatals, certain restrictions are placed on their actions, e.g. approvals are required for disbursements above a specified amount or for obtaining loans of more than one-year's duration, and adherence to legally ratified corporate objectives and financial reporting requirements is mandatory.

b. Ease of Implementation

8.21 Several of the attorneys interviewed in El Salvador believe that the reconfiguration of the SBFZ as an autonomous public corporation is the optimal approach at this time. The procedure would require several steps. First, the determination and verification of SBFZ property rights and their formal transfer to a single GOES entity; second, inventory of fixed assets and the separation of SBFZ finances; third, issuance of a GOES decree creating the new institution. Although this process would require the approval of the Legislative Assembly, the procedure is straightforward and has no shortage of precedents, including CEL, ANTEL, and CEPA, among others. The only real issue in implementation, therefore, is a political decision to proceed.

c. Viability of Approach

8.22 Public corporations have had a mixed track record. On the one hand, these parastatal corporations offset many of the disadvantages associated with a direct government activity. Principal advantages of a parastatal structure include the following:

- independently sets policy and performance objectives;

- flexibility in the composition and role of its Board of Directors;

- independent hiring of competent professional management, and determination of operating rules and procedures;

- capability to run the corporation as a commercial enterprise, hire and fire staff, and establish compensation levels;

- control over capital, preparation of annual budgets, and planning capital investments and overall development.

8.23 Free zones established as public corporations have been generally mediocre in their performance. For example, public sector zones in the Dominican Republic are frequently cited by proponents as examples of successful public free zone development. In point of fact, numerous TSG investigations since 1984 have convincingly pointed to the opposite. Despite the considerable investment by the Government of the Dominican Republic and numerous grants from USAID, the public sector zones have languished, and still require annual government subsidies to continue operations. It is quite clear that it is only after the Dominican government facilitated the development of private free zones (and after USAID discontinued their policy of providing grant funding to public zones) that free zone activity in the country has accelerated.

8.24 Although attractive on paper, public corporations generally have a number of shortcomings. Representatives on their Boards are frequently political representatives from other ministries or public companies. Members of a free zone board, typically, have little or no interest or knowledge of free zone operations. Such directors rarely contribute meaningfully to the needs of the corporation. Instead, the professional general manager often devotes considerable time to educating the Board members, and overcoming their risk aversion and inertia. In the process, the ability of the enterprise to maximize profits is compromised.

8.25 Other distortions stem from the fact that public corporations receive implicit or explicit subsidies. Because they can borrow private funds with a government guarantee, they have privileged access to scarce domestic capital, at below market rates (i.e., below the opportunity cost of capital). This is compounded when either "equity holders" or principal lenders to the enterprise are state-owned banks, that, in effect, guarantee automatic access to funds. The result is an implicit government subsidy that underwrites inefficient operations, and "crowds out" private competitors.

8.26 In summary, while the reconfiguration of the SBFZ as an autonomous public corporation is an option that bears consideration, it has significant limitations that will probably only become evident in the medium- to long-term. This alternative surely offsets some of the most egregious flaws of the SBFZ structure noted in this report. It also has political appeal in that it retains GOES ownership of the property. But, given the eventuality that free zone development will no longer be a monopoly in El Salvador, the ability of the SBFZ, even established as a public corporation, to compete fairly with the private sector is questionable.

4. Divest the SBFZ to the Private Sector

a. Description of Approach

8.27 Divestiture of public enterprises has come to mean almost everything from the outright liquidation of an enterprise where operations are suspended, to "privatization" of ownership through the whole or partial sale of assets to private interests. For the purposes of this discussion, divestiture is taken to be the partial or total sale of the enterprise to a private, for-profit business.

8.28 Divestiture of a state-owned enterprise (SOE) can proceed either formally or informally. Formal divestiture is usually undertaken through formal capital markets of a country, accompanied by a great deal of advertising and public scrutiny. Informal divestiture is conducted quietly through the private placement of shares with identified major companies. Another variant to the formal or informal sale of assets is through encouraging popular participation in the ownership of the national enterprise by promoting a wide sale of stock to the public at large. This is a way to "democratize" ownership while raising capital and has been applied successfully in some countries.

b. Ease of Implementation

8.29 The SBFZ is a prime candidate for divestiture. Upon completion of the new construction it will have a reasonably large and secure asset base, it offers a viable product in a surging market, will have a small employment dislocation effect, and has little or no government-owned or guaranteed debt. From an economic stand-point, therefore, there are no outstanding impediments to the divestiture option.

8.30 The mechanics of the operation are conceptually simple, but extremely difficult to implement in the absence of a strong political commitment to proceed, and legally ambiguous if precedents do not already exist. First, the

SBFZ must be prepared for divestiture. At a minimum, this will involve several steps: (a) establish legally enforceable ownership of the entirety of the property; (b) undertake a comprehensive independent audit to determine the value of SBFZ assets and evaluate claims on those assets; (c) determine the claims of employees (if any) to jobs and/or severance pay; (d) uncover any unrecorded arrears to prevent future surprises; and (e) uncover any currently unknown liens outstanding.

8.31 Once these steps have been undertaken, the legal procedure must be established. It may be necessary, for example, to have GOES issue a decree that reorganizes the SBFZ as an independent public corporation before undertaking a sale to the private sector. These and other legal issues must be resolved prior to the transaction itself.

8.32 The optimal method for conducting the financial transaction will have to be explored. On the one hand a formal sale of the SBFZ to the public at large has certain political appeal, but may be difficult to implement and control if strong opposition is engendered by the publicity. Instead, a quiet, structured sale to private parties through the services of a professional intermediary may ba an acceptable alternative. Moreover, structuring the transaction will be of primary importance. For example, further state investment in the enterprise may be necessary before effecting a sale. Alternatively, if a joint venture with the private sector is sought for the SBFZ, a form of equity-sharing arrangement that changes over time may be appropriate. For example, in order to offset the initial riskiness of the transaction, an optimal approach might be for GOES to retain ownership of the majority of the SBFZ, while a private owner manages operations. When a set performance level has been met, the private party might exercise an option to purchase the majority of zone equity.

8.33 Unlike divestiture in industrialized countries where the sale of stock is undertaken routinely in organized capital markets, this formal approach is far more difficult in a Salvadoran environment where capital markets lack depth and no formal equities market exists. In addition, accounting, auditing and trading regulations appear to be poorly developed, engendering public distrust of the security markets. As such, the best approach to the transaction may be through private placement. This is usually conducted through an auction system in which bids are solicited, and the enterprise is sold to the highest bidder.

c. Viability of Approach

8.34 The principal motivation for divestiture is that the private sector is more aggressive and will use resources more efficiently. They will offset the typical limitations of SOEs: slow decisionmaking due to political-bureaucratic procedural requirements; a preoccupation with processes rather than results, a neglect of markets and a management environment in which reward is only remotely related to performance. In a private company, financial transactions are generally more transparent. Clearly, if private management can improve efficiency and profits further, then the state benefits through taxation, as well as the economy as a whole, through the project's increased productivity.

8.35 The divestiture of the SBFZ is clearly an attractive medium-term option. From an economic perspective, it is clear that the zone can be more efficiently managed privately and therefore contribute strongly to the national economy. The creation of a public corporation is a strong motivation to the public sector, that wants to retain ownership of the enterprise. The argument for divestiture is that true competitiveness and sustainability of effort with the SBFZ over the long-term, in the face of increasingly sophisticated local and regional competition from private free zones, is optimally achieved through sale of the SBFZ. The primary obstacle of course is political, as divestiture is usually regarded as a public admission that national investment resources were wasted. Such an attitude is neither useful nor necessary given the strong potential of the SBFZ. In point of fact, any reasonable price negotiated for the assets of the SBFZ in a divestiture will more than compensate the GOES for the capital invested since 1976.

C. ASSESSMENT OF ALTERNATIVES IDENTIFIED

8.36 As set forth in the preceding discussion, it is clear that the GOES has a diverse set of options to consider if more sweeping changes in the SBFZ are deemed to be viable. By examining the relative merits and drawbacks of each, the analytic background for discussion of the future of the project among relevant GOES officials has been established. Key elements of each alternative are summarized in Figure 8-1 on the following page.

8.37 It is also evident that in selecting the optimal course of action vis a vis San Bartolo, political realities, legal practicalities and economic priorities must each be carefully considered. For example, expediency might indicate that a "quick fix" of some kind is in order for the project, and that the complex legal procedures required for a fundamental restructuring, i.e. reformation as a parastatal or some form of divestiture, would require too much time and discussion. However, a long-term economic view will clearly demonstrate that either of these two options has a greater likelihood of substantially enhancing the benefits generated by the zone.

8.38 By the same token, politically, vying for an option such as divestiture will "cut both ways." That is to say, that by undertaking this alternative, the GOES will be making a strong statement with regard to its support for privately led economic growth which could serve as a ideal springboard for other market-oriented changes in economic policies. Nevertheless, the political controversy that may ensue, and in fact has in other countries that have taken steps toward divestiture of assets long held by the government, is a formidable obstacle for an administration that has only recently taken office.

8.39 Another point which should be emphasized is that there is considerable complementarity between several of the alternatives presented. For example, the GOES could begin the process of renovation of the SBFZ by contracting out the management of the project while the legal and financial steps were initiated toward establishing the project as a separate legal entity. Once re-formed as an independent governmental corporation, the process of divestiture would be expedited, should it be undertaken.

FIGURE 8-1
EVALUATION OF STRATEGIC ALTERNATIVES

	FINANCIAL AUTONOMY	*CONTRACTED MANAGEMENT*	*AUTONOMOUS PARASTATAL*	*DIVESTITURE*
Experience of Other Countries	Zones operated as ministerial offices or divisions are generally among the least efficient worldwide.	Proven effective in the U.S. FTZ program, operated on percentage basis. Few precedents in LDCs.	Mixed performance. Successful in FZs of the Far East, where profitability is emphasized. In CAC region, most are heavily subsidized and inefficient.	Globally, privately owned and operated FZs have proven more profitable and responsive, are rising in number and are leaders in attracting new sectors.
Legal Considerations	No legal changes. Requires only approval of MICE, Hacienda, and Corte de Cuentas.	No legal changes. Can be done unilaterally by MICE, as set forth in Export Promotion Law and FZ Reglamento.	Property rights and boundaries formalized and consolidated. Inventory of assets and separation of finances. Issuance of GOES decree upon appproval by Legislative Assembly.	Property rights and boundaries formalized and consolidated. Full audit and valuation of assets. Identifiy all liens, claims on assets, salaries and severance. Establish as separate legal entity.
Political Considerations	Non-controversial. Several precedents in other GOES ministries.	Non-controversial. No transfer of ownership.	Substantial precedent. Relatively non-controversial. GOES ownership retained	Highly controversial. Sale of GOES assets. Valuation may be contentious.
Other Considerations	Requires an audit of SBFZ. Lack of permanence. Can be rescinded as easily as it is enacted.	Interest of qualified private managment firms in the project may be limited.	Lays substantial groundwork for divestiture.	Numerous configurations possible. Method of sale must be defined. Formal public sale likely difficult to implement.
Time Required for Implementation	3-6 months. Requisite approvals and set up of new financial system.	3-6 months. Although negotiaiions with firm may require more time.	6-12 months. Accounting and legal measures.	9-18 months. Financial, legal, and strategic measures, structuring of transaction.
Distinctive Impact	None. Little effect on problems identified. Financial structure proposed differs only minimally from present framework.	Increased revenues from businesslike management. MICE must make improvements in SBFZ structure or let contractor make them.	Potential for increased profitability with minimal political fallout, but susceptible to bureaucratic shortcomings.	Can serve as a major indicator of GOES support for private sector and has the highest potential for acheiving profitability.

8.40 Of the four options presented, the idea of setting up a special activities fund for the San Bartolo project bears little further consideration. Based upon the preliminary plan presented by MICE, the net impact of establishing such a fund would be minimal, providing a limited autonomy to the SBFZ management in its execution of standard collection and payment procedures, but falling far short of instituting true financial separation. Determination of the prevailing rental rates, for example, is a key management function which would be withheld under the fund-based system. By keeping salaried personnel on the general MICE payroll, a true understanding of the project's financial position will still be difficult to obtain, representing only a marginal improvement over the present accounting system. Most importantly, it does nothing to address the fundamental structural, managerial and procedural inefficiencies now afflicting the SBFZ.

8.41 Contracting private zone management represents a potentially attractive step toward improvement of the SBFZ's performance, as well as toward the more fundamental restructuring alternatives proposed. It is unlikely, however, that the SBFZ is an attractive commercial venture for a property management team as long as it remains simply a ministerial division. Few qualified companies would be drawn to a project where their decisionmaking power was constrained by the restrictions of governmental procedures and political considerations. On the other hand, if the institutional will is present within the GOES to truly assign full managerial and operational authority over the SBFZ to a private firm, then it would seem likely to consider going one step further to establish the zone as an autonomous parastatal.

8.42 The reconfiguration of the SBFZ as an autonomous parastatal would be an attractive middle course for the project. Free zones have demonstrated ability to both turn a profit and generate substantial economic benefits when operated as an independent business venture. There are several independent public corporations already established in El Salvador, and it is unlikely that the move to establish the zone as a separate GOES-owned entity would be subject to negative political pressures. However, as discussed above, free zone projects run by parastatal bodies have a mixed track record, whether the SBFZ could be configured and operated in such a manner as to optimize its performance is not certain. Much would depend on the structure of the corporation, the qualifications of the members of the Board of Directors and their interest in the project, and the degree to which the management and directorship is committed to running the zone in a businesslike fashion. To merely continue to operate as a heavily subsidized, "independent" unit would represent only a cosmetic change. If carefully configured and executed, implementation of this option would make economic, financial and political sense, and could be used as the foundation for divestiture.

8.43 Divestiture of the SBFZ is by far the most controversial of the three options but holds the greatest potential for creating the operating environment required to optimize the zone's performance. In recent years, there has been widespread recognition of the benefits to be gained by placing what are essentially government-owned business ventures in the hands of the private sector. As noted above, there are numerous obstacles to such initiatives. Politically, of course, sale of government assets is often difficult to defend. However, as a small industrial facility, the SBFZ has no large constituency behind it, nor is it presently much of a revenue generator for the GOES.

8.44 The San Bartolo Free Zone appears to be an excellent candidate for some form of privatization. The analysis conducted in this study has indicated the profitmaking potential of the zone, local demand is strong for industrial facilities, and the new government is interested in emphasizing and supporting the private sector involvement in its economic policies. Operated as a profit-oriented firm, the SBFZ would no longer present subsidized competition to new private free zone projects that might develop, would be far better able to meet the pressures of both local and regional competition, and would generate greater economic and financial benefits for the country.

8.45 Divestiture of the SBFZ is, ultimately, the most attractive and compelling of the four options presented. Whether it can be undertaken in the short-term is a decision to be made by the GOES. As discussed below it is recommended that the GOES undertake a series of actions that will pave the way for privatization of the project, in some form, which can be implemented as it sees fit.

D. PROPOSED ACTION PLAN

8.46 Assuming that the basic thrust of this Chapter -- that privatization of the SBFZ can best serve the national interest of El Salvador -- is adopted as national policy, a rational plan of action suggests itself, based on the analysis given above. As a practical matter, the strategic alternatives confronting the SBFZ at this time can be blended into a "strategic path," taking into account all the pros and cons already discussed in great detail and leading to the desired goal./1 The action plan recommended below, while essentially sequential given the variation in implementation times (estimated in Figure 8-1), will evidence a certain degree of overlap. In other words, two or more of the strategic alternatives can be under development at any given time. Each step nevertheless, lays the groundwork and facilitates the implementation of the next.

1. **Form an autonomous parastatal corporation.** Financial autonomy alone, as configured above, is not a worthwhile pursuit. Full potential benefits of the zone will accrue only if the SBFZ is removed from the ministerial framework and reconstituted as an independent self-governing entity (although still linked to MICE).

2. **Contract private management.** The likelihood of successfully negotiating an arrangement with a qualified management group, will be greatly enhanced if Step 1 has already taken place. Search for the candidate management group should be pursued actively when plans for formation of a parastatal have been approved and a target date for implementation set.

3. **Divest the project.** Of the strategic alternatives, this will take the longest time to conclude satisfactorily, whether in the form of a joint venture, outright takeover by a single entity, or public share distribution. Planning should begin simultaneously with Step 1.

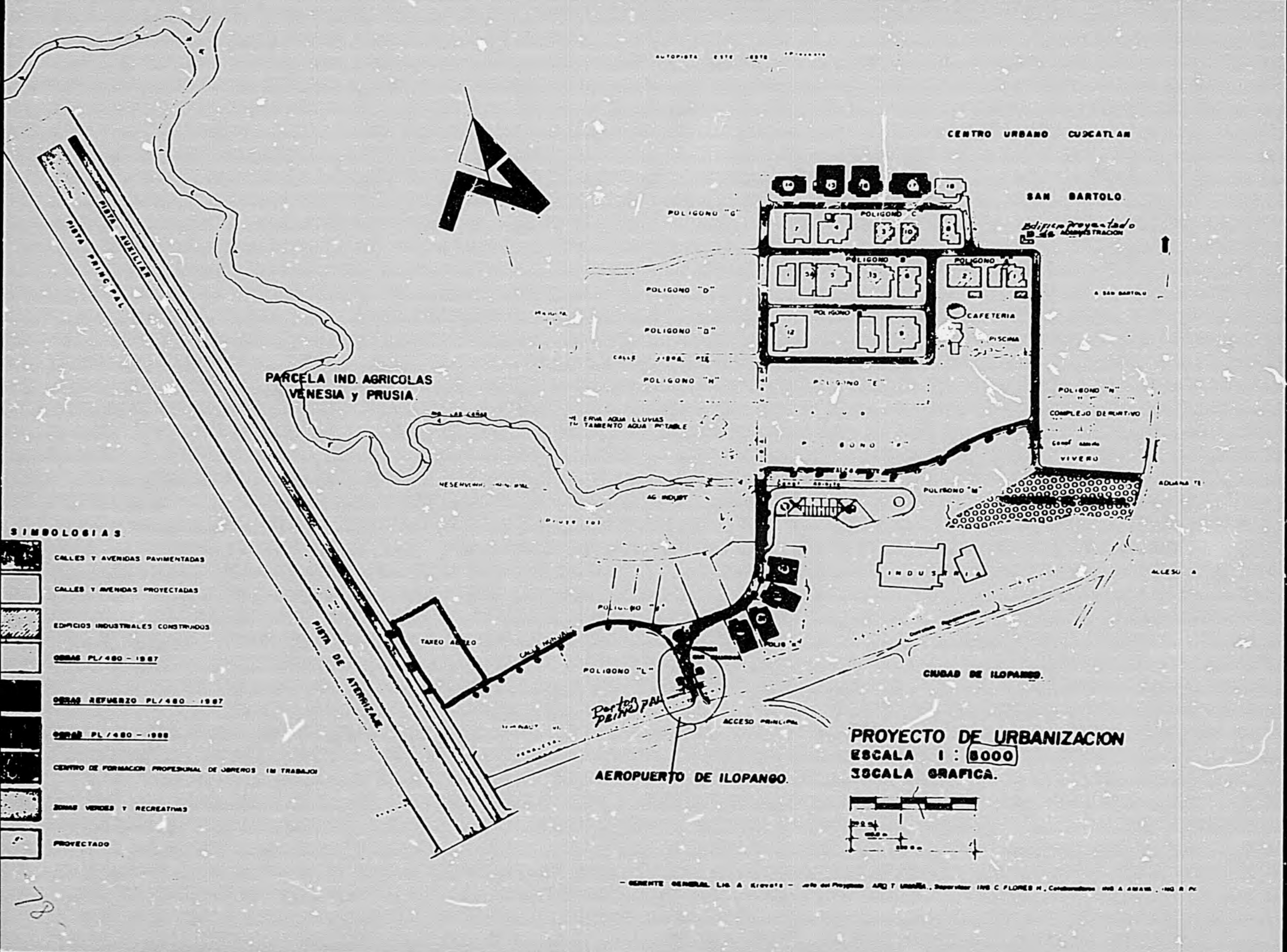
/1 The alternative of leaving the present structure untouched is assumed to be unacceptable.

8.47 It is recommended that a public-private committee, chaired by MICE, steer the implementation of the plan outlined above. It is important that this committee (perhaps CODEXI, the Committee for Development of Export and Investment) include representation from key ministries (e.g., MICE, Hacienda, BCR) to ensure that its activities represent a governmental consensus. A working group should be formed to conduct or supervise the legal, financial, and technical analysis that will be required, drawing on outside technical assistance in areas such as valuation, auditing of the SBFZ's financial records, and drafting of necessary legal documents. Ultimately, the key ingredient to the success of this strategic restructuring will be the GOES commitment to seeing it implemented.

ANNEXES

ANNEX 1

PHYSICAL PLAN OF SAN BARTOLO FREE ZONE



CENTRO URBANO CUSCATLAN
SAN BARTOLO
POLIGONO "G"
POLIGONO C
POLIGONO B
POLIGONO A
POLIGONO "D"
POLIGONO "D"
POLIGONO
CAFETERIA
PISCINA
POLIGONO "H"
POLIGONO "E"
POLIGONO "N"
COMPLEJO DEPORTIVO
VIVERO
POLIGONO "M"
ADUANA
INDUSTRIA
POLIGONO "L"
TAXEO AEREO
PARCELA IND. AGRICOLAS
VENESIA y PRUSIA
PISTA AUXILIAR
PISTA PRINCIPAL
PISTA DE ATERRIZAJE
ACCESO PRINCIPAL
CIUDAD DE ILOPANGO.
AEROPUERTO DE ILOPANGO.
PROYECTO DE URBANIZACION
ESCALA 1 : 8000
ESCALA GRAFICA.
SIMBOLOGIAS
CALLES Y AVENIDAS PAVIMENTADAS
CALLES Y AVENIDAS PROYECTADAS
EDIFICIOS INDUSTRIALES CONSTRUIDOS
OBRAS PL/480 - 1987
OBRAS REFUERZO PL/480 - 1987
OBRAS PL/480 - 1988
CENTRO DE FORMACION PROFESIONAL DE OBREROS (EN TRABAJO)
ZONAS VERDES Y RECREATIVAS
PROYECTADO

ANNEX 2

KEY ELEMENTS OF SBFZ PROMOTIONAL BROCHURE

Preparation of Promotional Literature

Using its own computers, or contracting an advertising/graphics design firm, MICE can produce basic promotional material for the SBFZ. Advances in computer technology have made desk-top publishing a practical and effective means to develop camera-ready copy for printing. Newsletters, brochures and other basic material can be produced at substantial cost savings relative to professional typesetting charges.

If desired, simple black and white narrative can be enhanced through the inclusion of black and white or color photographs, depending on the resources available for printing, and can be easily updated to reflect changes in rental rates, space availability, etc.

The material presented on the following pages has been prepared on a desk-top system, and is intended only as an indication of the type of information that should be presented in a promotional brochure prepared for the San Bartolo Free Zone. All materials should be prepared in English and Spanish.

SAN BARTOLO FREE ZONE

Office of Investment Promotion and Free Zones

Ministry of Foreign Trade
Paseo Escalon
San Salvador, El Salvador
Phone: 503/24-3000
Telex: 20-269

June 1989

Exterior photograph of SBFZ, showing size and layout of the zone.

Background

The San Bartolo Free Zone was established by the Government of El Salvador in 1975 as one of the pioneering export processing zone projects in the Central American and Caribbean region. Located on an 80-hectare site, just east of the capital city of San Salvador, in the industrial area of Ilopango, the SBFZ offers its clients fully serviced factory shells and ready access to a sizeable local labor force.

Zone Facilities and Services

With over 40,000 sq.m. of constructed industrial space, and an additional 24,000 sq.m. now under construction, the SBFZ provides an ideal operational environment for the full range of export manufacturing operations. The San Bartolo Free Zone offers its clients fully serviced factory shells ranging in size from 2,000 to 4,000 sq.m. These buildings are designed to allow for internal subdivision, for smaller firms, and to accommodate a second floor or mezzanine level for companies in need of additional space.

Lease Terms and Conditions

The SBFZ offers tenants highly competitive lease rates, with three-year terms. Lease rates vary depending on the type of building and use of space, as follows:

Industrial Building: US$2.00/sq.m./month (US$2.30/sq.ft./year)

Private Cafeteria Space: US$1,60/sq.m./month (US$1.78/sq.ft./year)

Warehouse Space: US$2.75/sq.m./month (US$3.06/sq.ft./year)

Salvadoran Free Zone Incentives and Market Access

In 1986, the Government of El Salvador passed a new Export Promotion Law making setting up business in the SBFZ even more attractive. Specific incentives provided to foreign and domestic export industries approved as free zone operations under the new law include:

- complete exemption on all import duties and other taxes on capital goods and equipment in perpetuity
- complete exemption from import duties and other taxes on raw materials, intermediate goods, and other products used in production in perpetuity
- exemption from import duties and other taxes on imports of fuels and other lubricants not produced domestically
- a 10-year tax holiday from tax on income, assets and invested capital
- unrestricted repatriation of capital
- local market access

In addition to these national benefits, export firms doing business in El Salvador enjoy duty-free access to the U.S. market for many products under the Caribbean Basin Initiative, the U.S. GSP, and Section 807 of the U.S. Tariff Schedule.

Industry Mix

The San Bartolo free zone is presently host to ten firms, employing over 3,800 workers engaged in a variety of industrial and commercial activities. Tenants include U.S, Far Eastern, and local firms in sectors such as electronics, garment manufacture, quality paper goods production, and commercial warehousing.

Labor Force

The San Bartolo Free Zone is ideally located in terms of access to an abundant pool of skilled and semi-skilled labor in the Ilopano and Soyopango districts. The Salvadoran work force is widely recognized as one of the most productive in the region, with highly competitive wage rates. Salaries for entry-level apparel workers, for example, average US$0.65/hour, including fringes. Experienced technical and managerial personnel are readily available and the SBFZ is located adjacent to a vocational training institution which can offer tailored courses for zone workers.

Access to Transportation

San Bartolo is an hour's drive from the El Salvador International Airport, one of the largest airports in the region. It is serviced by ten airlines, including Pan Am, Eastern, Taca, and Continental, with direct flights to Miami, New Orleans, Los Angeles, Mexico City and San Jose. Salvadoran exporters primarily utilize two seaports, Acajutla on the Pacific coast, and Santo Tomas de Castillo on the Atlantic. Regular trucking service is available from the SBFZ to both locations.

ANNEX 3

JOB DESCRIPTIONS FOR REVISED SBFZ MANAGEMENT STRUCTURE

JOB DESCRIPTIONS FOR REVISED SBFZ MANAGEMENT STRUCTURE

The following pages comprise a description of the duties of the three key professional positions within the Office of SBFZ Development.

General Manager

The key functions of the position are as follows:

1. Reports directly to the Minister or Vice Minister of MICE.

2. Responsible for the overall management of the SBFZ operations.

3. Supervises the Finance and Administration and Engineering Services Department. The Directors of each of these Departments report directly to him.

4. Liaison with MICE and other GOES ministries, departments and utility service providers.

5. Develops marketing and promotional strategy for SBFZ and undertakes its implementation with the approval of the Minister.

6. Responsible for tenant relations and services, contracts and agreements and tenants application review and approval as per MICE guidelines. Also responsible for public relation and information activities.

7. Accountable to MICE (Minister) for the profitability and financial health of the SBFZ as per guidelines established by MICE.

8. Prepares annual budgets -- revenue and capital with the assistance of department managers and seeks MICE approval for the same. Reviews and approves monthly operating summary prepared by SBFZ Finance and Administration department. Also reviews quarterly and annual statements and submits them for review to the Minister.

9. Prepares expansion strategy for SBFZ and reviews all construction plans submitted by the Engineering Services department.

10. Develops staff development and training programs. Also responsible for staff relations, hiring and firing with the assistance of respective directors.

Suggested Salary: C4,500/month

Suggested Qualifications: Individual with a minimum of 10 years active experience in private business management, preferably related to industry. Solid understanding of international trade and export sector activities in El Salvador.

Director, Finance and Administration

The key elements of the position are as follows:

1. Reports directly to the General Manager.

2. Maintains accounts and ledgers with staff assistance to include accounts payable/receivables, petty cash, lese payments and receipts, service charges, project and construction accounts, etc.

3. Prepares monthly, quarterly and annual accounting and financial statements, trial balances, profit and loss statements and other financial reports as per the statutory requirements.

4. Responsible for preparing audited financial statements for approval of the General Manager and MICE. Also responsible for budgetary control and internal audit.

5. Supervises and provides secretarial and office services to various departments with the assistance of office staff to include typing, secretarial work, filing mailings, etc.

6. Responsible for compilation of data regarding zone user activities and preparation and maintenance of zone information data base.

7. Responsible for estate security and security personnel; fire and safety; health service; first aid; and other relevant zone-wide services.

8. Prepare annual budgets -- revenue and capital and participates ion financial budget review meetings.

9. Supervises personnel and staff relations with regard to appointments, dismissals, leave, social security, health and maintains appropriate records as per statutory requirements.

10. Responsible for tenant relations as regards contracts, lease payments, services, security, plant safety, social services, etc.

11. The following staff reports directly to the Director of Finance and Administration: accounting assistant, security supervisor and Administrative assistant/secretary.

Suggested Salary: C3,500/month

Suggested Qualifications: Individual with a minimum of 5 years active experience in accounting and personnel management, preferably related to industry. Demonstrated organizational skills essential and knowledge of computer-based accounting and record maintenance preferred.

Director, Engineering Services

1. Reports directly to the General Manager.

2. Supervises and maintains estate roads, grounds, buildings, street lighting, landscaping, gardens, water and electricity supply, telephones, and other services to the tenants.

3. Undertakes regular inspections of the zone property (including both factory shells and common facilities) with regard to maintenance needs, fire hazards, disposal of waste, etc.

4. Supervises construction contractors and approves bill of works for their payment.

5. Prepares tender documents for new construction, makes recommendations to General Manager with regard to firm selected, and negotiates price based on General Manager input.

6. Reviews and makes recommendations to the General Manager with regard to all new construction plans of zone firms.

Suggested Salary: C3,500/month

Suggested Qualifications: Qualified civil engineer with a thorough knowledge of industrial construction methods and materials and infrastructural systems maintenance. Prior experience in managing a corps of workers highly desirable.

BACKGROUND NOTES TO THE REPORT

The PEDS Project

This study was conducted under the Private Enterprise Development Support Project. The PEDS Project is a five year (FY88 - FY92) $20 million project managed by the Bureau for Private Enterprise. The PEDS Project is designed to provide a wide range of expertise in private sector development. Areas of technical assistance include the following:

- Policy analysis related to private sector development
- Sector assessments and analyses
- USAID private sector strategy development
- Legal and regulatory analysis and reform
- Small-scale business development
- Trade promotion
- Investment promotion
- Free trade zone development
- Financial institutions and instruments
- Management and financial training
- The role of women in private enterprise
- Applications of MAPS: Manual for Action in the Private Sector

USAID Missions have the resources of thirteen contractors available to them through the PEDS Project.

- Arthur Young (prime)
- SRI International
- Management Systems International
- The Services Group
- Trade and Development, Inc.
- Multinational Strategies
- J.E. Austin Associates
- Ferris & Company
- Metametrics
- Elliot Berg Associates
- Robert Carlson Ass.
- Ronco
- Dimpex Associates

The Consultancy

USAID is undertaking an ambitious program in support of free zone development in El Salvador as a means to promote economic diversification and export expansion. Through USAID funding, the public sector San Bartolo Free Zone has been provided technical assistance to improve its economic and financial performance and competitive position. This study is directed toward developing a new strategic plan for San Bartolo that will enhance its operations and stimulate its growth. It examines the organizational structure and operational aspects of zone management, along with the physical development program underway, and proposes recommendations to assist the Government in its planning efforts for the project. The information presented in this report is based upon field missions conducted in February and April 1989, in addition to office-based analysis over a four-month period.

The Authors

Cecilia J. Sager, Vice President

Cecilia Sager specializes in the institutional, organizational and market analyses of institutions administering export regimes and in the identification, design, implementation and promotion of export processing zones. Ms. Sager has managed projects and conducted field research in Belize, El Salvador, the Dominican Republic, Uruguay, Guatemala, Grenada and Puerto Rico. She is the principal editor of a comprehensive guidebook on export processing zones. Prior to joining TSG, she was an Editor for the Sabre Foundation and a Research Associate for the Woodrow Wilson Center for International Scholars. Ms. Sager holds a B.A. in English Literature from the University of Florida and an M.A. in Political Science from George Washington University.

Kishore A. Rao, Vice President

Kishore Rao is an economist and financial analyst specializing in the design of export and investment promotion regimes and supporting institutions for industrial development. He has extensive public and private sector project experience in the assessment and configuration of policies and mechanisms to facilitate manufactured exports and in the design of industrial facilities for export manufacturing. Mr. Rao has managed projects in diverse locations internationally, including Mauritius, Kenya, the Dominican Republic, Costa Rica, El Salvador, the Bahamas, Belize, Honduras, India, Jamaica and Puerto Rica and has participated extensively in the analysis of projects in the Eastern Caribbean and West Africa. He has expertise in the assessment and design of credit mechanisms for the promotion of manufactured exports. He has evaluated the role of several innovative financial mechanisms and banking techniques in the area of industrial infrastructure development, including debt-equity conversion and securitization schemes. Before joining TSG, Mr. Rao was the vice president of an international trading company and a consultant to the United Nations Development Programme in tourism infrastructure development in the Fiji Islands. Mr. Rao holds a B.A. in Economics from Reed College and an M.B.A. in Finance from Georgetown University.

Carl D. Goderez, Director of Projects

A professional engineer with over 40 years of experience in industrial development, Carl Goderez specializes in planning, evaluating and implementing industrial estate and export processing zone projects. He also has experience in assessing the infrastructure and financial requirements of small and medium-scale export enterprises. Mr. Goderez came to TSG after 18 years as Senior Industrial Development Officer at the World Bank, where he specialized in the technical and financial analysis of export-oriented industrial estate and export processing zone programs. In his capacity with TSG, he has served as Senior Technical Advisor in export processing zone studies in some 25 countries worldwide, including projects in Mexico, Costa Rica, Belize, Guatemala, Honduras, El Salvador, Panama, the Dominican Republic, Jamaica, Barbados, St. Lucia, Grenada, the Bahamas, Ecuador, Egypt, Yugoslavia, Antigua, Haiti, Uruguay and Madagascar. Formerly a senior corporate executive with a multinational pharmaceuticals company, Mr. Goderez has had extensive experience in plant installation and operations in several locations in Latin America and Asia. He holds a B.S. in Engineering from the City College of New York and has pursued advanced studies at Princeton University and the Massachusetts Institute of Technology.

Bapu R. Deolalikar, Senior Associate

With over thirty years of experience in the private and public sectors, Bapu Deolalikar has developed wide-ranging expertise in the formulation of industrial development strategies, private sector development, restructuring of public enterprises, micro- and small-scale industry development, institutional and organizational analyses, private sector development, technology identification and assessment, strategic planning and investment and export promotion. He has undertaken consultancy assignments in various locations in Sub-Saharan Africa (Zimbabwe, Uganda, Kenya, Tanzania, Nigeria, Mauritius); Near East (Iran, Egypt, Jordan, Turkey); South Asia (India, Bangladesh, Nepal, Sri Lanka); Latin America (Brazil, Trinidad & Tobago, Barbados); and East Asia (Thailand, Korea, Japan, Malaysia, Indonesia, Philippines, Singapore, People's Republic of China). He has been actively involved in the establishment of manufacturing joint-ventures between U.S., European and Asian companies, with those located in several developing countries. Mr. Deolalikar is a former Executive Director of Sarabhai Enterprises, a diversified multinational company with a wide range of manufacturing activities throughout the world. Mr. Deolalikar is also a former member of several regional and state industrial planning boards, designing and coordinating small to medium scale enterprise and industrial facilities development. Among other academic positions, Mr. Deolalikar was a former Fellow at the Center for International Affairs and the Center for Population Studies at Harvard University. He holds an M.A. in Social Work from the University of Baroda, India, a B.Sc. in Chemistry and Physics from the University of Poona, India and has undertaken post-graduate studies at Harvard University, Massachusetts Institute of Technology and the Indian Institute of Management.

William C. Haney, Staff Consultant

William Haney specializes in performing market analyses for export processing zone projects. Mr. Haney has served as the principal marketing analyst for several EPZ projects located in El Salvador, Honduras, Belize, Jamaica, Uruguay, Madagascar and elsewhere. In these consultancies, he has identified high potential industrial and service sectors for location within the free zones, identified their physical facilities and services requirements, undertaken comprehensive direct market surveys and quantified demand for under-roof space and designed promotional strategies. Before joining TSG, Mr. Haney worked with the Pan American Development Foundation and Operation Mexico. He holds a B.A. in Economics from Northwestern University.